

growth value focus  
innovation quality  
diversity safety  
**2014** leaders  
commitment  
growth safety focus  
engagement

Canfor Corporation

## management's discussion & analysis

leaders growth value partnerships  
quality diversity sustainable  
safety commitment innovation  
diversity safety  
vision strength focus  
leaders innovation  
engagement



# 2014 MANAGEMENT'S DISCUSSION AND ANALYSIS

*This Management's Discussion and Analysis ("MD&A") provides a review of Canfor Corporation's ("Canfor" or "the Company") financial performance for the year ended December 31, 2014 relative to the year ended December 31, 2013, and the financial position of the Company at December 31, 2014. It should be read in conjunction with Canfor's Annual Information Form and its audited consolidated financial statements and accompanying notes for the years ended December 31, 2014 and 2013. The financial information contained in this MD&A has been prepared in accordance with International Financial Reporting Standards ("IFRS"), which is the required reporting framework for Canadian publicly accountable enterprises.*

*Throughout this discussion, reference is made to Operating Income before Amortization which Canfor considers to be a relevant indicator for measuring trends in the performance of each of its operating segments and the Company's ability to generate funds to meet its debt repayment and capital expenditure requirements. Reference is also made to Adjusted Shareholder Net Income (Loss) (calculated as Shareholder Net income (loss) less specific items affecting comparability with prior periods – for the full calculation, see reconciliation included in the section "Analysis Overview of Consolidated Results – 2014 Compared to 2013") and Adjusted Shareholder Net Income (Loss) per Share (calculated as Adjusted Shareholder Net Income (Loss) divided by the weighted average number of shares outstanding during the period). Operating Income before Amortization and Adjusted Shareholder Net Income (Loss) and Adjusted Shareholder Net Income (Loss) per Share are not generally accepted earnings measures and should not be considered as an alternative to net income or cash flows as determined in accordance with IFRS. As there is no standardized method of calculating these measures, Canfor's Operating Income before Amortization, Adjusted Shareholder Net Income (Loss) and Adjusted Shareholder Net Income (Loss) per Share may not be directly comparable with similarly titled measures used by other companies. Reconciliations of Operating Income before Amortization to Operating Income (Loss) and Adjusted Shareholder Net Income (Loss) to Net Income (Loss) reported in accordance with IFRS are included in this MD&A.*

*Factors that could impact future operations are also discussed. These factors may be influenced by known and unknown risks and uncertainties that could cause the actual results to be materially different from those stated in this discussion. Factors that could have a material impact on any future oriented statements made herein include, but are not limited to: general economic, market and business conditions; product selling prices; raw material and operating costs; currency exchange rates; interest rates; changes in law and public policy; the outcome of labour and trade disputes; and opportunities available to or pursued by Canfor.*

*All financial references are in millions of Canadian dollars unless otherwise noted. The information in this report is as at February 4, 2015.*

## Forward Looking Statements

*Certain statements in this MD&A constitute "forward-looking statements" which involve known and unknown risks, uncertainties and other factors that may cause actual results to be materially different from any future results, performance or achievements expressed or implied by such statements. Words such as "expects", "anticipates", "projects", "intends", "plans", "will", "believes", "seeks", "estimates", "should", "may", "could", and variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are based on management's current expectations and beliefs and actual events or results may differ materially. There are many factors that could cause such actual events or results expressed or implied by such forward-looking statements to differ materially from any future results expressed or implied by such statements. Forward-looking statements are based on current expectations and the Company assumes no obligation to update such information to reflect later events or developments, except as required by law.*

## COMPANY OVERVIEW

Canfor is a leading Canadian integrated forest products company based in Vancouver, British Columbia ("BC"), involved primarily in the lumber business, with production facilities in BC, Alberta, and the United States ("US"). Canfor also has a 50.5% interest in the pulp and paper business of Canfor Pulp Products Inc. ("CPPI"), and owned a bleached chemi-thermo mechanical pulp ("BCTMP") mill ("Taylor Pulp Mill"), all located in BC.

In 2014, the Company completed the second phase of the purchase of the lumber business of Scotch & Gulf Lumber, LLC ("Scotch Gulf") located in Mobile, Alabama increasing its ownership to 33%. Subsequent to year end, on January 30, 2015, the Company completed the third phase of the acquisition increasing its ownership to 50%. The final phase, whereby the Company will own 100% of Scotch Gulf, is scheduled to close in August 2016.

The Company completed the sale of its Daaquam Sawmill to Group Lebel Inc. in the first quarter of 2014. The Daaquam Sawmill contributed 120 million board feet of lumber production in 2013.

In 2014, the Company also formed the Canfor Energy North Partnership (the "Partnership") with Pacific BioEnergy Corporation ("Pacific BioEnergy") to build and operate two pellet plants located on the Chetwynd and Fort St. John Sawmill sites in northern British Columbia (the "Pellet Plants"). Construction of the Pellet Plants commenced in 2014 and is anticipated to be complete in the latter part of 2015. As at December 31, 2014, Canfor owned a 95% interest in the Partnership.

Also during 2014, Canfor's ownership of CPPI increased to 50.5% as a result of share purchases from non-controlling shareholders under CPPI's Normal Course Issuer Bid. Further discussion of the Normal Course Issuer Bid is provided in the "Financial Requirements and Liquidity" section of this document.

On January 2, 2015, Canfor completed the first phase of the purchase of Beadles Lumber Company and Balfour Lumber Company Inc. ("Beadles & Balfour") located in Georgia, representing an initial 55% ownership interest. The second phase of the acquisition whereby Canfor will own 100% of Beadles & Balfour is scheduled to close at the beginning of 2017. In April 2015, Canfor will also acquire 100% of Southern Lumber Company Inc. ("Southern Lumber") located in Mississippi.

Also subsequent to year end, on January 30, 2015, Canfor completed the sale of the Taylor Pulp Mill to CPPI (Further discussion of the sale of the Taylor Pulp Mill may be found in Note 32 of the Annual Financial Statements).

In the previous year, the Company completed the sale of its 50% share in Canfor-LP OSB Limited Partnership (renamed Louisiana LP OSB Limited Partnership) ("Peace Valley OSB"), which owns the Peace Valley OSB Mill, to Louisiana Pacific Corporation ("LP").

There were no other changes in percentage ownership in 2014 or 2013 for the entities listed above.

As of December 31, 2014, Canfor employed approximately 3,974 people in its wholly owned subsidiaries and 1,144 in majority owned operations for a total of 5,118 employees.

### Lumber

Canfor's lumber operations have a current annual production capacity of approximately 5.5 billion board feet of lumber, including 100% of the capacity of the Scotch Gulf sawmills adjusted for additional shifting at certain mills. Subsequent to the respective acquisitions in 2015, including 100% of the capacity of the Beadles & Balfour and Southern Lumber sawmills, Canfor's lumber production capacity is projected to be approximately 5.8 billion board feet. The majority of lumber produced by Canfor from its facilities is construction and specialty grade dimension lumber that ranges in size from one by three inches to two by twelve inches and in lengths from six to twenty-four feet. A significant proportion of Canfor's lumber production is comprised of specialty products that command premium prices, including Square Edge lumber for the North American market, J-grade lumber for the Japanese market, and machine stress rated ("MSR") lumber used in engineered applications such as roof trusses and floor joists.

Canfor's lumber operations also include a finger-joint plant, two lumber treating plants, a whole-log chipping plant and a trucking division. The lumber business segment also includes a 60% interest in the Houston Pellet Limited Partnership, which has an annual capacity of approximately 217,000 tonnes of wood pellets. As mentioned, in partnership with Pacific BioEnergy, the Company is currently building two pellet plants on the Chetwynd and Fort St. John Sawmill sites, scheduled for completion in the latter part of 2015.

Canfor holds approximately 11 million cubic metres of annual harvesting rights for its solid wood operations under various forest tenures located in the interior region of BC and northern Alberta, and harvests logs from those tenures to supply its interior lumber operations. Any shortfalls in mill requirements are made up with wood purchased from those areas. Operations in North and South Carolina and Alabama mostly purchase logs.

Canfor markets lumber products throughout North America and overseas, through its sales offices in Vancouver, Canada, Myrtle Beach, US, Tokyo, Japan and Shanghai, China. In addition to its own production, Canfor also markets lumber produced externally to complement its product line. While a significant proportion of Canfor's product is sold to markets in the United States, the proportion of shipments to offshore markets, particularly China, has risen significantly in recent years. The Company ships substantially all lumber destined for North America by truck and rail, while the vast majority of product sold offshore is transported by container ship.

### **Pulp and Paper**

Canfor's Pulp and Paper segment is comprised of the CPPI and Taylor Pulp Mill operations, all of which are located in BC. CPPI produces northern bleached softwood kraft ("NBSK") pulp and specialty paper. NBSK pulp is primarily a bleached product, although unbleached and semi-bleached grades are also produced at the Prince George Pulp and Paper Mill.

The CPPI mills have the capacity to produce over one million tonnes of pulp annually. Approximately 220,000 tonnes of BCTMP per year can be produced at the Taylor Pulp Mill. CPPI's paper machine, located at the Prince George Pulp and Paper Mill, has an annual production capacity, at optimum product mix levels, of 140,000 tonnes of kraft paper.

Canfor supplies CPPI with residual wood chips and hog fuel (principally bark) produced at certain of its specified sawmills. Prices paid by CPPI for residual wood chips are based on a pricing formula to reflect market prices and conditions, with hog fuel purchased by CPPI at market prices. CPPI also has fibre supply agreements with third parties to supplement its supply of wood chips and hog fuel.

All pulp produced by CPPI and the Taylor Pulp Mill is sold by CPPI's sales offices in Vancouver, Canada, and Tokyo, Japan, to customers, primarily in North America, Europe and Asia. The significant majority of product sold to North America is shipped by rail, while product sold overseas is transported by container or breakbulk vessels.

### **Other Operations**

As previously highlighted, Canfor sold its Daaquam Sawmill, located in Quebec, to Group Lebel Inc. during 2014 and in the prior year, Canfor sold its 50% share in the Peace Valley OSB Mill, located in Fort St. John, BC. Canfor also owns an OSB plant ("PolarBoard"), which is currently indefinitely idled, and a plywood plant ("Tackama"), which was permanently closed in December 2011.

### **Business Strategy**

Canfor's overall business strategy is to be a lumber industry leader with top-quartile financial performance, accomplished through:

- Expanding geographical markets, increasing market share of value-added products and building strong long-term partnerships with valued customers,
- Optimizing the extraction of high-margin products and value from its available fibre sources,
- Attaining world class supply chain performance,
- Achieving and maintaining a low cost structure,

- Maintaining a strong financial position,
- Developing an enterprise-wide culture of safety, innovation and engagement where Canfor is recognized as the preferred employer in its operating regions,
- Capitalizing on attractive growth opportunities, and
- Positioning the Company as a leading supplier of green, environmentally friendly building products.

Canfor is focused on being the preferred supplier of lumber to the building industry around the world, with a particular focus on North America and Asia. The Company is committed to being a major supplier to the retail segment of lumber consumption and expanding its presence in key offshore markets, including China and Japan. This objective includes making higher value structural lumber and specialized products to cater to specific customer requirements.

CPPI's overall business strategy is to be a pulp and paper industry leader with strong financial performance accomplished through:

- Preserving its low-cost operating position,
- Optimizing the premium quality of its products,
- Growing its green energy business,
- Developing an enterprise-wide culture of safety, innovation and engagement where CPPI is recognized as the preferred employer in its operating regions, and
- Capitalizing on attractive growth opportunities.

## OVERVIEW OF 2014

Lumber markets remained relatively balanced in 2014, as the US housing market continued its slow but gradual recovery. Housing starts showed a modest improvement, with many key economic indicators such as employment rates, consumer confidence and US housing prices trending positively through the year. The Canadian housing market saw another steady year, with housing starts slightly above the 20-year historical average. Offshore markets experienced somewhat lower lumber consumption in 2014 following multiple years of growth, as China's economy softened somewhat in the latter part of the year and Japan raised its consumption tax during 2014.

Average North American benchmark Western Spruce/Pine/Fir ("SPF") 2x4 #2 & Better grade ("#2&Btr") and Eastern Southern Yellow Pine ("SYP") 2x4 #2 lumber prices were broadly in line with 2013 on a US dollar basis. Canfor's 2014 overall lumber sales realizations benefitted from the favourable impact of a 7 cent, or 7%, weaker Canadian dollar compared to the US dollar and, to a lesser extent, the absence of export tax on US bound lumber shipments in 2014, offset slightly by a modest decrease in offshore prices relative to 2013.

The Company continued to position itself to take advantage of the improving lumber markets as evidenced by the announced acquisitions of Scotch Gulf in Alabama, Beadles & Balfour in Georgia and Southern Lumber in Mississippi. Combined, these additional sawmills will expand Canfor's US South lumber capacity by approximately 740 million board feet after near-term capital investments and additional shifting. During 2014, the Company also added shifts at several of its Canadian and US South operations and improved year-over-year productivity rates mostly the result of targeted capital investments at certain facilities in 2013 and 2014.

In March 2014, in response to the continued impact of the Mountain Pine Beetle infestation on fibre availability in BC, the Company made the difficult decision of permanently closing its Quesnel Sawmill. The Company also sold its Daaquam Sawmill in early 2014, which marked Canfor's exit from the Eastern SPF lumber business. Excluding the Quesnel and Daaquam Sawmills, lumber production was up slightly compared to 2013.

The Company in 2014 continued to build on its solid reputation as a producer and seller of high-margin lumber products to global markets, retaining its top-quartile margin performance in both Western Canada and the US South. Sales of #2&Btr lumber products increased over 2013 reflecting both the positive impact of recent capital upgrades and the closure of the Quesnel Sawmill. The Company's product offering has been boosted by the recent acquisitions of sawmills in the US South, all of which produce high volumes of value-added grades.

The Company's British Columbia lumber operations experienced continued cost pressures in 2014, particularly relating to log costs where higher logging and hauling rates and market-related stumpage increases, as well as increased road maintenance and construction costs, resulted in higher delivered unit log costs compared to 2013. In addition, Canadian operations faced increased log profile challenges, largely as a result of the continuing effects of the Mountain Pine Beetle and, to a lesser extent, more forest fires in 2014. This trend in British Columbia contrasted with Canfor's operations in the US South which continues to access significant volumes of high-quality fibre in close proximity to its sawmills and, as a consequence, saw little upward pressure on log costs through the year.

Cash conversion costs continued to reflect significant capital-related downtime and start-ups in 2014, with continued improvement in productivity. Cost, however, moved up year-over-year, largely as a result of higher labour costs, continued dust management efforts and the more challenging log profile at various Western SPF operations.

A major development in 2014 was the Company's decision to build two Pellet Plants at its Chetwynd and Fort St. John sawmill sites. Construction started in the fourth quarter of 2014 and is anticipated to be completed in the latter part of 2015. The pellet plants will be operated in partnership with Pacific BioEnergy, an established pellet plant operator in BC, and will enhance the utilization of Canfor's sawmill residual fibre in northern BC, provide stable long-term cash flow and contribute to the Company's sustainable value proposition.

Operating results for the lumber segment were lower in 2014 compared to 2013, principally reflecting the aforementioned higher unit manufacturing costs and lower lumber shipments offset in part by improved Canadian dollar unit sales realizations.

Global softwood pulp markets and prices were better than anticipated in 2014, as markets remained relatively stable through the year supported by solid global demand. Concerns around possible downward pressure on softwood pulp prices in 2014 from a significant increase in eucalyptus pulp capacity from South America proved ill-founded as annual softwood pulp demand remained steady and global softwood pulp producer inventories held in the balanced range for most of 2014, before increasing in December 2014, in part reflecting a slight softening of demand. Reflecting balanced markets, North American NBSK pulp list prices climbed above \$1,000 per tonne in January 2014 and stayed there through the rest of the year, although producers continued to come under pressure to increase discounts, in part reflecting the competitive landscape for key business accounts in North America. Pulp list prices to China and Europe also saw strong gains in 2014, increasing 5% and 7% from 2013, respectively, while global pulp demand was broadly in line with the prior year.

CPPI continued to maintain its top-quartile margin position in 2014, and its reputation for offering premium reinforcing pulp products was further enhanced in 2014 through its sales and marketing cooperation agreement with UPM-Kymmene Corporation ("UPM"). Operational excellence remained a key focus and while the year was not without its challenges, solid progress was made during the year as CPPI completed several important capital upgrades and the pulp mills exhibited solid operational performance as they worked to fully optimize the recently renewed asset base, with the Prince George Pulp and Paper Mill setting a new production record in 2014.

CPPI's green energy business continued to expand in 2014 through the completion of upgrades to cogeneration assets at the Northwood Pulp Mill and commencement of upgrades to the turbine at the Intercontinental Pulp Mill, the latter targeted for completion in the second quarter of 2015.

Operating results for the pulp and paper segment benefitted from the better than anticipated market conditions as well as the favourable impact of the weaker Canadian dollar and, to a lesser extent, an improved, higher-margin sales mix and increasing energy revenues. These gains were somewhat offset by increased fibre costs (linked mostly to improved NBSK pulp sales realizations), higher energy costs, and lower year-over-year shipments, the latter of which reflected a significant drawdown of inventories in late 2013.

Total consolidated operating earnings were broadly in line with the prior year at \$329.3 million in 2014, as improved results in the pulp and paper segment were offset by the lower operating earnings in the lumber segment. Compared to 2013, operating income in both segments reflected improved Canadian dollar sales realizations offset by higher unit manufacturing costs and lower shipments. The Company recorded a consolidated return on invested capital of 13.3%, down 4.5% from 2013, reflecting the lower lumber segment earnings in 2014.

The Company continued to preserve its strong financial position in 2014, retaining a focus on working capital management and delivering on its significant capital investments in recent years, both in terms of being on-time, on-budget and achieving targeted savings. In 2014, the Company purchased 4,527,600 common shares for \$108.9 million (an average price of \$24.05 per common share) under its renewed Normal Course Issuer Bid and improved its consolidated debt to capitalization ratio by 2.9% year-over-year to 5.1%.

A review of the more significant developments in 2014 follows.

## Markets and Pricing

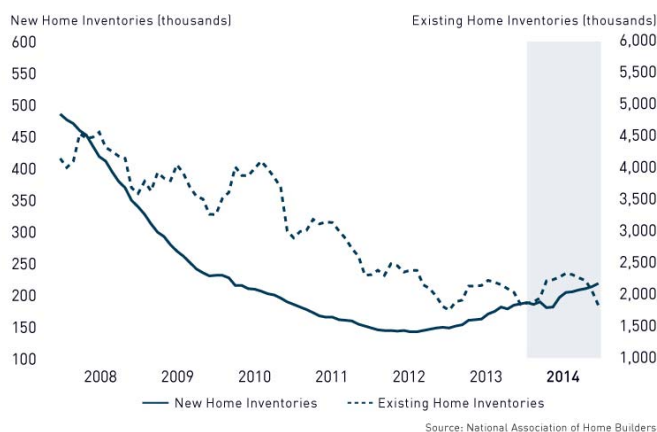
### (i) **Solid Wood – Slow-paced North American housing recovery continues; Offshore markets soften somewhat after multiple years of strong growth; Weaker Canadian dollar boosts sales realizations**

Lumber markets were relatively balanced in 2014 while the US housing market continued its slow but gradual recovery supported by steady employment growth and high housing affordability. The Company's offshore lumber shipments were lower in 2014 following multiple years of growth as China's economy softened somewhat in the latter part of the year and Japan raised its consumption tax from 5% to 8%. Average US dollar benchmark lumber prices for both Western SPF and SYP products were broadly in line with 2013 while prices on a Canadian dollar basis benefitted from the 7 cent, or 7%, weaker Canadian dollar. Challenging weather and a truckers' strike at Vancouver's largest port early in the year constrained producer shipments resulting in an inventory build early in the year which was released over the balance of the year.

New and existing home inventory levels trended upward through most of 2014, while existing home inventory levels decreased towards the end of the year as highlighted in Chart 1 below.

Chart 1

NEW AND EXISTING HOME INVENTORIES IN U.S.

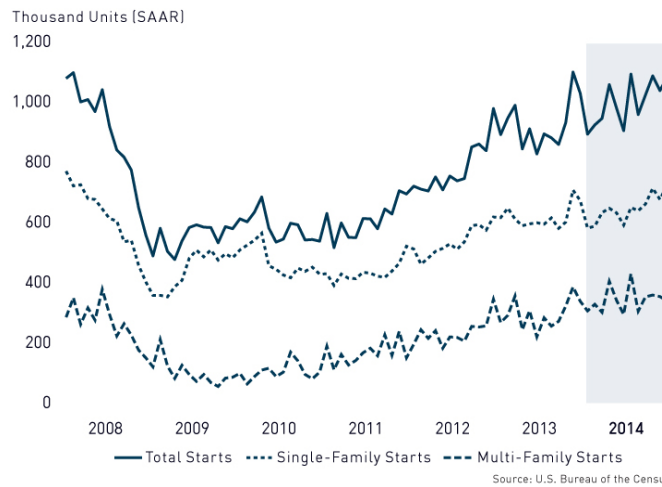


Total US housing starts were up 8% in 2014 compared to 2013, averaging 1,003,000 starts<sup>1</sup> for the year compared to 930,000 in 2013, and reaching the highest levels since 2007 (Chart 2). Both single-family unit and multi-family unit starts were up from 2013, with the increase in multi-family starts (up 17%) outpacing the increase in single-family starts (up 5%) year-over-year, reflecting growth in rental markets due to tighter lending regulations subsequent to the US housing downturn and current limited available land in major centres.

<sup>1</sup> Source: US Bureau of the Census

Chart 2

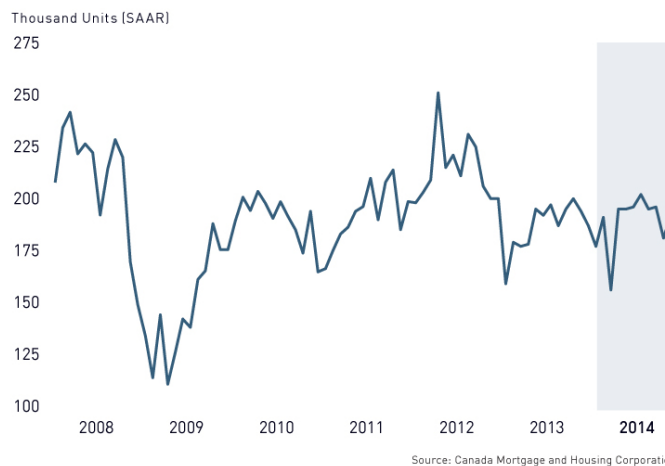
**U.S. HOUSING STARTS**



In Canada, housing starts at 189,000 units<sup>2</sup> in 2014 were broadly in line with 2013 (Chart 3), for the most part reflecting a stable housing market through the year. The recent decline in oil and other commodity prices, on which the Canadian economy is dependent, is anticipated to challenge the Canadian housing market in certain regions in 2015.

Chart 3

**CANADIAN HOUSING STARTS**



Canfor's lumber shipments to offshore markets eased somewhat in 2014 following several years of robust growth with shipments to China down 8% and shipments to Japan down 5% compared to 2013. The decrease in shipments to China in part reflects the closure of the Quesnel Sawmill at the beginning of 2014. China's economy and building construction activity slowed in the latter part of the year and Japan raised its consumption tax to 8% during 2014, resulting in lower consumer spending and lumber consumption in both markets compared to 2013.

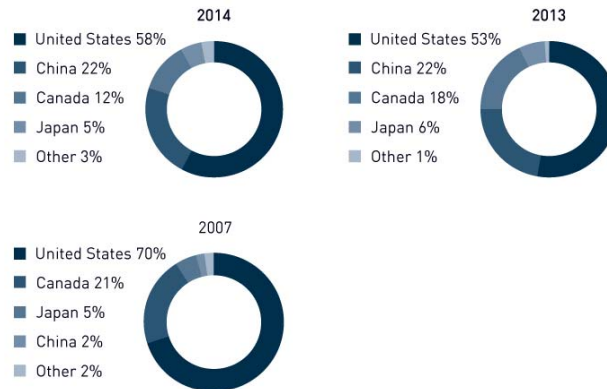
<sup>2</sup> Canada Mortgage and Housing Corporation ("CMHC")



The change in the Company's geographical sales mix over the past seven years is highlighted in Chart 4, which shows the continued shift to a more globally balanced distribution of sales in support of strategic growth objectives. The Company's recent growth in the US south will increase Canfor's exposure to the US market while Western SPF lumber sales are projected to remain geographically diversified.

Chart 4

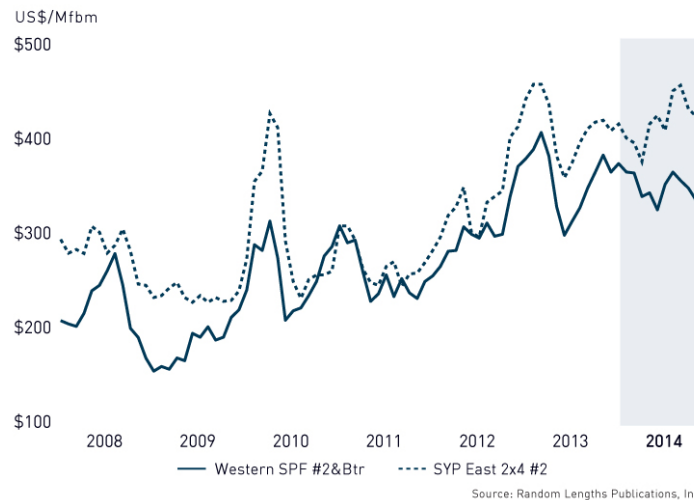
**CANFOR'S LUMBER SALES VOLUMES BY MARKET**



The benchmark Western SPF 2x4 #2&Btr price was relatively consistent with 2013, averaging US\$349 per thousand board feet ("Mfbm")<sup>3</sup> compared to US\$356 per Mfbm in the prior year. Prices for most other dimensions and grades were also broadly in line with 2013. The benchmark 2x4 #2 price for SYP lumber in 2014 averaged US\$418 per Mfbm which was also consistent with the average price of US\$413 per Mfbm in 2013. Overall prices for Western SPF products were relatively stable for most of the year, while the SYP 2x4 #2&Btr price showed a gradual increase in the second half of 2014, finishing the year at US\$434 per Mfbm, US\$26 higher than the 2013 year end (Chart 5).

Chart 5

**U.S. WESTERN SPF 2X4 #2&BTR AND SYP EAST #2 LUMBER PRICE COMPARISON**



The Canadian dollar continued to weaken against the US dollar in 2014, particularly towards the end of the year, as the US economy gained momentum and the Canadian economy was impacted by softer commodity prices. The weakening of the Canadian dollar accelerated towards the end of 2014 and continued into the beginning of 2015. On average the Canadian dollar was at \$0.905<sup>4</sup>, 7 cents, or 7%, lower than in 2013, resulting in improved sales realizations for all Canadian-produced exports.

<sup>3</sup> Random Lengths Publications, Inc.

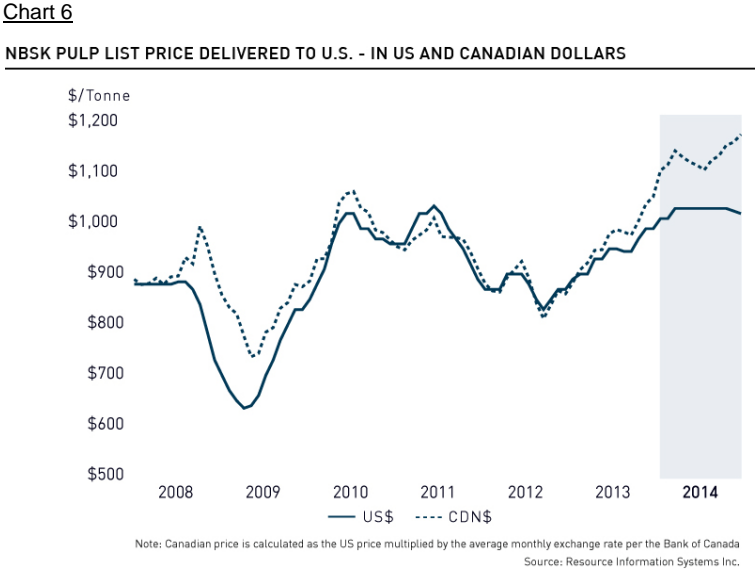
<sup>4</sup> Bank of Canada

**(ii) Pulp – Better than anticipated softwood pulp markets supporting historically-high pricing in 2014**

As mentioned, global softwood pulp markets were better than anticipated in 2014, as markets remained relatively stable through the year supported by solid demand from most markets. Additional hardwood pulp capacity, principally from South America, was absorbed into global markets through 2014; however, markets remained strong with limited incremental softwood pulp supply and solid demand for NBSK pulp. Global shipments of bleached softwood kraft pulp remained relatively unchanged compared to 2013. Prices moved up in the first quarter of 2014 supported by a combination of solid demand and constrained supply, the latter reflecting unusually severe weather and a truckers' strike in North America, and remained relatively stable for the balance of the year. Global softwood producer inventories remained in the balanced range through most of 2014, contributing to the historically higher pricing levels.

The benchmark North American NBSK pulp list price averaged US\$1,025 per tonne<sup>5</sup> in 2014, up US\$84, or 9%, from the prior year. NSBK pulp list prices in North America saw solid increases at the beginning of 2014, settling at a three-year high of \$1,030 per tonne for 8 months before declining US\$10 per tonne in late 2014 to end the year at US\$1,020 per tonne, up US\$30 per tonne, or 3%, from the end of 2013. List prices to Europe and China also saw strong gains in 2014, up US\$64 and US\$33 per tonne, respectively. In addition, higher sales realizations also reflected a 7% weaker Canadian dollar and an improved sales mix. Continued upward pressure on discounts, particularly in North America, partly eroded the solid gains in NBSK pulp list prices and the favourable foreign exchange trend.

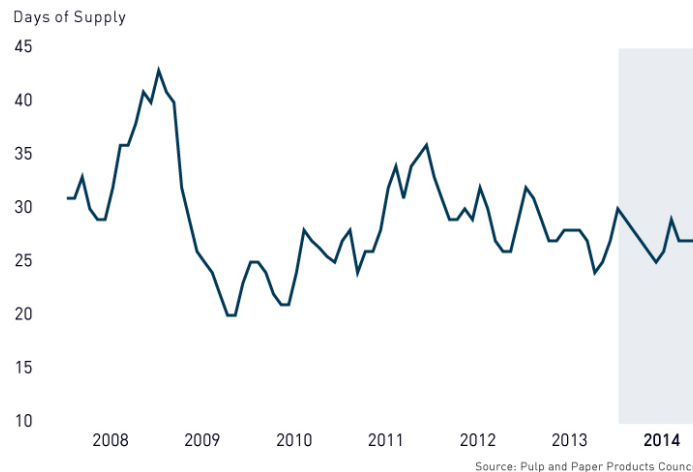
The following charts show the NBSK pulp price movements in 2014 (Chart 6) and the global pulp inventory levels (Chart 7), and serves to highlight the relatively stable list prices and producer inventories through the year, as discussed above.



<sup>5</sup> Resource Information Systems, Inc.

Chart 7

**WORLD SOFTWOOD PULP INVENTORIES**



Towards the end of 2013, CPPI entered into a strategic sales and marketing cooperation agreement with UPM. Beginning January 1, 2014, CPPI's sales network represented and co-marketed UPM pulp products in North America and Japan, while UPM's pulp sales network represented and co-marketed CPPI's products in Europe and China.

## **Solid Wood Operations**

### **(i) US South expansion and targeted capital projects in recent years positioning the Company to capitalize on improving markets**

The Company's confidence in the longer-term prospects of the lumber industry has driven an investment strategy aimed at positioning itself as a top-quartile industry performer during the lumber market recovery. In support of this objective, the Company has completed several targeted strategic capital initiatives at its sawmills since 2010, aimed at enhancing the quality and value offering of products to its customers from a top-tier productivity and cost position. Among the Company's completed projects were capital upgrade initiatives for its sawmills in the Kootenay region of BC, following their acquisition in early 2012. These strategic capital investments are designed to capitalize on the Company's strong fibre position in many regions of the BC Interior and the US South. In particular, the investments in upgraded facilities in high-value fibre areas in Western Canada are helping to mitigate fibre cost pressures. In 2014, the Company completed several major upgrades, most notably at its Houston and Mackenzie Sawmills, and after a number of ramp-up challenges, productivity saw a marked improvement towards the end of 2014.

In addition to its strategic capital initiatives, the Company has been expanding in the US South highlighted by its announced acquisitions of Scotch Gulf, Beadles & Balfour and Southern Lumber. Scotch Gulf includes three sawmills and a treating plant all of which are located in Alabama and produce primarily structural grade lumber. Beadles & Balfour includes two sawmills located in Georgia with one sawmill focused primarily on 1 inch lumber products and the other sawmill producing structural grade lumber. Finally, Southern Lumber owns a single sawmill in Mississippi that produces high-margin lumber in lengths up to 26 feet. All of the recently acquired US South sawmills are favourably located in areas of high-quality fibre supply and, with near-term capital investments and shifting additions, will contribute 740 million board feet of production capacity bringing Canfor's Southern Pine capacity to just under 1.4 billion board feet.

Capital spending in the lumber segment for 2014 totaled \$167 million and included major sawmill rebuilds or upgrades at the Company's Houston, Mackenzie and Polar Sawmills in BC and its Grande Prairie Sawmill in Alberta, continuous kiln projects at the Company's Kootenay and Southern Pine operations and commencement of construction of the Chetwynd and Fort St. John Pellet Plants towards the end of the year. In July of 2014, Canfor also implemented a new sales, transportation, supply chain and inventory management Enterprise Resource Planning ("ERP") software system across its entire Canadian operations.

**(ii) Strong focus on operational excellence in the face of log and manufacturing cost headwinds in British Columbia; Further residual fibre optimization initiatives underway**

In order to achieve top-quartile financial performance, and maximize profitability, the Company continues to focus on the key areas of maximizing product quality and value, tightly controlling unit manufacturing costs and maximizing residual fibre revenues.

**a. Product quality / value**

Product quality and value are key parts of the Company's focus going forward, with a view to ensuring that valued customers are provided with high quality products and service. Numerous initiatives have been undertaken to ensure continuous improvements in this area, including capital projects, such as the recent sawmill, kiln and planer upgrades, which are resulting in a higher proportion of higher-value lumber products, and transitioning to harvesting non-Mountain Pine Beetle fibre for use in the BC Interior sawmills.

The Company also has in place, or takes part in, various initiatives designed to promote the benefits of the use of lumber products by developers and end users. This includes initiatives to promote the environmental benefits of using lumber, and also industry-wide programs, such as the Softwood Lumber Board, to promote wood as a building product.

**b. Unit manufacturing costs**

The Company remains focused on ensuring strong operational performance at all of its operations, with continuous improvement initiatives, complementing and maximizing the benefits from capital upgrades. Compared to the prior year and excluding the impacts of the Quesnel and Daaquam Sawmills, year-over-year unit conversion costs increased as capital-related productivity improvements at certain operations were outweighed by higher labour costs, principally reflecting ratification of the USW (United Steelworkers) labour agreement in December 2013, continued dust management efforts, additional contractor services and smaller log profile at certain operations related to the ongoing effects of the Mountain Pine Beetle.

The continued lumber market improvement, increased upward pressures on non-quota timber, and a continued shift out of the Mountain Pine Beetle dominated log profile over the past several years has resulted in increases to stumpage, logging, hauling and purchased wood costs in BC operations. Added costs for road building and block development in 2014 have also resulted from this fibre profile shift. Further, during 2014, the Company saw increased hauling distances in certain regions in an effort to improve log inventory profile at its BC operations. The Company's US operations' log costs increased marginally from the prior year, in part reflecting the availability of significant volumes of high-quality fibre in the areas where the Company's sawmills operate.

**c. Residual fibre revenue**

Residual fibre revenue for the Company relates principally to the sale of sawmill residual chips to be used in the manufacture of pulp products. Prices for sawmill residual chips are typically based on a pricing formula with a number of inputs, predominantly driven by market prices for pulp products. Increased residual fibre revenue for 2014 reflected an increase in average chip prices related to pulp price increases offset in part by lower ship sales volumes principally reflecting the closure of the Quesnel Sawmill early in 2014.

Other residual fibre products also hold value, and the Company continued to focus on extracting maximum value from these sources in 2014, with relatively stable revenues from the sale of trim blocks, sawdust, shavings and bark. In addition, as part of its strategic capital investment focus, the Company now has modern energy systems at the significant majority of its sawmills that make use of other residual fibre products, such as bark hog, which have resulted in reduced energy costs and dependence on fossil fuels.

The partnership with Pacific BioEnergy to construct the two Pellet Plants in northern BC supports the Company's efforts to continue maximizing residual fibre utilization.

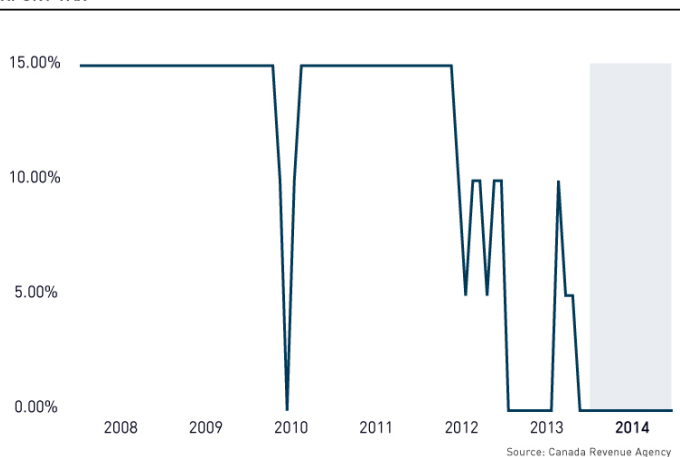
### (iii) Softwood Lumber Agreement

Under the Softwood Lumber Agreement (“SLA”) implemented by the federal governments of Canada and the US in 2006, Canadian softwood lumber exporters pay an export tax on lumber shipped to the US when the price of lumber is at or below US\$355 per Mfbm, as determined by the Random Lengths Framing Lumber Composite Price. When the price is at or below US\$355 per Mfbm, the export tax rate ranges between 5% and 15%. In January 2012, the governments of Canada and the US exercised an option to extend the SLA from its original expiry date in 2013 to October 2015. Discussions on the upcoming SLA expiry have begun between Canada and the US with Canada’s expectation that the current SLA be renewed or be allowed to expire without replacement. In 2015, Canfor will participate in discussions with industry counterparts to work towards a satisfactory resolution. The outcome of these discussions is uncertain and could result in significant impacts to the Company’s US lumber exports. (Further discussion of the SLA agreement may be found under “Softwood Lumber Agreement” in the “Risks and Uncertainties” section of this document).

No export taxes were paid on US bound shipments in 2014 while the average rate in 2013 was 2% resulting in tax payments of approximately \$9 million. The following chart shows the average SLA export tax rate in 2014 and the six years prior (Chart 8), with the rate fluctuating over this period of time in connection with the Random Lengths Framing Lumber Composite Price.

Chart 8

SLA EXPORT TAX



### (iv) Impacts of Mountain Pine Beetle (“MPB”) remain significant; Company well positioned going forward

For more than a decade, the MPB epidemic has been the primary focus for almost all of the Company’s Western Canadian operations. Only now has the infestation largely run its course with estimates indicating that pine mortality has reached approximately 55%, where it has been for the last 2 years. Northern Alberta is still experiencing higher levels of attack and anticipates this trend will continue for the next 2 to 4 years. In the most heavily attacked areas, salvage harvesting continues but the harvest profile is gradually shifting from dead pine into green or mixed stands and will do so for another 5 to 10 years as the remaining dead stands are harvested or the quality deteriorates to the point that the stands are no longer viable for sawlog harvest. In these areas, declining timber quality, smaller piece size and blow down are resulting in increased operational costs. This will be offset in the short to medium-term as the harvest moves into mixed species stands.

To ensure that sufficient dead pine is being harvested to sustain the current allowable harvest rates and minimize impacts to the mid-term timber supply, the British Columbia Provincial Government has instituted “partitions” in a number of timber supply areas. These partitions cap the harvest of non-pine species in the short-term, and will be revisited as the availability of merchantable dead pine stands declines. This is currently the case within the Prince George and Morice Timber Supply Areas. The Company maintains a significant focus on salvage harvesting and achieving these partitions where applicable.

Recent forecasts have predicted that annual allowable harvest rates could be reduced by more than 30% from current levels. Some reductions have already occurred, such as for the Prince George (16%), Quesnel (24%) and Lakes (38%) Timber Supply Areas. Timber Supply Review processes have recently been completed (or are very close to being complete) in other areas, and have resulted in increases in the annual allowable harvest rates. This includes Tree Farm License 30 in the Prince George region (25% increase), Mackenzie Timber Supply Area (48% increase for 10 years) and potentially Tree Farm License 48 in the Chetwynd region. In northern Alberta, it is anticipated that allowable harvest rates will also be increased temporarily to deal with the rising MPB infestation in that region.

In anticipation of these impacts, the Company has taken a number of actions to ensure the viability and competitiveness of its operations. These include the acquisition of the Kootenay area sawmills in 2012, the announced permanent closure of its Quesnel Sawmill, and the exchange of timber rights with West Fraser in 2013. The Company has also been actively working with many First Nations to build business relationships that provide the Company some level of certainty in gaining access to additional fibre. As a result of these initiatives, the Company has minimized its exposure to areas most heavily impacted by the MPB, and the remaining operations are forecast to have sufficient fibre supply through the transition to lower provincial harvest levels and green or mixed species stands. An additional benefit of this is that the Company is very well situated to start moving fibre between some of its traditional operating areas which will allow the Company to continue to meet both species and profile targets for its mills.

In Alberta, the provincial government has implemented short-term actions and a long-term strategy to mitigate the risks associated with the MPB. Included in these are comprehensive detection surveys and removal of individual trees from newly infested stands, as well as a collaborative approach by government and the forest industry to achieve a 75% reduction in the amount of susceptible pine in Alberta by 2026. The latter has resulted in a 12% increase in the annual allowable cut ("AAC") of the Company's Forest Management Agreement ("FMA") area for a 15 year period. Additionally, the Province of Alberta approved a 103% AAC increase for the Company's quota area north of Hines Creek, which will enable a shift of a significant portion of the harvest for the Grande Prairie Sawmill into the northern area where the MPB infestation has been most severe. This shift, which is forecast to last for 5-7 years, will result in higher than normal log transportation costs but will mitigate potential impacts to long-term timber supply and ensure the timber is harvested before the quality deteriorates significantly.

#### **Closed and indefinitely idled operations**

In the first quarter of 2014, the Company permanently closed its Quesnel Sawmill as a result of limited timber availability in the region following the MPB infestation. The closure removed approximately 250 million board feet SPF lumber capacity. In 2013, the Company recorded a related \$20.0 million provision, the significant majority of which has been paid in 2014.

In 2011 the Company closed, or announced the closing of, three of its operations in response to the continued difficult market conditions for solid wood products, and fibre supply challenges relating to the MPB impact. In January 2011 the Clear Lake lumber operation was permanently closed due to weak prices for stud lumber and a lack of economical long-term fibre available to that mill. In January 2012 the Rustad Sawmill and Tackama Plywood Plant were permanently closed due to a combination of MPB fibre challenges (Rustad), the difficult market conditions and the level of capital investment required to make both operations economically viable.

The Company's Radium Sawmill in British Columbia, which was idled in 2009, restarted in October 2012. The PolarBoard OSB Plant in Fort Nelson, which was indefinitely idled in mid-2008, remains idled.

## **Pulp and Paper Operations**

The Company's pulp and paper operational performance improved in 2014 with increased operating days, reflecting shorter scheduled outages, and improved operating rates compared to 2013. CPPI made headway against operational targets, with overall operating rates showing further signs of improvement at the end of 2014 and heading into 2015. Scheduled maintenance outages were completed at all facilities in 2014.

Energy revenue continued to build in 2014 reflecting eleven months of energy output from the upgrades to the Northwood Pulp Mill turbines, commissioned in the first quarter of 2014, as well as increased power generation from the turbine at the Company's Prince George operation, which was completed in the previous year. CPPI continued to advance the upgrades to the turbine at the Intercontinental Pulp Mill, which is targeted to be complete and commence selling power under an Electricity Purchase Agreement by the second quarter of 2015. Following completion of the upgrades to the Intercontinental Pulp Mill turbine in 2015, CPPI projects it will be over 100% energy self-sufficient, with the energy business anticipated to contribute approximately \$25 million to operating income before amortization annually.

## **Canfor and CPPI Integration**

The Company continues to build on the successful integration of Canfor and CPPI leadership teams and key business areas that commenced in 2012. Both companies continue to recognize sustainable benefits from further integration and alignment, specifically in the areas of residual fibre management, transportation and logistics. Integration remains a key focus area for Canfor and CPPI, as well as for Canfor Canadian and US South operations, particularly given the growth of the Company's operations in the US.

As mentioned, subsequent to year end, Canfor and CPPI completed the sale of the Company's BCTMP Taylor Pulp Mill which will result in further integration benefits for both companies.

# OVERVIEW OF CONSOLIDATED RESULTS – 2014 COMPARED TO 2013

## Selected Financial Information and Statistics

(millions of Canadian dollars, except for per share amounts)	2014	2013
Sales	\$ 3,347.6	\$ 3,194.9
Operating income before amortization	\$ 511.8	\$ 517.5
Operating income	\$ 329.3	\$ 331.3
Foreign exchange loss on long-term debt	\$ -	\$ (8.9)
Gain (loss) on derivative financial instruments <sup>6</sup>	\$ (8.9)	\$ 4.4
Net income	\$ 221.8	\$ 250.5
Net income attributable to equity shareholders of Company	\$ 175.2	\$ 228.6
Net income per share attributable to equity shareholders of Company, basic and diluted	\$ 1.28	\$ 1.61
ROIC – Consolidated <sup>7</sup>	13.3%	17.8%
Average exchange rate (US\$/CDN\$) <sup>8</sup>	\$ 0.905	\$ 0.971

<sup>6</sup> Includes gains (losses) from energy, foreign exchange, lumber and interest rate derivatives (see “Unallocated and Other Items” section for more details).

<sup>7</sup> Consolidated Return on Invested Capital (“ROIC”) is equal to operating income/loss, plus realized gains/losses on derivatives, equity income/loss from joint venture and other income/expense, all net of minority interest, divided by the average invested capital during the year. Invested capital is equal to capital assets, plus long-term investments and net non-cash working capital, all excluding minority interest components.

<sup>8</sup> Source – Bank of Canada (average noon rate for the period).

(millions of Canadian dollars)	2014	2013
Operating income (loss) by segment:		
Lumber	\$ 230.7	\$ 285.1
Pulp and Paper	\$ 129.9	\$ 72.2
Unallocated and Other	\$ (31.3)	\$ (26.0)
<b>Total operating income</b>	\$ 329.3	\$ 331.3
Add: Amortization	\$ 182.5	\$ 186.2
<b>Total operating income before amortization<sup>9</sup></b>	\$ 511.8	\$ 517.5
Add (deduct):		
Working capital movements	\$ (73.6)	\$ (7.5)
Defined benefit plan contributions	\$ (29.7)	\$ (53.0)
Income taxes paid, net	\$ (39.5)	\$ (0.3)
Other operating cash flows, net <sup>10</sup>	\$ 23.4	\$ 33.6
<b>Cash from operating activities</b>	\$ 392.4	\$ 490.3
Add (deduct):		
Finance expenses paid	\$ (11.4)	\$ (17.4)
Share purchases	\$ (108.9)	\$ (60.0)
Distributions paid to non-controlling interests	\$ (10.2)	\$ (9.3)
Capital additions, net	\$ (234.3)	\$ (237.3)
Proceeds from the sale of the Daaquam operation	\$ 23.6	\$ -
Investment in Scotch & Gulf Lumber, LLC	\$ (9.9)	\$ (29.5)
Repayment from (Loan to) Scotch & Gulf Lumber, LLC	\$ 12.2	\$ (31.9)
Change in restricted cash <sup>11</sup>	\$ (50.2)	\$ -
Proceeds from long-term debt	\$ 75.0	\$ -
Repayment of long-term debt	\$ -	\$ (139.8)
Proceeds from sale of Canfor-LP OSB	\$ -	\$ 77.9
Other, net	\$ (2.3)	\$ 16.0
<b>Change in cash / operating loans</b>	\$ 76.0	\$ 59.0

<sup>9</sup> Amortization includes certain capitalized major maintenance costs.

<sup>10</sup> Further information on operating cash flows can be found in the Company's annual consolidated financial statements.

<sup>11</sup> Change in restricted cash relates to amounts transferred into an escrow bank account for the first phase of the Beadles & Balfour acquisition which closed on January 2, 2015.



## Analysis of Specific Items Affecting Comparability of Shareholder Net Income

After-tax impact, net of non-controlling interests

(millions of Canadian dollars, except for per share amounts)

	2014	2013
<b>Shareholder Net Income, as reported</b>	<b>\$ 175.2</b>	\$ 228.6
(Gain) loss on derivative financial instruments	\$ 5.9	\$ (3.3)
Gain on sale of Daaquam operation	\$ (1.6)	\$ -
Mark-to-market adjustment to Canfor-LP OSB sale contingent consideration <sup>12</sup>	\$ 9.4	\$ -
Gain on sale on sale of Canfor-LP OSB (including contingent consideration) <sup>12</sup>	\$ -	\$ (28.8)
Canfor's 50% interest in Canfor-LP OSB's income, net of tax	\$ -	\$ 12.1
Foreign exchange loss on long-term debt	\$ -	\$ 4.6
Mill closure provisions	\$ -	\$ 14.8
One-time costs associated with collective agreements for the lumber business	\$ -	\$ 0.8
Change in substantively enacted tax rate	\$ -	\$ 4.2
Net impact of above items	<b>\$ 13.7</b>	\$ 4.4
<b>Adjusted shareholder net income</b>	<b>\$ 188.9</b>	\$ 233.0
<b>Shareholder net income per share (EPS), as reported</b>	<b>\$ 1.28</b>	\$ 1.61
Net impact of above items per share	\$ 0.10	\$ 0.03
<b>Adjusted shareholder net income per share</b>	<b>\$ 1.38</b>	\$ 1.64

<sup>12</sup> The Company completed the sale of its 50% share of the Canfor-LP OSB Limited Partnership ("Canfor-LP OSB") in 2013 and recorded a gain of \$33.4 million (after tax). As part of the sale, Canfor may receive additional annual consideration over a 3 year period, starting June 1, 2013, based on Peace Valley OSB's annual adjusted earnings before interest, tax, depreciation and amortization. An asset was recorded based on the fair value of this additional consideration and will be adjusted to current estimated fair value each reporting period. The estimated fair value of the contingent consideration at December 31, 2014 is nil.

The Company recorded net income attributable to equity shareholders of \$175.2 million, or \$1.28 per share, for the year ended December 31, 2014, a negative variance of \$53.4 million, or \$0.33 per share, from \$228.6 million, or \$1.61 per share, reported for the year ended December 31, 2013.

After taking account of specific items affecting comparability with prior periods, the Company's 2014 adjusted shareholder net income was \$188.9 million, or \$1.38 per share, a negative variance of \$44.1 million, or \$0.26 per share, compared to similarly adjusted shareholder net income of \$233.0 million, or \$1.64 per share, for 2013.

Reported operating income for 2014 was \$329.3 million, down \$2.0 million from operating income of \$331.3 million for 2013. Included in operating income in 2013 was an expense of \$20.0 million related to the announced closure of the Quesnel Sawmill and one-time costs of \$1.1 million associated with the new five year collective labour agreements for the lumber business. Excluding these items, operating income was down \$23.1 million from adjusted 2013 operating income of \$352.4 million, as improved results in the pulp and paper segment were more than offset by lower operating earnings in the lumber segment. Compared to 2013, operating income in both segments reflected improved Canadian dollar sales realizations, higher unit manufacturing costs and lower shipments.

A more detailed review of the Company's operational performance and results is provided in "Operating Results by Business Segment – 2014 compared to 2013", which follows this overview of consolidated results.

## OPERATING RESULTS BY BUSINESS SEGMENT – 2014 COMPARED TO 2013

The following discussion of Canfor's operating results relates to the operating segments and the non-segmented items as per the Segmented Information note in the Company's consolidated financial statements.

Canfor's operations include the Lumber and Pulp and Paper segments. The results of the panels business are included in the Unallocated & Other segment.

### Lumber

#### Selected Financial Information and Statistics – Lumber

Summarized results for the Lumber segment for 2014 and 2013 are as follows:

(millions of Canadian dollars, unless otherwise noted)	<b>2014</b>	<b>2013</b>
Sales	\$ 2,245.1	\$ 2,192.2
Operating income before amortization	\$ 345.8	\$ 398.6
Operating income	\$ 230.7	\$ 285.1
Mill closure provisions	\$ -	\$ 20.0
One-time costs associated with collective agreements	\$ -	\$ 1.1
Operating income excluding unusual items	\$ 230.7	\$ 306.2
Capital expenditures	\$ 166.6	\$ 164.7
Average SPF 2x4 #2&Btr lumber price in US\$ <sup>13</sup>	\$ 349	\$ 356
Average SPF price in Cdn\$	\$ 383	\$ 367
Average SYP 2x4 #2 lumber price in US\$ <sup>14</sup>	\$ 418	\$ 413
Average SYP price in Cdn\$	\$ 462	\$ 425
US housing starts (thousand units) <sup>15</sup>	1,003	930
Production – SPF lumber (MMfbm) <sup>16</sup>	3,735.3	4,058.1
Production – SYP lumber (MMfbm) <sup>16</sup>	581.0	526.3
Shipments – Canfor-produced SPF lumber (MMfbm) <sup>17</sup>	3,735.9	4,027.8
Shipments – Canfor-produced SYP lumber (MMfbm) <sup>17</sup>	625.0	545.2
Shipments – wholesale lumber (MMfbm)	18.6	24.8

<sup>13</sup> Western Spruce/Pine/Fir, per thousand board feet (Source – Random Lengths Publications, Inc.).

<sup>14</sup> Southern Yellow Pine, Eastside, per thousand board feet (Source – Random Lengths Publications, Inc.).

<sup>15</sup> Source – US Census Bureau.

<sup>16</sup> Excluding production of trim blocks.

<sup>17</sup> Canfor-produced lumber, including lumber purchased for remanufacture and excluding trim blocks.

#### Overview

The lumber segment reported operating income of \$230.7 million for 2014, down \$54.4 million from \$285.1 million in 2013. In 2013 results in the lumber segment were impacted by an expense of \$20.0 million related to the announced closure of the Quesnel Sawmill and one-time costs of \$1.1 million associated with new five year collective agreements ratified in the fourth quarter of 2013. Excluding the impact of these unusual items, operating income for 2014 was down \$75.5 million, compared to adjusted operating income of \$306.2 million in 2013.

For the most part, the decrease in lumber earnings was attributable to higher log costs in British Columbia reflecting market-driven pressures as well as increased road construction costs and higher purchased log costs in 2014. Also impacting the lumber segment were higher labour costs, continued dust management efforts, and additional contractor services. Lower lumber production compared to 2013 was largely the result of the closure of the Quesnel Sawmill and sale of the Daaquam Sawmill in the first quarter of 2014. Partly offsetting these factors were overall higher lumber sales realizations, which benefitted from the 7% weaker Canadian dollar and relatively stable SPF and SYP benchmark lumber prices throughout the year.

## Markets

Canfor-produced sales volume for 2014 was approximately 4.4 billion board feet, down 200 million board feet, or 5%, from 4.6 billion board feet for 2013, with SPF and SYP making up 86% and 14% of total 2014 sales volumes, respectively. The decrease in Canfor-produced lumber shipments largely reflected the aforementioned closure of the Quesnel Sawmill and sale of the Daaquam Sawmill.

In 2014, the North American lumber market continued to reflect the slow but gradual recovery in the US housing market. The improvement in US housing starts was supported by steady employment growth and higher housing affordability. Housing starts improved, especially in the second half of 2014, after unusually cold winter weather delayed building activity earlier in the year. Total US housing starts averaged just above 1 million units in each of the last four months of 2014. For the full year, housing starts averaged 1,003,000 units, an increase of 8% from 2013 and the highest annual average since 2007. The repair and remodeling sector also demonstrated continued modest growth throughout the year, bolstered by a rise in consumer confidence which led to an increase in home improvement projects.

In Canada, lumber consumption was stable in 2014 with housing starts averaging 189,000 units, which was in line with 2013.

Offshore lumber consumption was lower after multiple years of strong growth, with shipments to China down 8% and shipments to Japan down 5% compared to the record-high levels recorded for 2013. The decrease in shipments to China in 2014 was principally the result of the closure of the Quesnel Sawmill in early 2014. China's economy slowed somewhat in the latter part of the year and Japan raised its consumption tax to 8% during 2014 resulting in lower consumer spending and contributing to the reduced lumber consumption in both markets compared to 2013.

## Sales

Lumber segment revenues of over \$2.2 billion for 2014 were up 2% compared to 2013, reflecting the weaker Canadian dollar and relatively flat benchmark lumber prices partly offset by lower sales volume. Total shipments of Canfor-produced lumber were approximately 4.4 billion board feet for the year, down 5% from 4.6 billion board feet shipped in the previous year, mainly reflecting the closure of the Quesnel Sawmill and sale of the Daaquam Sawmill early in 2014. The Western SPF lumber 2x4 #2&Btr Random Lengths price averaged US\$349 per Mfbm, a US\$7 per Mfbm, or 2%, decrease over the previous year with relatively flat prices seen across most other dimensions and grades, as can be seen in the following table which shows benchmark Random Lengths prices for selected key grades and widths of Western SPF lumber:

(Average Western SPF US\$ price, per thousand board feet)	2014	2013
2x4 #2&Btr	\$ 349	\$ 356
2x4 #3	\$ 302	\$ 295
2x6	\$ 349	\$ 343
2x10	\$ 379	\$ 393

Offshore sales realizations, which also benefitted from the weaker Canadian dollar, saw a marginal increase compared to 2013. Further contributing to the year-over-year increase in sales realizations was the absence of any export taxes on US bound shipments from Canada, compared to a 2% average export tax rate in 2013. Freight costs showed a slight increase compared to the prior year reflecting the impact of the weaker Canadian dollar on US freight offset mostly by lower shipment volumes.

Prices for SYP products were also relatively flat compared to 2014, with the benchmark 2x4 #2 price up US\$5 per Mfbm, or 1%, from 2013 to US\$418 per Mfbm with similar small increases in most wider dimension SYP products.

Total residual fibre revenue for 2014 was up from the prior year primarily due to significantly higher sawmill residual chip prices, which reflected the higher NBSK pulp sales realizations, offset in part by lower residual sales volume.

### Export Taxes

Under the SLA implemented by the federal governments of Canada and the US in 2006, Canadian softwood lumber exporters pay an export tax on lumber shipped to the US when the price of lumber is at or below US\$355 per Mfbm, as determined by the Random Lengths Framing Lumber Composite Price ("RLCP") which includes benchmark lumber prices from a variety of lumber species and dimensions across the North American lumber market. The export tax rate is determined monthly, with the monthly price calculated as the four week average of the weekly RLCP available 21 days before the beginning of the month to which it applies. The rate is applied based on the following trigger prices:

<u>Trigger RLCP Price</u>	<u>Tax Rate</u>
Over US\$355	0 %
US\$336-\$355	5 %
US\$316-\$335	10 %
US\$315 and under	15 %

The SLA also includes a "Surge Mechanism", which increases the export tax rate for the month by 50% when the monthly volume of exports from a region exceeds a "Trigger Volume" as defined in the SLA.

For 2014, four week average lumber prices did not drop below the US\$355 per Mfbm level and no export tax amounts were paid during the year. In 2013, the BC export tax rate averaged 2%, resulting in total export tax payments of \$9.2 million. The average RLCP for 2014 was US\$383 per Mfbm in line with 2013. At December 31, 2014, the RLCP was US\$382 per Mfbm.

### Operations

Total lumber production for 2014 was 4.3 billion board feet, down approximately 250 million board feet, or 6%, from 2013. Lower lumber production in the current year predominantly reflected the closure of the Quesnel Sawmill and sale of the Daaquam Sawmill in early 2014. Excluding these, lumber production was up slightly compared to 2013, reflecting improved productivity following several major capital upgrades and additional shifts at certain sawmills, offset by smaller log profile at certain operations in BC.

Lumber unit manufacturing costs increased compared to the previous year driven by increased cost pressure on unit log costs in British Columbia and, to a lesser extent, higher unit conversion costs. Higher unit log costs reflected a continued shift out of the Mountain Pine Beetle dominated log profile over the past several years which resulted in increases to stumpage, logging, hauling and purchased wood costs in BC operations. Added costs for road building and block development in 2014 also resulted from the fibre profile shift. Further during 2014, the Company increased hauling distances in certain regions in an effort to improve log inventory profile at its BC operations. The Company's US operations' log costs increased marginally from the prior year in part reflecting the continued Southern Pine market improvement and higher lumber production capacity in the US South.

Unit conversion costs were also up from 2013 due to higher labour costs, principally reflecting the ratification of the USW labour agreement in December 2013, continued dust management efforts, as well as additional contractor services linked to limited availability of skilled trades in Western Canada. A smaller log profile at certain operations also led to higher unit conversion costs compared to 2013. Offsetting these factors were capital related productivity improvements and more downtime in 2013 for significant capital projects.

# Pulp and Paper

## Selected Financial Information and Statistics – Pulp and Paper<sup>18</sup>

Summarized results for the Pulp and Paper segment for 2014 and 2013 are as follows:

(millions of Canadian dollars, unless otherwise noted)	<b>2014</b>	<b>2013</b>
Sales	<b>\$ 1,102.5</b>	\$ 999.4
Operating income before amortization <sup>19</sup>	<b>\$ 194.5</b>	\$ 144.0
Operating income	<b>\$ 129.9</b>	\$ 72.2
Capital expenditures	<b>\$ 58.0</b>	\$ 62.6
Average pulp price delivered to US - in US\$ <sup>20</sup>	<b>\$ 1,025</b>	\$ 941
Average pulp price in Cdn\$	<b>\$ 1,133</b>	\$ 969
Production – pulp (000 mt)	<b>1,200.1</b>	1,192.9
Production – paper (000 mt)	<b>144.0</b>	134.7
Shipments – Canfor-produced pulp (000 mt)	<b>1,175.4</b>	1,213.0
Shipments – paper (000 mt)	<b>142.5</b>	138.8

<sup>18</sup> Includes Taylor Pulp Mill and 100% of CPPI, which is consolidated in Canfor's operating results. Pulp production and shipment volumes presented are for both NBSK pulp and BCTMP.

<sup>19</sup> Amortization includes certain capitalized major maintenance costs.

<sup>20</sup> Per tonne, NBSK pulp list price delivered to US (Resource Information Systems, Inc.).

### Overview

The Pulp and Paper segment reported operating income of \$129.9 million for 2014, up \$57.7 million from \$72.2 million in 2013. Improved earnings compared to 2013 principally reflected higher unit sales realizations, resulting from both improved NBSK pulp list prices, benefiting from relatively stable pulp markets through the year, and the favourable impact of the 7% weaker Canadian dollar. These gains were offset in part by lower shipments, largely reflecting the higher-than-normal shipments into China during the fourth quarter of 2013, and higher unit manufacturing costs, resulting mainly from market-driven increases in fibre costs and increased energy costs. The current year pulp segment results also included higher energy revenue compared to 2013, attributable to the upgrades to the Northwood Pulp Mill turbines, which were completed in the first quarter of 2014 and increased power generation at the Prince George Pulp Mill related to improved operational efficiency.

### Markets

Global softwood pulp markets were relatively stable through 2014 supported by solid demand from most markets. Additional hardwood pulp capacity was absorbed into global markets through 2014; however, with limited incremental softwood pulp capacity and solid demand for NBSK pulp, market conditions remained solid. On the supply side, extreme weather and a truckers' strike in North America in early 2014 constrained producer shipments. Global softwood inventories held by producers remained in the balanced range for the majority of 2014 due largely to the aforementioned solid demand and aforementioned supply constraints, all of which contributed to historically high price levels.

At the end of December 2014, World 20<sup>21</sup> producers of bleached softwood pulp inventories were at 31 days' supply, increasing just out of the balanced range due in part to strong producer operating rates. By comparison, December 2013 inventories were at 27 days' supply. Market conditions are generally considered balanced when inventories are in the 27-30 days of supply range.

### Sales

The Company's pulp shipments in 2014 were 1,175,400 tonnes, down approximately 37,600 tonnes, or 3%, from the prior year. The reduced shipment volumes largely reflected higher-than-normal shipments into China at the end of the previous year. The Company's paper shipments in 2014 were 142,500 tonnes, an increase of 3,700 tonnes, or 3%, from 2013.

<sup>21</sup> World 20 data is based on twenty producing countries representing 80% of world chemical market pulp capacity and is based on information compiled and prepared by the PPPC.

As mentioned, NBSK pulp list prices experienced solid gains in all regions in 2014. North American NBSK pulp list prices averaged US\$1,025 per tonne in 2014, up US\$84, or 9%, from US\$941 per tonne. North American NBSK pulp list prices were at a three-year high of \$1,030 per tonne for most of the year, before gradually trending down in the last quarter of 2014, and ended the year at US\$1,020 per tonne, up US\$30 per tonne, or 3%, from the end of 2013. NBSK pulp average list prices to Europe and China also saw strong gains in 2014, up US\$64 and US\$33 per tonne, respectively. Pulp sales realizations in 2014 were further bolstered by the 7% weaker Canadian dollar and increased sales to higher-margin regions, partially offset by continued upward pressure on discounts in North American markets. Increased sales in 2014 also included higher energy revenue, reflecting the output from the upgrades to the Northwood Pulp Mill turbines, completed in early 2014, as well as increased power generation at the Prince George Pulp Mill. BCTMP sales realizations were also up from 2013, with a modest increase in price through the year coupled with the weaker Canadian dollar. Unit sales realizations for paper products were up moderately from 2013, principally reflecting the 7% weaker Canadian dollar. Paper unit sales realizations in 2014 also benefited from higher prices and sales volumes to North America and a 4% increase in bleached paper shipments, which more than offset a decline in prices to Europe.

### Operations

Pulp production, at 1,200,100 tonnes in 2014, was relatively in line with the prior year principally related to improved operating rates, which were in part offset by increased transfers of slush pulp to the paper operations. 2014 results were impacted by outages at the Northwood, Prince George and Intercontinental Pulp Mills and the Company's BCTMP Taylor Pulp Mill, with the reductions in overall production broadly in line with 2013. During 2014, the Prince George Pulp and Paper Mill set an annual record for total production, surpassing the previous record set in 2013, while the other mills saw more modest improvements in operational performance with a renewed focus on reliability. Paper production in 2014 was 144,000 tonnes, up 9,300 tonnes, or 7%, from 2013, primarily due to higher overall operating rates and a shorter scheduled maintenance outage in 2014. Both years included a scheduled maintenance outage of the Company's paper machine, with the outage in the current year being approximately 5 days shorter than in 2013.

Unit manufacturing costs were up compared to the prior year, principally driven by a significant increase in fibre costs, and, to a lesser extent, marginally higher unit conversion costs, primarily reflecting higher energy costs in the current year. The increase in fibre costs compared to 2013 resulted largely from market-driven increases in delivered sawmill residual and whole log chip prices, and to a lesser extent, increased freight costs reflecting longer haul distances following certain sawmill closures in 2014, offset somewhat by a slightly lower proportion of higher-cost whole log chips (17% of total consumption in 2014, compared to 18% in 2013). Paper unit manufacturing costs were well up compared to 2013, with higher slush pulp costs (linked to higher market pulp prices) more than offsetting the higher production levels.

## Unallocated and Other Items

(millions of Canadian dollars)	2014	2013
Operating loss of Panels operations <sup>22</sup>	\$ (3.9)	\$ (1.7)
Corporate costs	\$ (27.4)	\$ (24.3)
Finance expense, net	\$ (18.2)	\$ (27.9)
Foreign exchange loss on long-term debt	\$ -	\$ (8.9)
Gain (loss) on derivative financial instruments	\$ (8.9)	\$ 4.4
Gain on sale of Canfor-LP OSB joint venture	\$ -	\$ 38.3
Other income (expense), net	\$ (4.2)	\$ 1.5

<sup>22</sup> The Panels operations include the Company's PolarBoard OSB plant, which is currently indefinitely idled and its Tackama plywood plant, which was closed in January 2012.

### Corporate Costs

Corporate costs, which comprise corporate, head office and general and administrative expenses, were \$27.4 million in 2014, up \$3.1 million from 2013. The increase includes higher employee compensation and transaction costs related to the recent acquisitions in the US South.

## Finance Income and Expense

Net finance expense for 2014 was \$18.2 million, down \$9.7 million from 2013. The decrease resulted from lower debt levels, lower-cost floating interest rate debt and a lower expense related to the Company's retirement benefit obligations in part due to the improved financial position of most of the Company's defined benefit plans.

## Foreign Exchange Loss on Translation of Long-Term Debt

The Company repaid all of its outstanding US dollar denominated debt in the fourth quarter of 2013. In 2013, the Company recorded a foreign exchange translation loss on its US dollar denominated debt of \$8.9 million.

## Gain (Loss) on Derivative Financial Instruments

The Company uses a variety of derivative financial instruments as partial economic hedges against unfavourable changes in foreign exchange rates, energy costs, lumber prices, pulp prices and interest rates.

In 2014, the Company recorded a net loss of \$8.9 million related to its derivative financial instruments, principally reflecting unrealized losses on crude oil collars stemming from a sharp decline in oil prices at the end of 2014, with oil prices declining further early in 2015, offset in part by realized gains on lumber futures through 2014. Further contributing to the net loss were unrealized losses on foreign exchange collars, as a result of the weakening of the Canadian dollar at the close of 2014 relative to the exchange rate at the close of 2013.

The following table summarizes the amounts of the various components for the comparable periods. Additional information on the derivative financial instruments in place at year end can be found in the "Financial Requirements and Liquidity" section, later in this document.

### Gain (Loss) on Derivative Financial Instruments:

(millions of Canadian dollars)	2014	2013
Foreign exchange collars and forward contracts	\$ (1.6)	\$ 0.2
Energy derivatives	\$ (7.8)	\$ 0.2
Lumber futures	\$ 2.2	\$ 4.2
Pulp futures	\$ (0.8)	\$ (0.1)
Interest rate swaps	\$ (0.9)	\$ (0.1)
	\$ (8.9)	\$ 4.4

## Other Income and Expense, net

Other expense, net in 2014 of \$4.2 million included a gain of \$9.2 million relating to foreign exchange movements on US dollar denominated cash, receivables and payables of Canadian operations, compared to a gain on foreign exchange in the prior year of \$5.9 million. In 2014, the Company also recorded a gain of \$2.2 million related to the sale of the Daaquam operation. Offsetting these factors was an unfavourable fair value adjustment of \$12.8 million related to the Canfor-LP OSB contingent consideration asset, largely reflecting a decrease in OSB prices since the sale in May 2013 and weaker forecast OSB prices over the earn-out period.

## Income Tax Expense

The Company recorded an income tax expense of \$76.2 million in 2014, compared to \$88.2 million in 2013, with an overall effective tax rate of 26% (2013 – 26%).

The reconciliation of income taxes calculated at the statutory rate to the actual income tax provision is as follows:

(millions of Canadian dollars)	2014	2013
Net income before income taxes	\$ 298.0	\$ 338.7
Income tax expense at statutory rate 2014 – 26.0% (2013 – 25.75%) <sup>23</sup>	\$ (77.5)	\$ (87.2)
Add (deduct):		
Non-taxable income related to non-controlling interests in limited partnerships	0.6	0.3
Entities with different income tax rates and other tax adjustments	0.8	0.5
Permanent difference from capital gains and losses and other non-deductible items	(0.1)	3.6
Change in substantively enacted tax rate <sup>23</sup>	-	(5.4)
Income tax expense	\$ (76.2)	\$ (88.2)

<sup>23</sup> Effective April 1, 2013, the British Columbia Provincial Government increased the corporate tax rate from 10% to 11%.

## Other Comprehensive Income (Loss)

(millions of Canadian dollars)	2014	2013
Foreign exchange translation differences for foreign operations, net of tax	\$ 22.7	\$ 15.0
Defined benefit actuarial gains (losses), net of tax	(85.2)	91.7
Other comprehensive income (loss), net of tax	\$ (62.5)	\$ 106.7

Canfor measures its accrued benefit obligations and the fair value of plan assets for accounting purposes as at December 31 of each year. Any actuarial gains or losses which arise are recognized immediately by means of a credit or charge through other comprehensive income. For 2014, an after-tax loss of \$85.2 million was recorded to other comprehensive income, which comprised losses on the defined benefit post-employment compensation plans and other non-pension post-employment benefits. The loss associated with the defined benefit post-employment compensation plans principally reflected a lower discount rate used to value the net defined benefit obligation and unfavourable actuarial experience adjustments as part of the tri-annual funding valuation for certain defined benefit pension plans, offset in part by a return on plan assets. The loss related to the other non-pension post-employment benefits principally reflected a lower discount rate used to value the post-employment obligation and unfavourable actuarial experience adjustments. In 2013, the after-tax gain was \$91.7 million, primarily reflecting a higher return on plan assets coupled with a higher discount rate used to value the net defined benefit obligation, offset in part by adjustments to mortality rate assumptions. For more information, see the "Employee Future Benefits" part of the "Critical Accounting Estimates" section later in this report.

In addition, the Company recorded a gain of \$22.7 million in 2014 related to foreign exchange differences for foreign operations, resulting from the weakening of the Canadian dollar relative to the US dollar in 2014. This compared to a gain of \$15.0 million in 2013 also due to a weakening of the Canadian dollar relative to the US counterpart.

## SUMMARY OF FINANCIAL POSITION

The following table summarizes Canfor's financial position as at December 31, 2014 and 2013:

(millions of Canadian dollars, except for ratios)	2014	2013
Cash and cash equivalents	\$ 158.3	\$ 89.5
Restricted cash	50.2	-
Operating working capital	320.3	266.5
Current portion of deferred reforestation	(52.1)	(44.1)
Net working capital	476.7	311.9
Property, plant and equipment	1,216.1	1,151.9
Timber licenses	519.5	534.6
Goodwill and other intangible assets	105.0	93.5
Retirement benefit surplus	0.6	42.2
Long-term investments and other	101.3	112.5
Net assets	\$ 2,419.2	\$ 2,246.6
Long-term debt	\$ 228.6	\$ 153.1
Retirement benefit obligations	263.2	200.5
Deferred reforestation obligations	60.0	69.8
Other long-term liabilities	19.6	14.9
Deferred income taxes, net	210.2	210.9
Non-controlling interests	250.4	223.1
Equity attributable to shareholders of Company	1,387.2	1,374.3
	\$ 2,419.2	\$ 2,246.6
Ratio of current assets to current liabilities	2.1 : 1	1.7 : 1
Net debt to total capitalization	5.1%	8.0%



The ratio of current assets to current liabilities at the end of 2014 was 2.1:1 compared to 1.7:1 at the end of 2013, and reflected the Company's higher cash and cash equivalent balances net of amounts drawn on operating loans at December 31, 2014 compared to December 31, 2013. The improved ratio also reflected an additional \$75.0 million term debt financing in the fourth quarter of 2014 for the construction of the recently announced Pellet Plants in Fort St. John and Chetwynd and various anticipated energy projects in the lumber segment.

The Company's net debt to capitalization was 5.1% at December 31, 2014 (December 31, 2013: 8.0%). The improvement reflected positive cash flow generated in the year and, to a lesser extent, higher shareholders' equity.

## CHANGES IN FINANCIAL POSITION

At the end of 2014, Canfor had \$158.3 million of cash and cash equivalents and \$50.2 million of restricted cash related to the first phase of the acquisition of Beadles & Balfour which closed on January 2, 2015.

(millions of Canadian dollars)	2014	2013
Cash generated from (used in)		
Operating activities	\$ 392.4	\$ 490.3
Financing activities	(64.7)	(181.4)
Investing activities	(258.9)	(202.3)
Increase in cash and cash equivalents	\$ 68.8	\$ 106.6

The changes in the components of these cash flows during 2014 are discussed in the following sections.

### Operating Activities

For the 2014 year, Canfor generated cash from operations of \$392.4 million, down \$97.9 million from cash generated of \$490.3 million in the previous year. Operating cash flows reflected a decrease in cash earnings, a build in non-cash working capital balances and higher income tax payments during 2014. Offsetting these factors was a significant decrease in contributions to the Company's employee future benefit plans reflecting the improvement in the financial position of the plans. The increase in non-cash working capital balances was largely due to higher finished lumber and pulp inventory levels at December 31, 2014 partly reflecting a significant drawdown of pulp inventory levels towards the end of 2013.

### Financing Activities

Financing activities in 2014 used net cash of \$64.7 million compared to net cash used of \$181.4 million in 2013. In 2014, a \$75.0 million floating rate term debt financing was completed for the construction of the Pellet Plants in Fort St. John and Chetwynd and certain other energy projects, while in 2013 CPPI completed a \$50.0 million floating rate term debt financing, which is being used to finance the high-returning energy projects at the Northwood and Intercontinental Mills. Also in the prior year, the Company repaid its US\$75.0 million 5.64% term debt and CPPI's US\$110.0 million 6.41% term debt for a total of \$192.9 million. Total dividend payments of \$10.2 million to non-controlling shareholders in 2014 were up \$0.9 million from 2013. At December 31, 2014, the Company had a consolidated amount of \$68.0 million drawn on its operating loan facilities.

Cash used for financing activities also included share purchases under Canfor's and CPPI's Normal Course Issuer Bids. During 2014, Canfor purchased 4,527,600 common shares for \$108.9 million (2013: \$60.0 million) and CPPI purchased 177,518 common shares from non-controlling shareholders for \$2.0 million (2013: \$2.4 million). See further discussion of the shares purchased under the Normal Course Issuer Bid in the following "Financial Requirements and Liquidity" section.

### Investing Activities

In 2014, the Company used net cash for investing activities of \$258.9 million, compared to \$202.3 million in 2013. Additions to property, plant and equipment totaled \$234.3 million, down \$3.0 million from 2013. In the lumber segment, capital spending of \$166.6 million included major capital projects at the Polar, Mackenzie, Grand Prairie and Houston operations as well the construction of the Pellet Plants in Chetwynd and Fort St. John and a major ERP software system implementation across its Canadian operations. In the pulp and paper segment, capital spending of \$58.0 million related primarily to the Northwood Pulp Mill upgrades that were completed in the first quarter and to the Intercontinental Pulp Mill turbine upgrade. CPPI anticipates that it will complete the upgrades to the Intercontinental Pulp Mill turbine and commence selling power under an Electricity Purchase Agreement in the second quarter of 2015.

During 2014, Canfor completed the second phase of the purchase of Scotch Gulf which included payment of \$9.9 million increasing the Company's ownership to 33.3%. During the year, Scotch Gulf repaid \$12.2 million of its secured term loan agreement, of which \$23.2 million was outstanding as at December 31, 2014. Also during the year, Canfor completed the sale of its Daaquam Sawmill with total gross proceeds related to the disposition approximating \$25.0 million. Investing activities during the 2014 year also included the transfer of \$50.2 million into an escrow account in connection with the first phase of the purchase of Beadles & Balfour, which closed on January 2, 2015. In 2013, Canfor completed the sale of its 50% interest in the Canfor-LP OSB joint venture for proceeds of \$77.9 million. Prior to completion of the sale on May 31, 2013, Canfor received \$16.5 million in partner distributions from Canfor-LP OSB.

## **FINANCIAL REQUIREMENTS AND LIQUIDITY**

### **Operating Loans**

At December 31, 2014, the Company on a consolidated basis had cash of \$208.5 million (including \$50.2 million of restricted cash), \$68.0 million drawn on its operating loans, and an additional \$26.0 million reserved for several standby letters of credit. Total available undrawn operating loans at year end were \$423.5 million.

Excluding CPPI, the Company's bank operating loans at December 31, 2014 totaled \$350.0 million, of which \$68.0 million was drawn, and an additional \$13.8 million reserved for several standby letters of credit, the majority of which related to unregistered pension plans. In 2014, Canfor extended the maturity on its operating loan to February 28, 2019. All other terms on the operating loan facility remain unchanged. Also in 2014, the Company entered into a \$37.5 million facility for letters of credit to support funding of certain pension plans.

At December 31, 2014, CPPI had a \$110.0 million bank loan facility with a maturity date of June 30, 2018 and no amounts drawn and a \$20.0 million energy-related facility with a maturity of June 30, 2015. At December 31, 2014, CPPI had \$12.2 million in standby letters of credit covered under its operating loan facilities.

### **Debt Covenants**

Canfor has certain financial covenants on its debt obligations that stipulate maximum net debt to total capitalization ratios and minimum net worth amounts based on total shareholders' equity. The net debt to total capitalization is calculated by dividing total debt, less cash and cash equivalents, by shareholders' equity plus total debt less cash and cash equivalents. Debt obligations are held by various entities within the Canfor group and the individual debt agreements specify the entities within the group that are to be included in the covenant calculations.

In circumstances when net debt to total capitalization exceeds a threshold, Canfor (excluding CPPI) is subject to an interest coverage ratio that requires a minimum amount of earnings before interest, taxes, depreciation and amortization relative to net interest expense. Canfor is not currently subject to this test.

The debt held by CPPI is subject to the same debt covenants as Canfor.

Provisions contained in both Canfor and CPPI's long-term borrowing agreements also limit the amount of indebtedness that the Company may incur and the amount of dividends it may pay on its common shares. The amount of dividends the Company is permitted to pay under its long-term borrowing agreements is determined by reference to consolidated net earnings less certain restricted payments.

Management reviews results and forecasts to monitor the Company's compliance with these covenant requirements. Canfor was in compliance with all its debt covenants for the year ended December 31, 2014.

Substantially all borrowings of CPPI (operating loans and long-term debt) are non-recourse to other entities within the Company.

## Normal Course Issuer Bid

On March 5, 2014, the Company renewed its normal course issuer bid whereby it can purchase for cancellation up to 6,995,228 common shares or approximately 5% of its issued and outstanding common shares as of February 28, 2014. The renewed normal course issuer bid is set to expire on March 4, 2015. In 2014, Canfor purchased 4,527,600 common shares for \$108.9 million (an average price of \$24.05 per common share), of which \$35.7 million was charged to share capital and \$73.2 million charged to retained earnings. In 2013, Canfor purchased 2,847,838 common shares for \$60.0 million (an average price of \$21.07 per common share), of which \$22.5 million was charged to share capital and \$37.5 million charged to retained earnings. Under a separate normal course issuer bid, CPPI purchased 177,518 common shares from non-controlling shareholders for \$2.0 million increasing Canfor's ownership of CPPI from 50.4% at December 31, 2013 to 50.5% at December 31, 2014.

## 2015 Projected Capital Spending and Debt Repayments

Based on its current outlook for 2015, assuming no deterioration in market conditions during the year, the Company plans to invest approximately \$235 million in capital projects, which will consist primarily of various improvement projects, maintenance of business expenditures, with proportionately more capital being allocated to the Company's growth in its US South lumber business, and the construction of the Fort St. John and Chetwynd Pellet Plants. There are no scheduled long-term debt payments in 2015. Canfor has sufficient liquidity in its cash reserves and operating loans to finance its planned capital expenditures as required during 2015.

## Derivative Financial Instruments

As at December 31, 2014, the Company had the following derivatives:

- Foreign exchange collars of US\$260.0 million and forward contracts of US\$4.5 million. There were unrealized losses of \$0.6 million on the foreign exchange derivatives at the end of the year. The contracts in place at the end of 2014 were as follows:

	2014	
	Notional Amount	Exchange Rates
<b>US dollar collars</b>	(millions of US dollars)	(protection/topside, per dollar)
0-12 months	<b>\$260.0</b>	<b>\$1.11/\$1.22</b>
<b>US dollar forward contracts</b>	(millions of US dollars)	(range of rates, per dollar)
0-12 months	<b>\$4.5</b>	<b>\$1.16</b>

- Canfor partly uses Brent oil and Western Texas Intermediate ("WTI") oil contracts as a proxy to hedge its diesel purchases. At December 31, 2014, collars for 453 thousand barrels of WTI oil were in place, which will be settled in 2015 and 2016, with weighted average protection of \$70.38 per barrel and topside of \$90.00 per barrel. There were unrealized losses of \$7.9 million on these contracts at the end of the year.
- Futures contracts for the sale of lumber with a total notional amount of 26.2 MMfbm. There were unrealized gains of \$0.3 million at year end on these contracts.

	2014	
	Notional Amount	Average Rate
<b>Lumber</b>	(MMfbm)	(US dollars per Mfbm)
Futures sales contracts 0 – 12 months	<b>26.2</b>	<b>\$320.50</b>

- Canfor uses interest rate swaps to reduce its exposure to interest rate risk associated with financial obligations bearing variable interest rates. At December 31, 2014, the Company had \$135.0 million in interest rate swaps with fixed interest rates from 2.32% to 3.45% and maturities between 2015 and 2017. There were unrealized losses of \$0.6 million at year end on these swaps.

## Commitments

The following table summarizes Canfor's financial contractual obligations at December 31, 2014 for each of the next five years and thereafter:

(millions of Canadian dollars)	2015	2016	2017	2018	2019	Thereafter	Total
Long-term debt obligations	\$ -	\$ -	\$ 100.0	\$ 50.0	\$ 75.0	\$ 3.6	\$ 228.6
Operating leases	\$ 8.6	\$ 6.6	\$ 5.1	\$ 3.5	\$ 2.3	\$ 7.9	\$ 34.0
	\$ 8.6	\$ 6.6	\$ 105.1	\$ 53.5	\$ 77.3	\$ 11.5	\$ 262.6

The interest payments associated with floating rate debt will depend on the lenders' Canadian prime rate or bankers' acceptance rate during the year of payment and have been excluded from the above commitments.

Other contractual obligations not included in the table above or highlighted previously are:

- Contractual commitments totaling \$71.1 million, which includes commitments for the construction of the Pellet Plants in Fort St. John and Chetwynd.
- Purchase obligations and contractual obligations in the normal course of business. For example, purchase obligations of a more substantial dollar amount generally relate to the pulp business and are subject to "force majeure" clauses. In these instances, actual volumes purchased may vary significantly from contracted amounts depending on Canfor's requirements in any given year.
- Contractual commitments of US\$164.0 million, excluding working capital and various lease arrangements, relating to the commitment to purchase the remaining 67% of Scotch Gulf, 100% of Beadles & Balfour and 100% of Southern Lumber remain outstanding at December 31, 2014.
- Deferred reforestation, for which a liability of \$112.1 million has been recorded at December 31, 2014. The reforestation liability is a fluctuating obligation, based on the area harvested. The future cash outflows are a function of the actual costs of silviculture programs and of harvesting and are based on, among other things, the location of the harvesting and the activities necessary to adequately stock harvested areas and achieve a "free-to-grow" state.
- Obligations to pay pension and other post-employment benefits, for which the net liability for accounting purposes at December 31, 2014 was \$262.6 million. As at December 31, 2014, Canfor estimated that it would make total contribution payments of \$14.9 million to its defined benefit plans in 2015.
- CPPI has entered into three separate energy agreements with a BC energy company and electricity transmission provider (the "Energy Agreements") for all three of the CPPI's mills, with commencement dates ranging from 2006 through 2015. These agreements are for the commitment of electrical load displacement and the sale of incremental power from the CPPI's pulp and paper mills. These Energy Agreements include incentive grants from the BC energy company for capital investments to increase electrical generation capacity, and also call for performance guarantees to ensure minimum required amounts of electricity are generated, with penalty clauses if they are not met. As part of these commitments, CPPI has entered into standby letters of credit for these guarantees. The standby letters of credit have variable expiry dates, depending on the capital invested and the length of the Energy Agreement involved. As at December 31, 2014 the Company had posted \$12.2 million of standby letters of credit under these agreements, and had no repayment obligations under the terms of any of these agreements.

## TRANSACTIONS WITH RELATED PARTIES

The Company undertakes transactions with various related entities. These transactions are in the normal course of business and are generally on the same terms as those accorded to unrelated third parties, except where noted otherwise. Related party transactions include the purchase of lumber, at market value, from Lakeland Mills Ltd. ("Lakeland") and Winton Global Lumber Ltd. ("Winton"), in which Canfor holds a one-third equity interest in both entities. In 2014, Canfor purchased \$1.6 million in logs from Lakeland and Winton with a balance of \$0.6 million outstanding at December 31, 2014. Related party transactions in 2014 also included lease and insurance services totaling \$2.0 million provided by subsidiaries owned by the Jim Pattison Group. There were no amounts outstanding at December 31, 2014 to the Jim Pattison Group subsidiaries.

As previously noted, during 2013, Canfor completed the first phase of the purchase of Scotch Gulf. As part of the transaction, Scotch Gulf borrowed \$34.0 million from Canfor in the form of a term loan, of which \$23.2 million is outstanding at December 31, 2014.

Additional details on related party transactions are contained in Note 23 to Canfor's 2014 consolidated financial statements

### Sale of Taylor Pulp Mill

On January 30, 2015, Canfor completed the sale of its BCTMP Taylor Pulp Mill to CPPI for cash proceeds of approximately \$15.0 million including working capital. The transaction also includes a long-term fibre supply agreement under which Canfor will supply fibre to the Taylor Pulp Mill at prices that approximate fair market value. In addition to the cash proceeds, Canfor may also receive contingent consideration over a 3 year period, starting January 31, 2015, based on the Taylor Pulp Mill's annual adjusted operating income before amortization. On the acquisition date the fair value of the contingent consideration was approximately \$1.8 million. CPPI recognized long-term assets acquired net of liabilities assumed of approximately \$2.8 million and net working capital of approximately \$14.0 million.

## SELECTED QUARTERLY FINANCIAL INFORMATION

	Q4 2014	Q3 2014	Q2 2014	Q1 2014	Q4 2013	Q3 2013	Q2 2013	Q1 2013
<b>Sales and income</b> (millions of Canadian dollars)								
Sales	\$ 860.4	\$ 838.0	\$ 907.3	\$ 741.9	\$ 809.5	\$ 755.9	\$ 843.2	\$ 786.3
Operating income	\$ 62.0	\$ 85.6	\$ 97.3	\$ 84.4	\$ 53.8	\$ 49.3	\$ 128.2	\$ 100.0
Net income	\$ 40.5	\$ 58.2	\$ 64.5	\$ 58.6	\$ 35.1	\$ 33.6	\$ 114.3	\$ 67.5
Shareholder net income	\$ 29.9	\$ 45.5	\$ 54.3	\$ 45.5	\$ 28.0	\$ 28.4	\$ 110.3	\$ 61.9
<b>Per common share</b> (Canadian dollars)								
Shareholder net income – basic and diluted	\$ 0.22	\$ 0.34	\$ 0.39	\$ 0.33	\$ 0.20	\$ 0.20	\$ 0.77	\$ 0.43
Book value <sup>24</sup>	\$ 10.25	\$ 10.24	\$ 9.75	\$ 10.05	\$ 9.82	\$ 9.47	\$ 9.25	\$ 8.29
<b>Statistics</b>								
Lumber shipments (MMfbm)	1,092	1,124	1,236	927	1,109	1,172	1,224	1,093
Pulp shipments (000 mt)	314	291	314	256	330	268	308	308
Average exchange rate – US\$/Cdn\$	\$ 0.881	\$ 0.918	\$ 0.917	\$ 0.906	\$ 0.953	\$ 0.963	\$ 0.977	\$ 0.991
Average Western SPF 2x4 #2&Btr lumber price (US\$)	\$ 340	\$ 357	\$ 335	\$ 367	\$ 370	\$ 328	\$ 335	\$ 391
Average SYP (East) 2x4 #2 lumber price (US\$)	\$ 427	\$ 438	\$ 405	\$ 403	\$ 415	\$ 393	\$ 392	\$ 452
Average NBSK pulp list price delivered to US (US\$)	\$ 1,025	\$ 1,030	\$ 1,030	\$ 1,017	\$ 983	\$ 947	\$ 937	\$ 897

<sup>24</sup> Book value per common share is equal to shareholders' equity at the end of the period, divided by the number of common shares outstanding at the end of the period.

In addition to exposure to changes in product prices and foreign exchange, the Company's financial results are impacted by seasonal factors such as weather and building activity. Adverse weather conditions can cause logging curtailments, which can affect the supply of raw materials to sawmills and pulp mills. Market demand also varies seasonally to some degree. For example, building activity and repair and renovation work, which affects demand for lumber products, is generally stronger in the spring and summer months. Shipment volumes are affected by these factors as well as by global supply and demand conditions.

(millions of Canadian dollars)	Q4 2014	Q3 2014	Q2 2014	Q1 2014	Q4 2013	Q3 2013	Q2 2013	Q1 2013
Operating income (loss) by segment:								
Lumber	\$ 40.6	\$ 59.6	\$ 74.1	\$ 56.4	\$ 37.4	\$ 43.8	\$ 115.5	\$ 88.4
Pulp and Paper	\$ 29.4	\$ 33.1	\$ 30.9	\$ 36.5	\$ 23.2	\$ 11.5	\$ 18.6	\$ 18.9
Unallocated and Other	\$ (8.0)	\$ (7.1)	\$ (7.7)	\$ (8.5)	\$ (6.8)	\$ (6.0)	\$ (5.9)	\$ (7.3)
<b>Total operating income</b>	<b>\$ 62.0</b>	<b>\$ 85.6</b>	<b>\$ 97.3</b>	<b>\$ 84.4</b>	<b>\$ 53.8</b>	<b>\$ 49.3</b>	<b>\$ 128.2</b>	<b>\$ 100.0</b>
Add: Amortization	\$ 46.9	\$ 47.1	\$ 44.0	\$ 44.5	\$ 44.9	\$ 44.8	\$ 49.6	\$ 46.9
<b>Total operating income before amortization<sup>25</sup></b>	<b>\$ 108.9</b>	<b>\$ 132.7</b>	<b>\$ 141.3</b>	<b>\$ 128.9</b>	<b>\$ 98.7</b>	<b>\$ 94.1</b>	<b>\$ 177.8</b>	<b>\$ 146.9</b>
Add (deduct):								
Working capital movements	\$ 11.6	\$ (0.2)	\$ 92.8	\$ (177.8)	\$ (14.5)	\$ 4.6	\$ 96.9	\$ (94.5)
Defined benefit pension plan contributions	\$ (3.9)	\$ (6.4)	\$ (5.9)	\$ (13.5)	\$ (14.0)	\$ (12.9)	\$ (12.6)	\$ (13.5)
Income taxes paid, net	\$ (3.1)	\$ (15.1)	\$ (9.5)	\$ (11.8)	\$ (0.3)	\$ (0.5)	\$ -	\$ 0.5
Other operating cash flows, net <sup>26</sup>	\$ 3.2	\$ 8.5	\$ (12.4)	\$ 24.1	\$ 28.9	\$ (10.0)	\$ (1.9)	\$ 16.6
<b>Cash from (used in) operating activities</b>	<b>\$ 116.7</b>	<b>\$ 119.5</b>	<b>\$ 206.3</b>	<b>\$ (50.1)</b>	<b>\$ 98.8</b>	<b>\$ 75.3</b>	<b>\$ 260.2</b>	<b>\$ 56.0</b>
Add (deduct):								
Finance expenses paid	\$ (2.7)	\$ (3.3)	\$ (2.6)	\$ (2.8)	\$ (5.9)	\$ (1.5)	\$ (7.5)	\$ (2.5)
Share purchases	\$ -	\$ (1.2)	\$ (105.7)	\$ (2.0)	\$ (33.4)	\$ (16.3)	\$ (10.3)	\$ -
Distributions paid to non-controlling interests	\$ (2.5)	\$ (2.7)	\$ (2.9)	\$ (2.1)	\$ (2.4)	\$ (2.4)	\$ (2.1)	\$ (2.4)
Capital additions, net	\$ (54.7)	\$ (63.5)	\$ (63.0)	\$ (53.1)	\$ (67.5)	\$ (74.6)	\$ (48.8)	\$ (46.4)
Proceeds from the sale of Daaquam operation	\$ -	\$ 0.7	\$ 22.9	\$ -	\$ -	\$ -	\$ -	\$ -
Investment in Scotch & Gulf Lumber, LLC	\$ -	\$ (9.9)	\$ -	\$ -	\$ (0.5)	\$ (29.0)	\$ -	\$ -
Repayment from (Loan to) Scotch & Gulf Lumber, LLC	\$ 4.8	\$ 2.7	\$ 2.1	\$ 2.6	\$ 2.1	\$ (34.0)	\$ -	\$ -
Change in restricted cash <sup>27</sup>	\$ (50.2)	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Proceeds from long-term debt	\$ 75.0	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Repayment of long-term debt	\$ -	\$ -	\$ -	\$ -	\$ (66.6)	\$ -	\$ (73.2)	\$ -
Proceeds from sale of Canfor-LP OSB	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 1.3	\$ 76.6	\$ -
Other, net	\$ 2.5	\$ (5.6)	\$ 1.7	\$ (0.9)	\$ 0.4	\$ (0.6)	\$ 10.6	\$ 5.6
<b>Change in cash / operating loans</b>	<b>\$ 88.9</b>	<b>\$ 36.7</b>	<b>\$ 58.8</b>	<b>\$ (108.4)</b>	<b>\$ (75.0)</b>	<b>\$ (81.8)</b>	<b>\$ 205.5</b>	<b>\$ 10.3</b>

<sup>25</sup> Amortization includes certain capitalized major maintenance costs.

<sup>26</sup> Further information on operating cash flows can be found in the Company's annual consolidated financial statements.

<sup>27</sup> Change in restricted cash relates to amounts transferred into an escrow bank account for the first phase of the Beadles & Balfour acquisition which closed on January 2, 2015.

## THREE-YEAR COMPARATIVE REVIEW

(millions of Canadian dollars, except per share amounts)	2014	2013	2012
Sales	\$ 3,347.6	\$ 3,194.9	\$ 2,642.8
Net income	\$ 221.8	\$ 250.5	\$ 35.6
Shareholder net income	\$ 175.2	\$ 228.6	\$ 26.4
Total assets	\$ 2,846.8	\$ 2,693.3	\$ 2,490.6
Total long-term financial liabilities	\$ 228.6	\$ 153.1	\$ 100.0
Shareholder net income per share, basic and diluted	\$ 1.28	\$ 1.61	\$ 0.18

## QUARTER ENDED DECEMBER 31, 2014 VS. QUARTER ENDED DECEMBER 31, 2013

### Overview of Operating Results

The Company recorded operating income of \$62.0 million and a shareholder net income of \$29.9 million for the fourth quarter of 2014, compared to \$53.8 million and shareholder net income of \$28.0 million in the fourth quarter of 2013. The shareholder net income per share was \$0.22 for the fourth quarter of 2014, compared to \$0.20 per share in the fourth quarter of 2013. Included in the fourth quarter of 2013 were restructuring costs of \$20.0 million related to the announced closure of the Company's Quesnel Sawmill and one-time costs of \$1.1 million associated with new five year collective labour agreements for the lumber business ratified in December 2013. Adjusted for these one-time items, operating income was down \$12.9 million from an adjusted operating income of \$74.9 million in the fourth quarter of 2013.

An overview of the results by business segment for the fourth quarter of 2014 compared to the last quarter of 2013 follows.

### Lumber

#### Selected Financial Information and Statistics – Lumber

Summarized results for the Lumber segment for the fourth quarter of 2014 and 2013 were as follows:

(millions of Canadian dollars, unless otherwise noted)	Q4 2014	Q4 2013
Sales	\$ 564.4	\$ 533.7
Operating income before amortization	\$ 70.6	\$ 66.1
Operating income	\$ 40.6	\$ 37.4
Mill closure provisions	\$ -	\$ 20.0
One-time costs associated with collective agreements	\$ -	\$ 1.1
Operating income excluding impact of unusual items	\$ 40.6	\$ 58.5
Average SPF 2x4 #2 & Btr lumber price in US\$ <sup>28</sup>	\$ 340	\$ 370
Average SPF price in Cdn\$	\$ 386	\$ 388
Average SYP 2x4 #2 lumber price in US\$ <sup>29</sup>	\$ 427	\$ 415
Average SYP price in Cdn\$	\$ 485	\$ 436
US housing starts (thousand units SAAR) <sup>30</sup>	1,075	1,025
Production – SPF lumber (MMfbm) <sup>31</sup>	893.1	944.8
Production – SYP lumber (MMfbm) <sup>31</sup>	141.6	135.3
Shipments – Canfor-produced SPF lumber (MMfbm) <sup>32</sup>	937.7	961.1
Shipments – Canfor-produced SYP lumber (MMfbm) <sup>32</sup>	151.3	142.4
Shipments – wholesale lumber (MMfbm)	2.5	5.7

<sup>28</sup> Western Spruce/Pine/Fir, per thousand board feet (Source – Random Lengths Publications, Inc.).

<sup>29</sup> Southern Yellow Pine, Eastside, per thousand board feet (Source – Random Lengths Publications, Inc.).

<sup>30</sup> Source – US Census Bureau, seasonally adjusted annual rate ("SAAR").

<sup>31</sup> Excluding production of trim blocks.

<sup>32</sup> Canfor-produced lumber, including lumber purchased for remanufacture and excluding trim blocks.

#### Overview

Operating income for the lumber segment was \$40.6 million for the fourth quarter of 2014, a decrease of \$17.9 million from operating income, adjusted for one-time items, of \$58.5 million reported for the fourth quarter of 2013. Current quarter results, for the most part, reflected higher unit manufacturing costs at the Company's Canadian operations due mostly to increased log costs in British Columbia. Lower production volume compared to the same quarter in 2013 mainly reflected the closure of the Quesnel Sawmill and sale of the Daaquam Sawmill in the first quarter of 2014, offset in part by increased production at several recently upgraded sawmill operations. Partly offsetting the impact of unit log costs and lower total production volume in the lumber segment were modestly higher sales realizations, which benefitted from an 8% weaker Canadian dollar, stronger SYP benchmark prices and, to a lesser extent, the absence of export tax on US bound shipments.

## Markets

North American lumber demand was relatively stable with balanced lumber consumption from all segments of the market despite the seasonally slower construction period in the fourth quarter of 2014. The US housing market continued its slow but gradual recovery, supported by lower mortgage rates, improved housing affordability and increasing consumer confidence. Total housing starts averaged 1,075,000 units SAAR, up 5% from the same period in 2013. Single-family starts, which consume a higher proportion of lumber, increased 7% compared to the fourth quarter of 2013 to 708,000 units SAAR. The repair and remodeling sector saw a modest increase, with sustained home improvement activities in North America.

In Canada, housing starts at an average of 188,000 SAAR were down 5% compared to the fourth quarter of 2013.

Offshore lumber demand in China and Japan were relatively stable during the fourth quarter of 2014 while Canfor's offshore lumber shipments saw a moderate decrease compared to the same quarter in 2013. At period end, log and lumber inventory levels in China were higher-than-normal in part reflecting increased Russian supply late in the quarter as a result of the sharp devaluation of the Russian Ruble.

## Sales

Sales for the lumber segment for the fourth quarter of 2014 were \$564.4 million, compared to \$533.7 million in the fourth quarter of 2013. The increase in sales from the comparable period in 2013 was the result of higher unit sales realizations offset in part by lower lumber shipments at just under 1.1 billion board feet, down 2% from the comparable quarter. The decrease in shipments largely reflected the closure of the Quesnel Sawmill and sale of the Daaquam Sawmill in the first quarter of 2014 offset in part by additional shifts and modest productivity improvements following several major capital projects and related production ramp-ups.

Compared to the fourth quarter of 2013, overall lumber sales realizations benefitted moderately from a weaker Canadian dollar, stronger SYP lumber prices and, to a lesser extent, the absence of export tax on US bound shipments. The benchmark North American Random Lengths Western SPF 2x4 #2&Btr price was 8% or US\$30 per Mfbm lower than the same quarter in the prior year. More than offsetting the decline in the Western SPF benchmark price was a 7 cent, or 8%, weaker Canadian dollar compared to the fourth quarter of 2013, as well as less pronounced price decreases in certain lumber grades and dimensions period-over-period. Current quarter sales realizations also included the positive impact of a higher percentage of prime products sold, largely reflecting the closure of the Company's Quesnel Sawmill in the first quarter of 2014, and no export taxes on US bound shipments compared to a 2% duty in the comparative period. The benchmark SYP 2x4 #2 price was up US\$12 per Mfbm, or 3%, from the fourth quarter of 2013 contributing to improved sales realizations at the Company's US South operations.

Total residual fibre revenue was up compared to the fourth quarter of 2013, principally due to a market-driven increase in sawmill residual chip prices, tied in part to higher NBSK pulp sales realizations.

## Operations

Lumber production, at over 1.0 billion board feet, was down 4% from the fourth quarter of 2013, primarily due to the closures of the Company's Quesnel Sawmill and sale of the Company's Daaquam Sawmill in the first quarter of 2014. Excluding the impact of the Quesnel closure and Daaquam sale, lumber production was up 5%, reflecting operating shifts added at certain operations earlier in 2014 and more downtime for capital installations and ramp-ups occurring in the comparable period of 2013.

Compared to the fourth quarter of 2013, unit manufacturing costs were higher at the Canadian operations and relatively flat at the Company's US South operations. Higher unit log costs in the Canadian operations were primarily the result of increased logging and hauling rates, higher market-driven stumpage costs and higher purchased log costs compared to the same quarter in 2013. Higher unit cash conversion costs compared to the same period in 2013 principally reflected higher maintenance costs in part due to certain one-time projects completed during the quarter, continued dust management efforts and higher labour costs.



## Pulp and Paper

### Selected Financial Information and Statistics – Pulp and Paper<sup>33</sup>

Summarized results for the Pulp and Paper segment for the fourth quarter of 2014 and 2013 were as follows:

(millions of Canadian dollars, unless otherwise noted)	<b>Q4 2014</b>	<b>Q4 2013</b>
Sales	\$ 296.0	\$ 275.8
Operating income before amortization <sup>34</sup>	\$ 45.0	\$ 39.2
Operating income	\$ 29.4	\$ 23.2
Average pulp price delivered to US – US\$ <sup>35</sup>	\$ 1,025	\$ 983
Average price in Cdn\$	\$ 1,164	\$ 1,032
Production – pulp (000 mt)	295.7	299.5
Production – paper (000 mt)	36.0	30.8
Shipments – Canfor-produced pulp (000 mt)	314.0	329.5
Shipments – paper (000 mt)	35.8	31.1

<sup>33</sup> Includes the Taylor Pulp Mill and 100% of CPPI, which is consolidated in Canfor's operating results. Pulp production and shipment volumes presented are for both NBSK pulp and BCTMP.

<sup>34</sup> Amortization includes certain capitalized major maintenance costs.

<sup>35</sup> Per tonne, NBSK pulp price delivered to US (RISI).

#### Overview

Operating income for the pulp and paper segment was \$29.4 million for the fourth quarter of 2014, up \$6.2 million from the fourth quarter of 2013.

Compared to the fourth quarter of 2013, the pulp and paper segment's results were up with strong gains in sales realizations offset in part by higher unit manufacturing costs and lower shipment volumes. The higher sales realizations were largely a result of the 8% weaker Canadian dollar and marginal improvements in pulp US dollar prices in most regions, while shipments for the last quarter of 2013 were at higher-than-normal levels. Unit manufacturing costs were up moderately, primarily reflecting higher market-driven fibre costs and the impact of a longer scheduled maintenance outage in the current quarter compared to a scheduled outage taken in the fourth quarter of 2013. Results in the Company's paper business boosted the overall pulp and paper segment's earnings compared to same in quarter in 2013 largely reflecting increased shipment volumes and higher unit sales realizations coupled with lower unit manufacturing costs principally resulting from higher production volume in the current quarter due to a scheduled maintenance outage in the comparable period in 2013. These gains in the paper business were partially offset by market-driven increases in slush pulp costs in the current quarter.

#### Markets

Global softwood pulp markets were relatively stable in the fourth quarter of 2014, softening slightly towards the end of the quarter, with pricing down modestly in North America and China and solid demand in most regions through the quarter. Global softwood pulp producer inventory levels remained balanced during the first two months of the quarter before increasing in December 2014 to 31 days of supply, up 4 days from September 2014, driven in part by strong producer operating rates. Market conditions are generally considered balanced when inventories are in the 27-30 days of supply range.

Global shipments of bleached softwood kraft pulp were relatively unchanged from the fourth quarter of 2013, with stable demand seen to most regions compared to the same period in 2013.

#### Sales

The Company's pulp shipments in the fourth quarter of 2014 totalled 314,000 tonnes, down 15,500 tonnes, or 5%, due in part to higher-than-normal shipments into China in the fourth quarter of 2013, partly offset by improved demand in North America. Paper shipments at 35,800 tonnes in the fourth quarter of 2014 were up 4,700 tonnes, or 15%, compared to the same quarter in 2013 principally reflecting higher production levels.

Pulp sales realizations showed strong gains compared to the fourth quarter of 2013, largely as a result of the 8% weaker Canadian dollar, increased US-dollar pulp prices in most regions, and increased shipments to higher-margin regions. The average NBSK pulp list price to North America increased US\$42 per tonne, or 4%, with list prices to Europe seeing similar gains. Partially offsetting these gains were increased discounts in North America and a 3%

decrease in the average list price to China. Higher energy revenue compared to the same period in 2013 continued to reflect output from the upgrades to the Northwood Pulp Mill turbines, completed in early 2014, as well as increased power generation from the turbine at the Company's Prince George Pulp Mill facility. BCTMP sales realizations experienced modest gains compared to the fourth quarter of 2013, reflecting the weaker Canadian dollar offset in part by lower market prices. Paper unit sales realizations were well up compared to the same quarter in 2013, largely the result of the weaker Canadian dollar as well as increased prices and higher prime bleached paper shipments.

### Operations

Pulp production in the current quarter at 295,700 tonnes was down 3,800 tonnes, or 1%, from the fourth quarter of 2013 reflecting a scheduled maintenance outage at the Northwood Pulp Mill in the current quarter which resulted in reduced market pulp production of 17,000 tonnes. In comparison, production in the fourth quarter of 2013 reflected a scheduled maintenance outage at the Prince George Pulp Mill, which resulted in reduced market pulp production of 4,000 tonnes. Current quarter production levels were favourably impacted by higher operating rates than the same period in 2013. Paper production in the fourth quarter of 2014 was 36,000 tonnes, up 5,200 tonnes, or 17%, from the fourth quarter of 2013, mostly due to a scheduled maintenance outage at the Company's paper machine in October 2013.

Compared to the fourth quarter of 2013, unit manufacturing costs were up, reflecting the impact of higher fibre costs coupled with higher costs attributable to the longer maintenance outage in the current quarter. The higher fibre costs resulted largely from market-driven increases in sawmill residual and whole log chip prices and, to a lesser extent, an increased proportion of higher-cost whole log chips. Paper unit manufacturing costs showed a marginal increase compared to the same quarter in 2013, as higher costs for slush pulp and chemicals in the current quarter, were partly offset by lower maintenance and operating costs, mostly due to the scheduled maintenance outage in the comparative period.

### **Unallocated and Other Items**

(millions of Canadian dollars)	Q4 2014	Q4 2013
Operating loss of Panels operations <sup>36</sup>	\$ (0.8)	\$ (0.5)
Corporate costs	\$ (7.2)	\$ (6.3)
Finance expense, net	\$ (4.6)	\$ (6.4)
Foreign exchange loss on long-term debt	\$ -	\$ (3.4)
Loss on derivative financial instruments	\$ (7.4)	\$ (0.2)
Other income (expense), net	\$ 3.1	\$ (3.1)

<sup>36</sup> The Panels operations include the Company's PolarBoard OSB plant, which is currently indefinitely idled and its Tackama plywood plant, which was closed in January 2012.

Corporate costs were \$7.2 million for the fourth quarter of 2014, up \$0.9 million from the fourth quarter of 2013 partly reflecting increased share based compensation costs.

Net finance expense at \$4.6 million for the fourth quarter of 2014 was down \$1.8 million from the fourth quarter of 2013. The decrease compared to the same quarter in 2013 reflects lower employee future benefit net interest costs, due in part to the improved financial position of most of the Company's defined benefit plans.

The Company uses a variety of derivative financial instruments as partial economic hedges against unfavourable changes in foreign exchange rates, energy costs, lumber prices, pulp prices and interest rates. In the fourth quarter of 2014, the Company recorded a net loss of \$7.4 million related to its derivatives instruments, principally reflecting unrealized losses on crude oil collars stemming from the sharp decline in oil prices at the end of 2014, with oil prices declining further early in 2015. Also contributing to the loss, to a lesser degree, were losses on US dollar foreign exchange collars as a result of the weakening of the Canadian dollar at the close of the current quarter relative to the exchange rate at the close of the third quarter of 2014. These losses were partly offset by realized gains on lumber futures contracts settled during the quarter.

Other income, net of \$3.1 million in the fourth quarter of 2014, principally reflected foreign exchange gains on US dollar denominated working capital resulting from the weakening of the Canadian dollar relative to the US dollar over the course of the quarter.

## SPECIFIC ITEMS AFFECTING COMPARABILITY

### Specific Items Affecting Comparability of Shareholder Net Income (Loss)

Factors that impact the comparability of the quarters are noted below:

After-tax impact, net of non-controlling interests

(millions of Canadian dollars, except for per share amounts)	Q4 2014	Q3 2014	Q2 2014	Q1 2014	Q4 2013	Q3 2013	Q2 2013	Q1 2013
<b>Shareholder net income, as reported</b>	\$ 29.9	\$ 45.5	\$ 54.3	\$ 45.5	\$ 28.0	\$ 28.4	\$ 110.3	\$ 61.9
(Gain) loss on derivative financial instruments	\$ 5.2	\$ 0.7	\$ (2.1)	\$ 2.1	\$ 0.1	\$ (2.2)	\$ 1.0	\$ (2.2)
Mark-to-market adjustment to Canfor-LP OSB sale contingent consideration	\$ -	\$ 4.5	\$ 4.5	\$ 0.4	\$ 3.6	\$ 1.0	\$ -	\$ -
Gain on sale of Canfor-LP OSB (including contingent consideration)	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ (33.4)	\$ -
Gain on sale of Daaquam operation	\$ -	\$ -	\$ -	\$ (1.6)	\$ -	\$ -	\$ -	\$ -
Foreign exchange (gain) loss on long-term debt	\$ -	\$ -	\$ -	\$ -	\$ 1.5	\$ (1.0)	\$ 1.8	\$ 2.3
Mill closure provisions	\$ -	\$ -	\$ -	\$ -	\$ 14.8	\$ -	\$ -	\$ -
One-time costs associated with collective agreements for the lumber business	\$ -	\$ -	\$ -	\$ -	\$ 0.8	\$ -	\$ -	\$ -
Canfor's 50% interest in Canfor-LP OSB's income, net of tax	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 3.8	\$ 8.3
Change in substantively enacted tax rate	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 4.2	\$ -
Net impact of above items	\$ 5.2	\$ 5.2	\$ 2.4	\$ 0.9	\$ 20.8	\$ (2.2)	\$ (22.6)	\$ 8.4
<b>Adjusted shareholder net income</b>	\$ 35.1	\$ 50.7	\$ 56.7	\$ 46.4	\$ 48.8	\$ 26.2	\$ 87.7	\$ 70.3
<b>Shareholder net income per share (EPS), as reported</b>	\$ 0.22	\$ 0.34	\$ 0.39	\$ 0.33	\$ 0.20	\$ 0.20	\$ 0.77	\$ 0.43
Net impact of above items per share <sup>37</sup>	\$ 0.04	\$ 0.04	\$ 0.02	\$ 0.01	\$ 0.15	\$ (0.02)	\$ (0.16)	\$ 0.06
<b>Adjusted net income per share<sup>37</sup></b>	\$ 0.26	\$ 0.38	\$ 0.41	\$ 0.34	\$ 0.35	\$ 0.18	\$ 0.61	\$ 0.49

<sup>37</sup> The year-to-date net impact of the adjusting items per share and adjusted net income per share does not equal the sum of the quarterly per share amounts due to rounding.

## OUTLOOK

### Lumber Markets

For 2015, North American lumber demand is expected to improve with the steady recovery in the US housing market. Stronger economic fundamentals, notably employment growth, low mortgage rates and moderate home prices will support higher US housing demand. The offshore markets are forecast to ease with softer demand in Asia coupled with higher-than-normal inventory levels in China at the end of 2014 and an increase in Russian supply due to the Russian currency devaluation benefitting Russian exports to offshore markets. Sales realizations on Canadian exports are currently projected to benefit from the continued weakening of the Canadian dollar in the first quarter of 2015.

### Pulp and Paper Markets

For the month of January 2015, NBSK pulp list prices were down from December 2014, with the NBSK pulp list price to North America at US\$1,010 per tonne, down US\$10 per tonne, and the list prices to China and Europe down US\$20 per tonne at US\$680 per tonne and US\$915 per tonne, respectively. For the month of February 2015, CPPI has announced a NBSK pulp list price of US\$1,000 per tonne in North America. There are no maintenance outages planned for the first quarter of 2015. NBSK pulp list prices are anticipated to continue to soften modestly through the first quarter of 2015, with a modest growth in producer inventories due in part to minimal industry maintenance during the first quarter and NBSK pulp production facilities running at or near capacity; however, the continued weakening of the Canadian dollar is currently projected to outweigh the forecast declines in NBSK pulp list prices. For the second quarter of 2015, producer inventories are forecast to decline during the industry's spring maintenance period.

Maintenance outages are currently planned at the Intercontinental and Prince George Mills in the second quarter of 2015 with a projected 10,000 tonnes of reduced production and at the Northwood Mill in the fourth quarter of 2015 with a projected 25,000 tonnes of reduced production.

## CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements in conformity with International Financial Reporting Standards (“IFRS”) requires management to make estimates and assumptions that affect the amounts recorded in the financial statements. Management regularly reviews these estimates and assumptions based on currently available information. While it is reasonably possible that circumstances may arise which cause actual results to differ from these estimates, management does not believe it is likely that any such differences will materially affect Canfor’s financial position. Unless otherwise indicated the critical accounting estimates discussed affect all of the Company’s reportable segments.

### Employee Future Benefits

Canfor has various defined benefit and defined contribution plans providing both pension and other retirement benefits to most of its salaried employees and certain hourly employees not covered by forest industry union plans. Canfor also provides certain health care benefits and pension bridging benefits to eligible retired employees. The costs and related obligations of the pension and other retirement benefit plans are accrued in accordance with the requirements of IFRS.

Canfor uses independent actuarial firms to perform actuarial valuations of the fair value of pension and other retirement benefit plan obligations. The application of IFRS requires judgments regarding certain assumptions that affect the accrued benefit provisions and related expenses, including the discount rate used to calculate the present value of the obligations, the rate of compensation increase, mortality assumptions, and the assumed health care cost trend rates. Management evaluates these assumptions annually based on experience and the recommendations of its actuarial firms. Changes in these assumptions result in actuarial gains or losses, which are recognized in full in each period with an adjustment through Other Comprehensive Income (Loss).

The actuarial assumptions used in measuring Canfor’s benefit plan provisions and benefit costs are as follows:

	December 31, 2014		December 31, 2013	
	Pension Benefit Plans	Other Benefit Plans	Pension Benefit Plans	Other Benefit Plans
Discount rate	3.90%	3.90%	4.80%	4.90%
Rate of compensation increases	3.00%	n/a	3.00%	n/a
Future salary increases	2.50%	n/a	3.00%	n/a
Initial medical cost trend rate	n/a	7.00%	n/a	7.00%
Ultimate medical cost trend rate	n/a	4.50%	n/a	4.50%
Year ultimate rate is reached	n/a	2021	n/a	2021

In addition to the significant assumptions listed in the table above, the average life expectancy of a 65 year old at December 31, 2014 is between 20.7 years and 24.0 years (2013 – 19.8 years and 23.0 years). As at December 31, 2014, the weighted average duration of the defined benefit obligation is 12.4 years (2013 – 11.4 years). The weighted average duration of the other benefit plans is 13.9 years (2013 – 13.7 years).

Assumed discount rates and medical cost trend rates have a significant effect on the accrued benefit obligation. A one percentage point change in these assumptions would have the following effects on the accrued benefit obligation for 2014:

(millions of Canadian dollars)	1% Increase	1% Decrease
Pension benefit plans		
Discount rate	\$ (91.4)	\$ 100.1
Other benefit plans		
Discount rate	\$ (21.6)	\$ 26.7
Initial medical cost trend rate	\$ 18.3	\$ (15.5)

See “Financial Requirements and Liquidity” section for further discussion regarding the funding position of Canfor’s pension plans.

## **Deferred Reforestation**

Canfor accrues an estimate of its future liability to perform forestry activities, defined to mean those silviculture treatments or activities that are carried out to ensure the establishment of a free-growing stand of young trees, including logging road rehabilitation on its forestry tenures in BC and Alberta. An estimate is recorded in the financial statements based on the number of hectares of timber harvested in the period and the estimated costs of fulfilling Canfor's obligation. Payments in relation to reforestation are expected to occur over periods of up to 15 years (the significant majority occurring in the first seven years) and have been discounted accordingly at risk-free rates ranging from 1.0% to 2.3%. The actual costs that will be incurred in the future may vary based on, among other things, the actual costs at the time of silviculture activities.

## **Deferred Taxes**

In accordance with IFRS, Canfor recognizes deferred income tax assets when it is probable that the deferred income tax assets will be realized. This assumption is based on management's best estimate of future circumstances and events. If these estimates and assumptions are changed in the future, the value of the deferred income tax assets could be reduced or increased, resulting in an income tax expense or recovery. Canfor reevaluates its deferred income tax assets on a regular basis.

## **Asset Retirement Obligations**

Canfor records the estimated fair value of a liability for asset retirement obligations, such as landfill closures, in the period when it is incurred. For CPPI's landfill closure costs, the fair value is determined using estimated closure costs discounted over the estimated useful life. Payments relating to landfill closure costs are expected to occur at periods ranging from 4 to 37 years and have been discounted at risk-free rates ranging from 1.4% to 2.4%. The actual closure costs and periods of payment may differ from the estimates used in determining the year end liability. On initial recognition, the fair value of the liability is added to the carrying amount of the associated asset and amortized over its useful life. The liability is accreted over time through charges to earnings and reduced by actual costs of settlement.

## **Environmental Remediation Costs**

Costs associated with environmental remediation obligations are accrued and expensed when there exists a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. Such accruals are adjusted as further information develops or circumstances change. Costs of future expenditures for environmental remediation obligations are discounted to their present value when the amount and timing of expected cash payments are reliably determinable.

## **Impairment of Goodwill**

Goodwill, which is the excess of the cost of an acquisition over the fair value of the net identifiable assets acquired, is not amortized but is assessed annually for impairment or more frequently if events or circumstances indicate that it may be impaired.

An impairment loss is recognized in net income at the amount that the carrying value, including goodwill, of the relevant operating division exceeds its recoverable amount. The recoverable amount is the higher of the unit's fair value less costs to sell and value in use. For Canfor's goodwill (which is allocated to the lumber segment), the fair value of the relevant assets is determined by estimating the future expected discounted cash flows of the unit as a whole on an annual basis, and more often if required. As part of this process, assumptions are made in relation to forecast product prices and exchange rates. Price forecasts are determined with reference to Resource Information Systems, Inc. ("RISI") and Forest Economic Advisors ("FEA") publications and management estimates. Other significant assumptions include the discount rate. The net present value of the future expected cash flows, which approximates fair value, is compared to the carrying value of the Company's investment in these assets, including goodwill, at year end.

Based upon the analysis performed in 2014 the net present value of the estimated future discounted cash flows exceeded the value of the investment, and therefore no impairments to goodwill were required. However, if the US and global economic recovery were to be longer than anticipated in the forecast assumptions, there is a possibility that an impairment of goodwill may be required in future periods.

## Valuation of Log and Finished Product Inventories

Log and finished product inventories are recorded at the lower of cost and net realizable value. For inventories of solid wood products, the net realizable value is determined by taking into account forecast prices and exchange rates for the period over which the inventories are expected to be sold. Forecast prices are determined using RISI forecasts and management's estimates as at the year end, and may differ from the actual prices at which the inventories are sold. At the end of December 2014, there were no write-downs against inventory balances.

## Allowance for Doubtful Accounts

An allowance for doubtful accounts of \$3.7 million has been recorded at December 31, 2014 which reflects management's assessment of risks attached to the collection of receivable balances. While significant bad debts have not been experienced in prior years, the provision is considered appropriate due to several risks still existing which may affect the ability of certain customers to pay amounts owed to the Company.

## FUTURE CHANGES IN ACCOUNTING POLICIES

In July 2014, the International Accounting Standards Board ("IASB") issued IFRS 9, *Financial Instruments*. The required adoption date for IFRS 9 is January 1, 2018 and the Company is in the process of assessing the impact, if any, on the financial statements of this new standard.

In May 2014, the IASB issued IFRS 15, *Revenue from Contracts with Customers*, which will supersede IAS 18, *Revenue*, IAS 11, *Construction Contracts* and related interpretations. The new standard is effective for annual periods beginning on or after January 1, 2017. The Company is in the process of assessing the impact, if any, on the financial statements of this new standard.

## RISKS AND UNCERTAINTIES

*Risks and uncertainties fall into the general business areas of markets, international commodity prices, competition, currency exchange rates, environmental issues, forest land base, government regulations, public policy and labour disputes, and, for Canadian companies, a history of trade disputes and issues and Aboriginal land claims. The future impact of the various uncertainties and potential risks described in the following paragraphs (together with the risks and uncertainties identified under each of the Company's business segments) cannot be quantified or predicted with certainty. However, Canfor does not foresee unmanageable adverse effects on its business operations from, and believes that it is well positioned to deal with, such matters as may arise. The risks and uncertainties are set out in alphabetical order.*

### Aboriginal Issues

Canadian judicial decisions have recognized the continued existence of Aboriginal rights and title to lands continuously and exclusively used or occupied by Aboriginal groups; however, until recently, the courts have not identified any specific lands where Aboriginal title exists. In June 2014, the Supreme Court of Canada, for the first time, recognized Aboriginal title for the Tsilhqot'in Nation over approximately 1,750 square kilometres of land in central BC ("William decision"). It found that provisions of BC's *Forest Act*, dealing with the disposition or harvest of Crown timber, no longer applied to timber located on these lands, but also confirmed provincial law can apply on Aboriginal title lands.

While Aboriginal title had previously been assumed to exist over specific, intensively occupied areas such as villages, the William decision marks the first time Canada's highest court has recognized Aboriginal title over a specific piece of land and, in so doing, affirmed a broader territorial use-based approach to Aboriginal title. The decision also further defines what Aboriginal title means and the types of land uses consistent with this form of collective ownership.

Presently, Aboriginal title has not been established by law in any areas overlapping Canfor's tenure areas; however, Aboriginal rights continue to exist over traditional territories, and the Company cannot assure that this will not affect its timber harvesting rights. Forest harvesting operations are continuing to proceed under these current requirements. The Government of BC delegates procedural aspects of consultation to tenure holders, including Canfor, and Canfor works to establish productive and mutually beneficial relationships with First Nations whose traditional territories overlap the Company's operating areas. The Government of BC has also taken steps to improve certainty and access to timber resources through interim agreements with First Nations that include timber rights.

Canfor holds numerous agreements with individual First Nations whereby the Company manages and/or purchases their timber.

The impacts of the Supreme Court of Canada's decision on the timber supply from Crown lands and on Canfor's operations is unknown at this time; and the Company does not know if the decision will lead to changes in BC laws or policies. However, as issues relating to Aboriginal rights and title continue to develop and be resolved in Canadian courts, Canfor will continue to engage, cooperate and exchange information and views with First Nations and Government to foster good relationships and minimize risks to the Company's tenures and operational plans.

## **Employee Future Benefits**

Canfor has several defined benefit plans, which provide pension and other post-retirement benefits to certain salaried and hourly employees. Pension plan benefits are based on years of service and final average salary (for salaried employees), and flat rate benefit and years of service (for hourly employees). Canfor's other post-retirement benefit plans are non-contributory and include a range of health care and other benefits. Canfor also provides pension bridge benefits to certain eligible former employees.

Cash payments required to fund the pension plan are determined by actuarial valuation completed at least once every three years, with the most recent actuarial valuation for the largest plan completed as of December 31, 2013. Other post-retirement benefit plans are unfunded, and the Company makes payments as required to cover liabilities as they arise.

The funded surplus (deficit) of each defined benefit plan is calculated as the difference between the value of any plan assets and an actuarial estimate of future liabilities. Any deficit in the registered pension plans determined following an actuarial valuation must be funded in accordance with regulatory requirements, normally over 5 or 15 years. Some of the unregistered plans are also partially funded.

Through its pension funding requirements, Canfor is exposed to the risk of fluctuating market values for the securities making up the plan assets, and to changes in prevailing interest rates which determine the discount rate used in calculating the estimated future liabilities. The funding requirements may also change to the extent that other assumptions used are revised, such as inflation rates or mortality assumptions.

For Canfor's pension benefit plans, a one percentage point increase in the discount rate used in calculating the actuarial estimate of future liabilities would reduce the accrued benefit obligation by an estimated \$91.4 million and a one percentage point decrease in the discount rate would increase the accrued benefit obligation by an estimated \$100.1 million. These changes would only impact the Company's funding requirements in years where a new actuarial funding valuation was performed and regulatory approval for a change in funding contributions was obtained.

## **Environmental Issues**

Canfor's operations are subject to environmental regulation by federal, provincial, state and local authorities, including specific environmental regulations relating to air emissions and pollutants, wastewater (effluent) discharges, solid waste, landfill operations, forestry practices, site remediation and the protection of endangered species and critical habitat. Canfor has incurred, and will continue to incur, capital expenditures and operating costs to comply with environmental laws and regulations. No assurance can be given that changes in these laws and regulations or their application will not have a material adverse effect on Canfor's business, operations, financial condition and operational results. Similarly, no assurance can be given that capital expenditures necessary for future compliance with existing and new environmental laws and regulations could be financed from Canfor's available cash flow. In addition, Canfor may discover currently unknown environmental issues, contamination, or conditions relating to its past or present operations. This may require site or other remediation costs to maintain compliance or correct violations or result in governmental or private claims for damage to person, property or the environment, which could have a material adverse effect on Canfor's business, financial condition and operational results.

Canfor has systems in place to identify, account for and appropriately address potential environmental liabilities. The Company also has governance in place including an Environmental, Health and Safety Committee of the Board, a Corporate Environmental Management Committee including Officers of the Company, and environmental professionals on staff to manage potential risks, issues and liabilities.

Canfor has in place internal policies and procedures under which all its forestry and manufacturing operations are regularly audited for compliance with laws and accepted standards and with its management system requirements.

Canfor's woodlands operations employ environmental management systems following the ISO 14001 Environmental Management System Standard. Further, approximately 100% of Canfor's forest tenures in Canada are third-party certified to the Canadian Standards Association ("CSA"), the Forest Stewardship Council ("FSC") or the Sustainable Forestry Initiative ("SFI") sustainable forest management standards. Canfor's operations and its ability to sell its products could be adversely affected if those operations did not, or were perceived by the public as failing to, comply with applicable laws and standards, including responsible environmental and sustainable forestry standards.

On November 25, 2009, the BC Ministry of Environment released the greenhouse gas ("GHG") reporting regulations under the Greenhouse Gas Reduction Act, requiring any facilities emitting more than 10,000 tonnes of CO<sub>2</sub> to report 2010 emissions in 2011. In 2014, one of Canfor's sawmills and all of the pulp mills (including CPPI's pulp mills) reported GHG emissions under the BC GHG reporting regulation. GHG emission reporting has been required federally and in Alberta for several years with CPPI's facilities meeting the requirements for federal reporting, though Canfor's wood products facilities have not triggered federal or Alberta reporting thresholds. Canfor's New South facilities located in North and South Carolina are subject to state GHG reporting requirements.

At this point carbon policy in BC, apart from the existing carbon tax, is uncertain. Canfor's BC sawmill facility GHG emissions are all well below any foreseeable Regulation thresholds. Canfor's one Alberta sawmill GHG emissions are a small fraction of the Alberta Specified Gas Emission Regulation threshold.

At the federal level Environment Canada has indicated the pulp and paper sector will be included in its GHG Regulatory system, currently under development. Canfor Pulp's three Prince George pulp mills are well positioned having already substantially reduced GHG emissions through energy efficiency measures and switching from fossil to carbon dioxide emission neutral biomass fuels.

In the United States carbon policy at the federal and state levels is also uncertain however direct GHG emissions from Canfor's US sawmills are very low, due to the use of biomass fuels for heat energy. The mills are exposed to potential pass through of future electrical utility GHG emission reduction requirements related to electricity purchases.

Canfor is a participant in the carbon offset market in Alberta and British Columbia, selling offset credits tied to its biomass cogeneration facility in Grande Prairie and from biomass heat energy projects recently completed at several mills in BC. Canfor is also a participant in the carbon offset market in BC.

### **Fibre Cost and Availability**

The Company's fibre costs are affected by a number of different factors which could have a significant impact on operating results. Lumber market fluctuations and log market speculative bidding can also have a significant impact on both fibre supply and costs. In the interior of BC, the majority of the Company's tenure harvesting continues to advance to the north in an effort to maximize the salvage of pine impacted by the Mountain Pine Beetle epidemic. In other areas where the amount of pine left to be salvaged has significantly declined, tenure harvesting is transitioning back to traditional harvesting patterns and areas. While this has the added benefit of improving the quality of fibre, it also increases transportation, road construction and reforestation costs. These factors also contribute to higher log costs and are anticipated to provide upward pressure on the Company's log costs for the foreseeable future. In addition, the Company's ability to harvest fibre for use in its operations could be adversely impacted by natural events such as forest fires, severe weather conditions or insect infestations. In the event that sufficient volumes of economically viable fibre cannot be provided to an operation, it may be necessary to close that operation for a period of time, or even permanently. Such closures could result in significant costs to the Company. The Company is not insured for loss of standing timber. Canfor has secured its fibre position in Western Canada relative to its existing sawmills and no shortage of supply is anticipated at this time.

### **Financial Risk Management and Earnings Sensitivities**

Demand for forest products, both wood products and pulp and paper, is closely related to global business conditions and tends to be cyclical in nature. Product prices can be subject to volatile change. Canfor, like the majority of the Canadian forest products industry, competes in a global market and the majority of its products are sold in US dollars. Consequently, changes in foreign currency relative to the Canadian dollar can impact Canfor's revenues and earnings.



## ***Financial Risk Management***

Canfor is exposed to a number of risks as a result of holding financial instruments. These risks include credit risk, liquidity risk and market risk.

Canfor's Risk Management Committee manages risk in accordance with a Board approved Price Risk Management Controls Policy. This policy provides the framework for risk management related to commodity price, foreign exchange, interest rate and counterparty credit risk of Canfor.

### *(a) Credit risk:*

Credit risk is the risk of financial loss to Canfor if a counterparty to a financial instrument fails to meet its contractual obligations.

Financial instruments that are subject to credit risk include cash and cash equivalents, accounts receivable, and long-term investments. Cash and cash equivalents includes cash held through major Canadian and international financial institutions as well as temporary investments with an original maturity date of three months or less.

Canfor utilizes credit insurance to mitigate the risk associated with some of its trade receivables. As at December 31, 2014, approximately 75% (2013 – 67%) of the outstanding trade receivables are covered by credit insurance. Canfor's trade receivable balance at December 31, 2014 is \$95.0 million before an allowance for doubtful accounts of \$3.7 million (2013 - \$115.3 million and \$2.7 million, respectively). At December 31, 2014, approximately 99% (2013 - 98%) of the trade accounts receivable balance was within Canfor's established credit terms.

### *(b) Liquidity risk:*

Liquidity risk is the risk that Canfor will be unable to meet its financial obligations as they come due. Canfor manages liquidity risk through regular cash-flow forecasting in conjunction with an adequate committed operating loan facility.

At December 31, 2014, Canfor had \$68.0 million drawn on its operating loans (2013 – \$74.6 million), and accounts payable and accrued liabilities of \$305.8 million (2013 - \$321.8 million) all of which are due within twelve months of the balance sheet date.

### *(c) Market risk:*

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in interest rates, foreign currency, energy and commodity prices.

#### *(i) Interest Rate risk:*

Canfor is exposed to interest rate risk through its current financial assets and financial obligations bearing variable interest rates.

Canfor utilizes interest rate swaps to reduce its exposure to interest rate risk associated with financial obligations bearing variable interest rates (see "Derivative Financial Instruments" section later in this document).

As noted earlier in this section (under "Employee Future Benefits"), Canfor is also exposed to interest rate risk in relation to the measurement of the Company's pension liabilities.

#### *(ii) Currency risk:*

Canfor is exposed to foreign exchange risk primarily related to the US dollar, as Canfor's products are sold principally in US dollars. In addition, Canfor holds financial assets and liabilities primarily related to New South Companies Inc. based in South Carolina, in US dollars.

A portion of the currency risk associated with US dollar denominated sales is naturally offset by US dollar denominated expenses. Part of the remaining exposure is at times covered by foreign exchange collars that effectively limit the minimum and maximum Canadian dollar recovery related to the sale of those US dollars (see "Derivative Financial Instruments" section later in this document).

(iii) *Commodity price risk:*

Canfor is exposed to commodity price risk related to the sale of lumber, pulp and paper. From time to time, Canfor enters into futures contracts on the Chicago Mercantile Exchange for lumber and forward contracts direct with customers for pulp. Under the Price Risk Management Controls Policy, up to 15% of lumber sales and 5% of pulp sales may be sold in this way.

(iv) *Energy price risk:*

Canfor is exposed to energy price risk relating to purchases of natural gas and diesel oil for use in its operations.

The exposure may be hedged up to 100% through the use of floating to fixed swap contracts or option contracts with maturity dates up to a maximum of three years. In the case of diesel, Canfor uses Brent oil and WTI oil contracts to hedge its exposure (see "Derivative Financial Instruments" section later in this document).

### ***Derivative Financial Instruments***

Subject to risk management policies approved by its Board of Directors, Canfor, from time to time, uses derivative instruments, such as forward exchange contracts and option contracts to hedge future movements of exchange rates and interest rates and futures and forward contracts to hedge commodity prices and energy costs. See section "Financial Requirements and Liquidity" for details of Canfor's derivative financial instruments outstanding at year end.

### ***Earnings Sensitivities***

Estimates of the sensitivity of Canfor's pre-tax results to currency fluctuations and prices for its principal products, based on 2015 Business Plan forecast production and year end foreign exchange rates, are set out in the following table:

(millions of Canadian dollars)	Impact on annual pre-tax earnings
SPF lumber – US\$10 change per Mfbm <sup>38, 39</sup>	\$ 43
SYP lumber – US\$10 change per Mfbm <sup>38, 39</sup>	\$ 13
Pulp – US\$10 change per tonne <sup>38, 39, 40</sup>	\$ 10
Canadian dollar – US\$0.01 change per Canadian dollar <sup>40, 41</sup>	\$ 22

<sup>38</sup> Based on sales of Canfor-produced product including 100% of the production from Scotch Gulf and Beadles & Balfour.

<sup>39</sup> Excluding impacts of exchange rate, freight, discounting, potential change in fibre costs and other deductions.

<sup>40</sup> Includes 100% of CPP1.

<sup>41</sup> Represents impact on operating income as no outstanding US dollar denominated debt at December 31, 2014. Decrease of US\$0.01 per Canadian dollar results in an increase to pre-tax annual earnings and an increase of US\$0.01 per Canadian dollar results in a decrease to pre-tax annual earnings.

### **Government and Other Regulations**

Canfor is subject to a wide range of general and industry-specific environmental, health and safety, building and product standards and other laws and regulations imposed by federal, provincial and local authorities, including those governing the use, storage, handling, generation, treatment, emission, release, discharge and disposal of certain hazardous materials and wastes, the remediation of contaminated soil and ground water, the use and design values of the Company's products and the health and safety of employees. Further, certain agreements and contracts relating to the ownership or transfer of forestry tenures and licenses are subject to review by applicable regulatory bodies. If Canfor is unable to extend or renew a material licence or permit required by such laws, any transfer is challenged by a regulatory body, or if there is a delay in renewing any material approval, licence or permit, Canfor's business, financial condition, results of operations and cash flows could be materially adversely affected. Future events such as any changes in these laws and regulations or any change in their interpretation or enforcement, or the discovery of currently unknown conditions, may give rise to additional expenditures or liabilities.

## **Labour Agreements and Competition for Professional Skilled Labour**

Canfor ratified new five year collective agreements with the USW (United Steelworkers) in late 2013, with terms expiring on June 30, 2018. The Company's collective agreement with the PPWC (Pulp, Paper and Woodworkers of Canada) expires in June 2014 for its Mackenzie lumber operation but will be automatically extended for five years on the same terms as the USW collective agreement ratified in 2013. Canfor's collective agreement with Unifor for its Grande Prairie lumber operation was ratified in late 2014 and expired September 30, 2017. In addition, CPPI's collective agreements with the CEP and PPWC have terms expiring on April 30, 2017. Any inability to negotiate acceptable contracts with the unions as they expire could result in a strike or work stoppage by the affected workers and increased operating costs as a result of higher wages or benefits paid to unionized workers.

Market conditions may cause shortages of both professional and skilled labour, which could have an adverse impact on the operation and management of Canfor's facilities.

## **Maintenance Obligations and Facility Disruptions**

Canfor's manufacturing processes are vulnerable to operational problems that could impair its ability to manufacture its products. Canfor could experience a breakdown in any of its machines, or other important equipment, and from time to time, planned or unplanned maintenance outages that cannot be performed safely or efficiently during operations must be conducted. Such disruptions could cause a significant loss of production, which could have a material adverse effect on Canfor's business, financial condition and operating results.

## **Mountain Pine Beetle**

As noted earlier in this document (Section (iv) of the Overview of 2014), timber affected by the Mountain Pine Beetle remained the focus for Canfor harvesting activities in BC as it has been for the past decade and will continue to be in 2015 for many of the operations. The focus on salvage harvesting and achievement of required harvest partitions will have an upward pressure on harvesting costs, as a result of smaller piece sizes, lower volumes per hectare and increasing haul distances. These will be offset somewhat by the transition to green or mixed stands (lower cost and/or higher quality) in some areas as partitions start to be removed or become less constraining and by uplifted harvest levels in others. The impact of the infestation on Canfor's operations continues to be manageable in the short term and the Company has taken steps to minimize its exposure to reductions in annual allowable harvests and to ensure a sufficient supply for its existing operations.

In Alberta, the Mountain Pine Beetle infestation is still significantly less wide-spread than in the BC Interior, and detection surveys in 2014 indicated that the rate of spread has declined. The largest and most successful beetle populations are found in the West Central and Northwestern parts of the Province but an accelerated harvest of susceptible pine on the Canfor FMA area since 2009 has helped contain the spread there. Pine mortality in areas north of the Peace River, including the Canfor quota area, on the other hand, has been extensive and harvesting objectives are now focused on salvage rather than spread prevention. The significant AAC increase approved for the quota area has maximized the opportunity to harvest infected pine stands before significant reduction in log quality occurs. In addition, the Alberta government has committed funds for the rehabilitation of dead pine stands that have not been harvested due to merchantability limitations. In 2014 Canfor initiated a project on the FMA area under the MPB Rehabilitation Program that will result in the reforestation of approximately 450 hectares of infested area. The project includes a significant research component that will help forest practitioners determine optimal rehabilitation treatments in MPB killed stands that have not been subject to commercial harvesting.

## **Residual Fibre Revenues**

Wood chips are a residual product of Canfor's lumber manufacturing process and are primarily sold to CPPI. These chips are the principal raw material utilized by CPPI in its pulp manufacturing operations. Canfor has a Chip Supply Agreement with CPPI, which contains a pricing formula that currently results in CPPI paying Canfor a price for wood chips based on pulp markets and CPPI's product mix. In 2014, Canfor provided approximately 59% of CPPI's chip requirements. Following the sale of the Taylor Pulp Mill to CPPI on January 30, 2015, the Company anticipates providing approximately 62% of CPPI's chip requirements. If market conditions caused CPPI to cease pulp operations for an extended period of time, Canfor would have a limited market for its chip supply and this could affect its ability to run its sawmills economically. Similarly, if lumber market conditions were such that Canfor is unable to provide the current volume of chips to CPPI as a result of sawmill closures, whether temporary or permanent, CPPI's financial results could be materially affected.

Bark hog is a residual product of Canfor's lumber manufacturing process. Bark hog has exhibited increasing value to Canfor over the past several years. It is utilized in Canfor's bark-fueled thermal oil energy systems to dry lumber and is sold predominately to Pulp customers, including CPPI, to be used in the generation of steam to manufacture power and heat.

Currently, sales of sawdust and shavings are made primarily to other customers and the demand is increasing and robust. Canfor is constructing two Pellet Plants in Fort St. John and Chetwynd to enhance fibre utilization in northern BC.

### **Softwood Lumber Agreement**

Canadian softwood lumber exports to the US are currently subject to export taxes under the Softwood Lumber Agreement ("SLA") which has been in place since October 2006. Export taxes are paid by Canadian softwood exporters on US lumber exports when the four-week average Random Lengths Framing Lumber Composite price is below US\$355/Mfbm. The SLA includes a "Surge Mechanism", which increases the export tax rate for the month by 50% when the monthly volume of exports from a region exceeds a certain "Trigger Volume" as defined in the SLA. Canfor did not pay any export taxes under the SLA in 2014.

Both Canada and US have rights under the SLA to terminate the agreement. In order to terminate, the US must provide a six month notice period, and cannot launch a new countervailing duty ("CVD") or anti-dumping duty ("ADD") investigation for 12 months after termination. Canada may terminate at any time with six months' notice. Any early termination of the SLA would likely result in the US initiating a new CVD and ADD investigation, potentially leading to duties imposed on the Canadian lumber producers, including the Company.

In January 2012, Canada and the US agreed to a two year extension to the SLA extending the expiry of the agreement to October 2015. Discussions on the upcoming SLA expiry have begun between Canada and the US with Canada's expectation that the current SLA be renewed or be allowed to expire without replacement. The outcome of these discussions is uncertain and could result in significant impacts the Company's US lumber exports.

### **Stumpage Rates**

The BC government introduced a Market Pricing System ("MPS") for the BC Interior on July 1, 2006. On July 1, 2010 the Ministry of Forests and Range (the "Ministry") implemented changes to the interior market pricing system for timber, and from a stumpage distribution perspective, transitioned over two years to a system more sensitive to market forces such as lumber market pricing and competition for supply of logs through the BC Timber Sales program, both of which could have a material impact on stumpage rates and Canfor's business. These changes dealt with issues raised by the MPB epidemic and included the introduction of "stand-as-a-whole" pricing with cruise-based billing for MPB damaged timber. For stands with 35% or more MPB damaged timber a single stumpage rate is established with billing based on the cruise rather than scaling. For these stands, determination of log grades is no longer necessary. An impact of these changes is to increase the overall market sensitivity of interior timber pricing and to improve the utilization of low value material. These changes are consistent with the 2006 SLA.

Canfor is actively participating in discussions on MPS with the Ministry, which is scheduled for its ninth annual update on July 1, 2015. Further changes to the BC market driven stumpage system and resultant stumpage rates could have a material impact on Canfor's business and the BC forest products industry.

The Alberta government is currently reviewing their provincial stumpage rates (timber dues) and a possible adjustment to the general rate of timber dues could occur sometime in 2015.

### **Transportation Services**

Canfor relies primarily on third parties for transportation of its products, as well as delivery of raw materials, a significant portion of which are transported by railroad, trucks and ships. If any of Canfor's third party transportation providers were to fail to deliver the raw materials or products or distribute them in a timely manner, Canfor may be unable to sell those products at full value, or at all, or unable to manufacture its products in response to customer demand, which could have a material adverse effect on Canfor's financial condition and operating results. In addition, if any of these third parties were to cease operations, suffer labour-related disruptions, or cease doing business with Canfor, the Company's operations or cost structure may be adversely impacted. Transportation services may also be impacted by seasonal factors, which could impact the timely delivery of raw materials and distribution of products to customers and have a resulting material adverse impact on Canfor's financial condition and

operating results. As a result of increased government regulation on truck driver work hours and rail capacity constraints access to adequate transportation capacity has at times been strained and could affect Canfor's ability to move its log, lumber and wood chips at market competitive prices.

### **Wood Dust Management**

Following two sawmill explosions at non-Canfor sawmills in the BC Interior, the wood products industry and government regulators have been actively addressing the risks posed by wood dust in manufacturing facilities. Specifically, Canfor has taken extensive steps to mitigate the risks of a combustible dust incident in our facilities, including significant capital investment, a formalized wood dust control program, and extensive employee training. Regulatory agencies across the Province of British Columbia, including WorkSafeBC, BC Safety Authority, and the Office of the Fire Commissioner have implemented various regulatory initiatives in response to these explosions. Additional regulatory initiatives, up to and including stop work conditions within the industry, could be a possibility.

## **OUTSTANDING SHARE DATA**

At February 4, 2015, there were 135,376,993 common shares issued and outstanding.

## **DISCLOSURE CONTROLS AND INTERNAL CONTROLS OVER FINANCIAL REPORTING**

The Company has established disclosure controls and procedures to ensure that information disclosed in this MD&A and the related financial statements was properly recorded, processed, summarized and reported to the Board of Directors and the Audit Committee. The Company's chief executive officer ("CEO") and chief financial officer ("CFO") have evaluated the effectiveness of these disclosure controls and procedures for the year ending December 31, 2014, and have concluded that they are effective.

The CEO and CFO acknowledge responsibility for the design of internal controls over financial reporting ("ICFR"), and confirm that there were no changes in these controls that occurred during the year ended December 31, 2014 which materially affected, or are reasonably likely to materially affect, the Company's ICFR. Based upon their evaluation of these controls for the year ended December 31, 2014, the CEO and CFO have concluded that these controls are operating effectively.

Additional information about the Company, including its 2014 Annual Information Form, is available at <a href="http://www.sedar.com">www.sedar.com</a> or at <a href="http://www.canfor.com">www.canfor.com</a> .
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