FINAL TRANSCRIPT

Canfor Corporation

Canfor and Canfor Pulp Fourth Quarter Analyst Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Canfor and Canfor Pulp Fourth Quarter Analyst Call. A recording and transcript of the call will be available on Canfor's website.

During the call, Canfor and Canfor Pulp's Chief Financial Officer will be referring to a slide presentation that is available in the Investor Relations section of the Company's website.

Also, the companies would like to point out that this call will include forward-looking statements, so please refer to the press releases for the associated risks of such statements.

I now would like to turn the conference over to Mr. Don Kayne, Canfor and Canfor Pulp's Chief Executive Officer. Please go ahead, Mr. Kayne.

Don Kayne — Chief Executive Officer, Canfor Corporation and Canfor Pulp, Canfor Corporation

Okay. Thank you, Operator, and good morning, everyone. Thank you for joining the Canfor and Canfor Pulp Q4 2018 results conference call.

I'll make a few comments before I turn things over to Alan Nicholl, our Executive VP of Canfor Pulp Operations and Chief Financial Officer of Canfor Corporation and Canfor Pulp. Alan will provide a more detailed overview of our performance in Q4.

Joining Alan and I today are Kevin Pankratz, Senior VP of Sales and Marketing, and Stephen Mackie, Senior Vice President of Canadian Operations.

I would also mention that in January, Kevin Pankratz assumed the responsibility for the sales and marketing of our pulp group, in addition to our lumber group.

And Brian Yuen, who has had several years of increasing responsibilities in our pulp group, was appointed Vice President of Pulp and Paper Sales and Marketing.

Before I discuss the fourth quarter, I'd like to make a couple of comments about 2018. Canfor Pulp reported record operating income of $247 million and a return on invested capital of 37 percent. Canfor Corporation reported operating income of $609 million, the highest in over 10 years and a return on invested capital of 19 percent.

These results were achieved in a year which featured extreme transportation challenges, extreme weather events, significant forest fires, log supply constraints, significantly higher log costs, and market volatility. Despite these many challenges, our people performed exceptionally well under these difficult circumstances.

During the year, we completed our $100 million investment in green energy upgrades at Taylor and Northwood. In addition, our $350 million board foot, US$125 million organic capital program at our US South operations remains on track to be substantially completed by the end of 2019. The spending includes large sawmill rebuilds at Camden, South Carolina and Moultrie, Georgia; a new planer at Fulton, Alabama; and continuous dry kilns at Darlington, South Carolina and Urbana, Arkansas.

Now turning to the fourth quarter. Earnings were significantly impacted by a sharp decline in market pricing for both lumber and pulp, with a consolidated operating loss of $79 million. For Canfor Pulp, the Company had a challenging quarter, generating operating income of $16 million, which was down significantly from the third quarter, principally due to lower shipment levels, reflecting repair work on our recovery boiler at Northwood and a natural gas pipeline explosion near Prince George.

Total scheduled and unscheduled downtime reduced our NBSK production by 90,000 tonnes. Global Softwood Kraft pulp markets are projected to remain steady throughout the first half of 2019, reflecting a forecast increase in demand in China, and reduced supply due to the traditional spring maintenance period for our pulp mills.

Moving to our lumber business. We reported an operating loss of $88 million. Lumber production was down significantly in the quarter, reflecting a series of production curtailments in British Columbia and inclement weather in the US South, which impacted log inventories, log profiles, and overall manufacturing costs.

We have further curtailed our BC operations in Q1 by 90 million feet across our system, primarily at Vavenby, Houston, and Mackenzie, due to continued log supply constraints, significantly increased log costs, and market conditions. We will continue to review our operating rates as market conditions warrant.

Current markets have been challenging. However, our outlook is for pricing to stabilize and gradually increase, which we have begun to see in early 2019. We expect a normal seasonal pickup in demand to coincide with relatively low inventory and supply chains and have seen strong increases in both our retail and builder business.

Demand from offshore markets continues positive after a strong Q4 and expected to remain solid through the first quarter of the year.

Overall supply continues to be impacted in BC, with an estimated 1 billion board feet of announced temporary or permanent capacity reductions.

We are encouraged that a memorandum of agreement for a new five-year term has been reached with the USW. The agreement includes seven of Canfor's certified mills in British Columbia. The USW will be conducting ratification votes on the agreement over the coming weeks.

In addition, we have three mills represented in the negotiation process being led by the Interior Forestry Labour Relations Association. We remain optimistic that a settlement will be reached between the Association and the USW.

Transportation networks have been generally good, but we are seeing increased challenges due to significant cold weather in parts of western Canada.

With respect to our previously announced greenfield mill in Washington, Georgia, we are deferring any decision on this project to the end of 2019. This decision is based on challenging market conditions and inflationary cost pressures.

In terms of Softwood Lumber Agreement, there are currently no negotiations underway. In early December, a NAFTA panel was formed that includes three Canadian and two American panelists. We'll be following the decisions of the panel very closely.

Finally, we are anticipating closing the VIDA transaction shortly. We are extremely excited about our investment in Europe, as it further diversifies our business from both a geographic and product profile standpoint—an earnings profile that is much more consistent than what we typically see here in North America. This purchase supports our long-term strategy of growing our high-value and non-commodity lumber businesses and further positions the Company for strong, stable earnings in the future.

I will now turn the call over to Alan Nicholl, who will provide an overview of our financial results.

Alan Nicholl — Chief Financial Officer and Executive Vice President, Finance and Canfor Pulp Products Inc., Canfor Corporation

Thank you, Don, and good morning, everyone.

My comments will focus principally on our financial performance for the fourth quarter by reference to the previous quarter. And full details of our results are contained in the Canfor Pulp and Canfor news releases, both of which were issued yesterday afternoon.

As always, you'll find an overview slide presentation on both the Canfor and Canfor Pulp websites in the Investor Relations section under Webcasts. And the presentation highlights consolidated unsegmented results, and I'll be referring to this presentation during my comments.

For the fourth quarter of 2018, Canfor reported a shareholder net loss of $52 million, or $0.42 a share, down from net income of $125 million, or $0.98 a share, reported for the third quarter, and net income of $132 million, or $1.02 a share, reported for the fourth quarter of 2017.

On Slide 3 of our presentation, we highlight various nonoperating items, net of tax and noncontrolling interests, which affect the comparability of our results between the quarters.

In the fourth quarter of 2018, these items totalled $24 million, the largest being a $29 million expense related to countervailing and anti-dumping duty deposits.

After adjusting for these nonoperating items, the shareholder net loss was $28 million, or $0.23 a share, for Q4, compared to net income of $157 million, or $1.23 a share, for the third quarter.

As highlighted on Slide 6 of our presentation, the lumber segment recorded an operating loss of $88 million for Q4, down $237 million from the previous quarter.

After adjusting for CVD and ADD, as highlighted on Slide 5, as well as an inventory write-down of $37 million at year-end, the Q4 operating loss was $11 million, down 203 million from a similarly adjusted operating income of $192 million in Q3.

The major variance reflected substantially lower Western SPF and Southern Yellow Pine lumber prices, which translated into materially lower unit sales realizations. These declines were accompanied by higher unit log costs in Western Canada and lower production and shipments.

The significant price erosion reflected slowing North American demand, coupled with excess inventory in the supply chain. The North American Random Lengths Western SPF price averaged US$327 per 1,000 board feet, down some 32 percent from the previous quarter, while prices for other grades saw a more moderate correction.

Southern Yellow Pine sales realizations reflected a 6 percent decline in the benchmark 2x4 price, but declines in the wider width dimensions were more pronounced, some of which was attributable to seasonal factors.

As a result of these weaker market conditions, as well as log supply constraints and elevated log costs, the Company took approximately 100 million board feet of curtailment at its BC lumber operations in Q4, and this was the primary contributing factor accounting for a 12 percent decline in production and a 14 percent decline in shipment volumes in the current quarter.

The higher unit manufacturing costs in Q4 reflected a 10 percent increase in Western Canadian log costs resulting mainly from the timing of market-based stumpage increases, higher purchased wood costs, and log supply shortages, as well as lower productivity in both regions, reflecting both the impact of curtailments in BC, as well as weather-related challenges at the Company's US site operations. Log costs in the US South remained stable through the quarter.

Canfor's pulp and paper segment comprises the results of Canfor Pulp Products Inc. As highlighted on Slide 7, the Company reported net income of $14 million, or $0.21 a share, for the fourth quarter of 2018, compared to net income of $43 million, or $0.66 per share, for the previous quarter.

As Slide 7 highlights, the Q4's financial results reflected the continuation of the scheduled maintenance outage at Northwood from the previous quarter. The previously announced repairs to Northwood's No. 5 recovery boiler are on scheduled downtime, taken as a result of a third-party natural gas pipeline explosion in Prince George just early in the quarter; and to a lesser extent, several other operational challenges during the quarter, all of which reduced NBSK pulp production by approximately 90,000 tonnes.

In addition, BCTMP production was impacted by a seven-day curtailment in late December as a result of reduced residual fibre availability following various sawmill curtailments in the region. At the end of December and into January, the Company experienced kiln-related operational disruptions at two of its NBSK pulp mills. While these challenges have now been resolved, the related production loss was approximately 20,000 tonnes early in the first quarter of 2019.

Unit manufacturing costs in Q4 were significantly higher than the previous quarter as a result, primarily of the lower Q4 production, as well as higher related maintenance, energy, and chemical costs associated with the unscheduled outages, particularly at Northwood.

Sales realizations were broadly in line with the previous quarter, as weaker US dollar list prices to China were partially offset by higher list prices to North America, and proportionately higher shipments to the US and, to a lesser extent, Europe.

Operating income for the Company's paper segment in Q4 was $4 million, up slightly from the previous quarter, reflecting solid operating performance at the Company's PG paper machine and steady paper unit sales realizations.

Capital spending for the fourth quarter totalled approximately $140 million and included approximately $100 million for the lumber business and $40 million in Canfor Pulp. In 2018, capital spend totalled just over $400 million and comprised $272 million for lumber and $121 million for pulp.

As Don mentioned, the Company continues to execute on its US$125 million organic growth program, targeting an additional 350 million board feet of production in the US South, and we remain on schedule to have this program substantially completed by the end of this year. Including organic growth, our 2019 forecasted capital spend is approximately $300 million, with approximately $190 million for lumber and $110 million for pulp.

At the end of the year, Canfor, excluding Canfor Pulp, had cash of $246 million and drawn debt of $408 million, with $450 million of available liquidity under its operating line, as well as additional C$100 million and US$100 million term debt facilities, both of which are currently undrawn. All of our operating and term credit facilities now go out to 2024 or later.

It's currently contemplated that the VIDA acquisition price will be paid from the Company's cash on hand, the additional term debt facilities, and the balance from the operating line.

We are currently forecasting Canfor's net debt to total capitalization at the end of Q1 to be approximately 30 percent, when we typically have our peak log inventories. This is significantly below the level at which any financial covenants would kick in. And while these debt levels are relatively high by Canfor's standards, we anticipate a healthy reduction in the second quarter as our Western Canadian log inventory is consumed during spring breakup.

Canfor Pulp had net cash of $7 million, with available liquidity of $99 million at the end of the year. Net debt to total capitalization, excluding Canfor Pulp, was 7 percent and on a consolidated basis, was 6 percent.

Yesterday, Canfor Pulp's Board of Directors approved the continuance of a quarterly dividend of $0.0625 a share for the fourth quarter.

And finally, by way of information, our earnings in 2019 will reflect the transition to new lease accounting standards, and as a result, our EBITDA is projected to increase by approximately $13 million for lumber and $1 million for pulp.

And with that, Don, I'll turn the call back over to you.

Don Kayne

All right. Thanks, Alan. So, Operator, we're now ready to take questions from the analysts.

Q&A

Operator

Thank you, Mr. Kayne. Ladies and gentlemen, we will now take questions from analysts as stated. If you have a question, please press *, 1 on your telephone keypad. If you are using a speakerphone, please lift your receiver and then press *, 1. And if, at any time, you wish to cancel your question, please press *, then 2. Please press *, 1 now if you have any questions. There may be a brief pause while we wait for participants to register their questions. Thank you for your patience.

And your first question will be from Sean Steuart at TD Securities. Please go ahead.

Sean Steuart — TD Securities

Thanks. Good morning, guys. Lots to get through.

Don Kayne

Good morning, Sean.

Alan Nicholl

Good morning, Sean.

Sean Steuart

Just so I understand the Western Canadian lumber production this quarter—you took 100 million board feet of downtime related to markets and fibre availability constraints. Your production was down 130 million board feet sequentially in Western Canada. Is the rest just holiday shuts? And that's the component we would expect to come back in Q1? Is that the right way to think of it?

Don Kayne

Yeah. For sure, Sean. Yeah, no. For sure, Sean. Maybe I'll get Stephen to give you a bit of an update on our current and forward planning here around the shutdowns.

Stephen Mackie — Senior Vice President, Canadian Operations, Canfor Corporation

Yeah. Sure. Thanks, Don, and good morning, Sean. Just in terms of the gap between the 100 million capacity reduction and the 30 million—the incremental 30 million that we were off there, some of that was just operational challenges related to the fourth quarter—winter weather, log profile, delivery issues, as well as, as we work through the USW negotiations, and some operating rate changes in terms of labour disruptions that were associated with those negotiations.

Sean Steuart

Okay. So the tough weather extending into Q1—if I'm thinking about 90 million board feet tied to weak markets and log availability issues, there could be incremental curtailments on top of that related to weather, that sort of stuff?

Stephen Mackie

In terms of the forecast for Q1, I think that what I would say there, Sean, is that we did take additional capacity reductions, as you say, for the 90 million. We have experienced some extreme weather conditions as we work our way through Q1 here, that have had some impacts. And we've only just recently concluded and are pleased, as Don indicated in his comments, with the memorandum of agreement we've signed that impacts the majority of our USW-certified mills. So we're hoping that a lot of that will be behind us as we work through the balance of Q1.

Sean Steuart

Okay. I think you said Western Canadian log costs were up 10 percent sequentially. Can you give us a sense of you're expecting your log costs to trend over the short to midterm in Western Canada the next few quarters?

Stephen Mackie

Sure, Sean. Stephen here again. I'll tackle that one. Sorry. We did see 10 percent, as Alan referenced, in the quarter-over-quarter increase in Q4. Really, we're expecting those trends to kind of continue through the balance of 2019, comparative to what we saw in 2018. Q4 numbers were disproportionately a little bit high, in terms of that increase, as we prioritized shipments of some purchased wood and deferred quota deliveries to capitalize on a stumpage reduction that was coming due here in January.

As you know, we are anticipating lower stumpage for the first half of 2019, as a result of the market conditions that we experienced in the back half of 2018, but then stumpage will increase again in the second half '19. So all in all, we do expect continued upward pressure on log costs in British Columbia, and we would expect that trend to continue until we see some material rationalization and permanent capacity reductions.

Sean Steuart

Okay. And maybe to that point, Stephen, you guys won't reference potential for permanent shuts, I suppose, on this call. But your thoughts on how much more supply in the Interior needs to come out, permanently, across the industry to rightsize the production base to the fibre resource going forward? You have any thoughts there?

Don Kayne

Yeah. Sean, it's Don. And just on that, as we've kind of talked about before, our view has been and continues to be, in total, that we believe there has to be approximately seven to eight mills that need to go away, about 2 billion overall, roughly, in terms of production. So depending on the size of the mill, it gives you a bit of a sense overall.

With what we've seen so far between—like I mentioned, I think, in my comments, maybe I didn't—but in terms of the permanent shuts and what we've seen so far, is it points to about $1 billion of that. A lot of that's not permanent, though, right? So we still think there's a fair bit of rationalization that has to take place.

And certainly, with the way things are looking right now and the challenges of British Columbia, we think that might be, maybe, advanced, and we may see some of that. Not ourselves, but I think we'll see that across the industry more in, probably, 2019 than we would've originally thought.

Sean Steuart

Okay. I'll get back in the queue. Thanks very much.

Don Kayne

All right. Thanks, Sean. See you.

Sean Steuart

Yep.

Operator

Thank you. Next question will be from Ketan Mamtora from BMO. Please go ahead.

Ketan Mamtora — BMO Capital Markets

Good morning, Don, Alan.

Alan Nicholl

Good morning, Ketan.

Ketan Mamtora

First question, I just want to talk a little bit about and get your thoughts on housing. Obviously there are a lot of crosscurrents going on right now and the back half of last year. Housing activity slowed, but in the last couple of months, we've also seen rates come down a lot, and we've had affordability issues last year. So can you talk about what you guys are seeing right now in terms of activity? And your expectations for the spring season?

Don Kayne

Okay. Go ahead.

Kevin Pankratz — Senior Vice President, Sales and Marketing, Canfor Corporation

Yeah. Sure. It's Kevin Pankratz here. And you're right, we did see a little bit of a pause in Q4 on housing. But our expectation is that housing's going to come in at around 1.26 billion for the year. I think we'll get the final results here next week on February 26, when we get the actual confirmation. But that is our expectation. And for 2019, based on our intel and the conversation with customers, we expect to see a modest pickup for 2019, maybe approaching 1.3 billion.

Don Kayne

Ketan, maybe one thing to add, Kevin, to that is—just because it's interesting and it's actually a bigger consumer of lumber, is on the retail side.

Kevin Pankratz

Right.

Don Kayne

And we—through the back half of the year, and we're seeing that continue into Q1 also—is some very positive numbers in terms of the DIY side of the business or retail side of the business with the big boxes—

Ketan Mamtora

Uh-huh. Yep.

Don Kayne

—and you know the Home Depot and Lowe's and those types, and that's encouraging. And it's been significant increases. They're more than we've seen in past years. So that gives us a lot of—a fair bit of encouragement in terms of trying to gauge consumer confidence—

Ketan Mamtora

Right.

Don Kayne

—and consumer sentiment going forward. And so, I guess, that's maybe the only thing I would add to that, in addition to the comments that Kevin responded to around the home building side.

Ketan Mamtora

Got it. That's very helpful. Can you also talk a little bit about offshore demand in China, both in lumber as well as in pulp?

Don Kayne

Yeah. Well, maybe—I don't know if, Kevin, you can—why don't you answer that one—

Kevin Pankratz

Sure.

Don Kayne

—on the lumber? And maybe Brian can talk about the pulp side?

Kevin Pankratz

Sure. On the lumber side here, we've actually seen some pretty good demand here, really picking up in Q4, where we've had significant increase in our shipments starting, really, being impacted in November and December. And based on our current order file, we have that trend continuing well into Q1 and into April, so pretty strong demand in order files in place for China from the lumber perspective.

And, Brian, maybe just a comment on the pulp side?

Brian Yuen — Director, Asia Pulp Sales, Canfor Corporation

Sure, Kevin. Good morning. Yes. On the China side, we saw the market bottom out at the end of 2018. Since then, we've seen that the market has stabilized. And in fact, as China comes back to rebuild their pulp stocks, we've seen an uptick in softwood demand. So we anticipate that moving forward—optimistic that prices will be trending up.

Ketan Mamtora

Got it. That's very helpful. And then one last, kind of cleanup question—this is regarding the duties. So we saw a pretty sharp drop in Western SPF prices. Volumes of SPF was also down quite a bit, yet the duties were down only 2 million quarter over quarter. What am I missing?

Don Kayne

Alan, why don't you—

Alan Nicholl

Yeah. Good morning. Yeah. Ketan—yeah. So it's a fair question. So the duties in Q4 reflected a higher ADD rate that applied not just to the quarter, but actually to the 18-month period under review, and that was largely a factor of dynamics in BC, principally the higher cost and the lower pricing. We did offset that, Ketan, as you probably gathered, by shipping more offshore. And obviously, the production curtailments reduced the amount that we shipped in the quarter as well. So hopefully, that helps answer your question.

Ketan Mamtora

It does. No, that's very helpful. I'll turn it over. Good luck in 2019.

Alan Nicholl

Yeah. Thanks very much, Ketan.

Don Kayne

Thank you.

Operator

Thank you. At this time, Mr. Kayne, we have no further questions, so I would like to turn the call back over to you, sir.

Don Kayne

All right. Thanks, Operator. And thanks to all of you that were on the call. We appreciate your interest in Canfor, and we'll talk to you at the end of Q1.

Operator

Thank you, sir. Ladies and gentlemen, this does indeed conclude your conference call for today. Once again, thank you for attending. And at this time, we do ask that you please disconnect your lines. Enjoy the rest of your day.