FINAL TRANSCRIPT

Canfor Corporation

Canfor and Canfor Pulp Quarter One 2019 Results Conference Call

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PRESENTATION

Operator

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

During this 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 risk of such statements.

I would now like to turn the meeting 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

Thank you, Operator, and good morning, everyone. Thanks for joining the Canfor and Canfor Pulp Quarter One 2019 Results Conference Call.

I'll make a few comments before I turn things over to Alan Nicholl, 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, our Senior Vice President of Sales and Marketing; and Stephen Mackie, Senior Vice President of Canadian Operations.

The first quarter was a challenging one, as severe winter weather dominated our key production regions and end-use markets. These poor weather conditions impacted operations, our log costs, transportations systems, and customer demand for both lumber and pulp. That said, our pulp business ran better as the quarter progressed, after suffering a number of issues early in the year.

The maintenance shut at Intercon was completed in early Q2 and now, the focus is on improving productivity and a return to stronger income levels.

During the quarter, the Company successfully completed construction of its $65 million Turbo Generator turbine, which will make Canfor Pulp more self-sufficient for power and provide additional green energy available to sell to the grid. Global softwood Kraft pulp markets are projected to remain steady through the second quarter, with inventory levels forecast to move towards a more balanced range in the latter half of 2019, with an improved pricing outlook.

Moving to lumber. Our BC SPF business saw continued weakness, but our Alberta, US, and European operations generated solid financial returns. We successfully closed the Vida acquisition at the end of February, and are already seeing the benefits of their more consistent and high-margin returns.

Lumber production was up in the US South but remained steady in British Columbia, reflecting continuing curtailments, most notably at Vavenby, which was down for six weeks. Last week, we announced a further 100 million board feet of curtailments in British Columbia as weak market pricing and high log costs materially impacted our BC returns.

We will continue to monitor market conditions and take necessary additional steps as required. We expect the July 1st market-based stumpage adjustment to put severe additional pressure on British Columbia production levels, which could result in additional curtailments across the industry, given the increasingly challenging competitive environment.

Transportation networks were impacted in the quarter due to poor winter weather. However, the impact was not as severe as last year, and we expect additional inventory reductions as weather conditions improve.

Looking ahead, we expect lumber prices to show modest improvement over the next several months in response to tightening of supply, due to recent curtailments and as a typically strong spring building season begins.

Demand from Asian markets was slowed somewhat early in the year as inventory levels increased, although we are seeing recent improvement in port shipments. Pricing has been relatively flat in China and is expected to remain flat and gradually increase in Q3 and Q4.

European markets were steady, having declined only a small amount from 2018 record levels, and will be flat to moderately lower for the coming quarter.

Looking ahead, we are excited about the upcoming closing on May 31st of the phased acquisition of Elliott Sawmilling, which will further grow our US South footprint to 2 billion feet annually, approximately 30 percent of our total production.

Overall, despite the challenging start to 2019, we expect gradual improvement throughout the year. Canfor will benefit from our improved geographic diversification, as well as our continued focus on specialty and high-value products.

And with that, I'll turn the call over to Alan, who will provide an overview of our financial results.

Alan Nicholl — Executive VP of Canfor Pulp Operations and Chief Financial Officer of Canfor Corporation and Canfor Pulp, Canfor Corporation

Thanks, Don, and good morning, everyone. As Don mentioned, the Canfor and Canfor Pulp quarterly results were released yesterday morning, and these results come together with our quarterly overview slide presentation in the Investor Relations section of the respective companies' websites.

In my comments this morning, I'll expand on a number of Don's points and also speak specifically to several quarterly financial highlights.

Our lumber segment reported an operating loss of $78 million for Q1, an improvement of 10 million from the previous quarter. Results included an additional inventory write-down of $39 million and a net duty expense of $36 million, as well as a onetime—one month of Vida's earnings that are included in our consolidated results. After taking account of the inventory write-downs and the duties, the operating loss was $3 million.

Lumber segment results continued to reflect challenging market conditions and elevated log costs in British Columbia. The Company took $95 million board feet of curtailment in BC in Q1 and additional reductions in Q2, as Don has already mentioned.

While average lumber prices saw a modest improvement over the previous quarter, partly in response to the curtailed supply, the well documented extreme wet weather seen across much of North America contributed to a slow start to the spring building season, resulting in higher inventories through the supply chain and significant downward price pressure experienced in March and into April.

Our US South and newly acquired European lumber businesses performed well in the quarter. In the case of the US South, this was despite the impacts of very wet weather on log supply and takeaway. With respect to our new European business, in our MD&A we have provided a preliminary internal benchmark price for the Vida product, reflected in Swedish krona per thousand board feet. This benchmark is indicative of the overall basket of lumber products produced by Vida, and as you will note, it has been much more stable than North American lumber prices over the last year.

In our pulp business, Canfor Pulp generated operating income of $18 million in the first quarter, with increased operational uptime more than offsetting materially lower quarter-over-quarter prices to China. While pulp production was impacted by previously announced kiln-related disruptions, and to a lesser extent, to the extreme weather and the curtailment of our Taylor mill, overall operating rates improved in the first quarter. Our Northwood pulp mill ran well in February and March, following the significant challenges experienced in the previous quarter.

Prices to China in Q1 reflected the sharp decrease in demand and a corresponding spike in inventory levels that we saw towards the end of 2018. After bottoming out in January, prices showed a modest recovery, but over the quarter, prices were down by about 12 percent. Sales realizations to North America and Europe fared somewhat better but came under pressure as the quarter progressed. And for Q2, overall pricing is anticipated to remain relatively steady, as inventory levels gradually return to a more balanced range through the remainder of the year.

Capital spending for the first quarter totalled approximately $75 million and included about 48 million for the lumber business and $26 million for Canfor Pulp. For 2019, we are currently anticipating total capital spending of $185 million and $95 million for Canfor and Canfor Pulp, respectively.

Reflecting the acquisition of Vida and our seasonal log inventory build in Western Canada, Canfor at the end of the first quarter had net debt of approximately $950 million and available liquidity of $340 million, excluding Canfor Pulp. We anticipate a reduction of net debt and improved liquidity in the second quarter as our Western Canadian log inventory is consumed during spring breakup.

Canfor Pulp ended the first quarter with $23 million drawn down on its operating line and available liquidity of $74 million. The Company has now moved back into a cash positive position in Q2.

And lastly, Canfor Pulp’s directors approved the continuance of a quarterly dividend of $0.0625 per share for the first quarter.

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

Don Kayne

Thanks very much, Alan. So with that, Operator, we'll turn it back to you for questions from analysts.

Q&A

Operator

Thank you. We will now take questions from financial analysts. 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. If at any time you wish to cancel your question, please press *, 2.

Please press *, 1 now if you have a question. There will be a brief pause while participants register for questions. Thank you for your patience.

Your first question is from Ketan Mamtora from BMO Capital Markets. Ketan, please go ahead.

Ketan Mamtora — BMO Capital Markets

Thank you. Good morning, Don, Alan.

Don Kayne

Hey. Good morning, Ketan.

Alan Nicholl

Good morning.

Ketan Mamtora

First question, and this is just a clarification. Did you say that you all are taking 100 million of economic downtime in the second quarter in the BC? Did I hear that correctly?

Don Kayne

Sorry, Ketan. Can you repeat that question? I couldn't hear that.

Ketan Mamtora

Oh, I'm sorry.

Don Kayne

There you go. That's—

Ketan Mamtora

Is this better?

Don Kayne

Yeah. That's better, much better.

Ketan Mamtora

I just wanted to clarify, did you just say that you all are continuing the downtime that you all took in Q1, and for Q2 it will be about 100 million board feet? Did I catch that correctly?

Don Kayne

With the one week at all the mills in British Columbia, except for WynnWood, it equates to about 100 million feet in total downtime.

Ketan Mamtora

Got it. That's helpful. And then second question on Vida. Is there any way for you to just give us at least sort of rough sense in terms of sales and EBITDA contribution in Q1 from Vida? I know it was only for one month, but if you can quantify in any way?

Don Kayne

We can't do that, for sure, Ketan. But what I can say is, in having spent some time with them and seeing some of the recent performance there, that it's in line with what we expected for sure, if not a little bit better, but certainly in line with what we expected.

Ketan Mamtora

I see. Okay. That's helpful. And then can you provide some thoughts on the recent policy initiative by the BC government regarding the caribou plan and Bill 22?

Don Kayne

Yeah. I mean, for sure. And I think it's early days on that at this stage of the game and certainly, we're all looking at some of the details of that closely because—but clearly, what that's mostly about is, certainly, the ability to transfer tenure between companies and within the Company. And so that's the main thing that we're working on right now. So we're trying to—we're just evaluating ourselves in terms of what that might be in terms of impacts on us. And we're not there yet on that.

So we're—but I will say, though, that if you think about, overall, just the competitiveness challenges that we face in BC, they're obviously severe. And they're all—we're working on all of those as a result of the imbalance of supply and demand in British Columbia. And with the reduction of AACs, a result of the beetle and then, clearly, you talked about Bill 22 and the OIC, and caribou and soft lumber, all those things that we're faced with, all those are things that we're looking at right now.

But I can also say, though, that we are working closely, as we have been all along, with government to try to figure out and look for solutions and how to deal with this going forward to ensure, ultimately—which we're all focused on, I think, as an industry—to get this industry in BC back in a competitive situation.

Ketan Mamtora

Got it. That's helpful colour. And then just one last question before I turn it over. Turning to the US South, we know that because of very wet weather, log costs were up quite a bit in Q1. But what are you seeing so far in Q2? Have those moderated? Or are you seeing some log cost inflation in the US South?

Don Kayne

Yeah. As we've mentioned, I believe before—yeah, as you state accurately, in Q1, with the weather situation and all the—particularly, the wet weather that we've seen, they were up in the first quarter more than we typically see. We do see that moderating over the balance of the year, and we would say, on average, we're probably going to end up about 2 percent, in that order of magnitude, in terms of price inflation on logs in the South.

Ketan Mamtora

Okay. That's very helpful. I'll turn it over. Thank you.

Alan Nicholl

Thanks, Ketan.

Operator

Thank you.

Don Kayne

Thanks, Ketan.

Operator

Your next question is from Sean Steuart from TD Securities. Sean, please go ahead.

Sean Steuart — TD Securities

Thanks. Good morning, everyone.

Don Kayne

Morning, Sean.

Sean Steuart

A few questions. I want to circle back on Vida. When you announced the deal, you'd indicated that 2018 EBITDA was at an annual run rate of, I think, about $145 million. You reference in the MD&A stable prices for Sweden specifically for lumber, but the wood market's international. They're European composite lumber price. They've shown some more pronounced weakness recently. And I guess what I'm trying to get at is, are you at—are you around that $145 million run rate right now? Or when you say it's meeting expectations, is it meeting expectations in the context of some broader price pressure in Europe?

Alan Nicholl

Yeah. Maybe I'll start off there, Sean, so I understand where you're coming from. I will tell you that March was very much consistent with that guidance, and it was a very strong month, as Don guided. Over the balance of the year, I think the prices absolutely are much more stable. There will be some decline here, to the point you mentioned. But we're still guiding, as I think we said in our press release, to very solid financial results for the year that clearly show the benefits of that more stable environment.

Sean Steuart

Okay. Thanks for that. North American demand, let's start with, I guess, the renovation segment. Are you seeing any headwinds there? And can you speak to broader volume growth assumptions into the US reno market that you're forecasting this year?

Don Kayne

I think just on that, I think, Sean, as we've mentioned before, and I think you're accurate there, is the R&R business has been a positive surprise for us the last several quarters. Looking forward, we think that will continue from our best guesstimate. And we had Home Depot actually in town, and Lowe's, all the guys here recently. And so from our standpoint, we're pretty consistent here. They're pretty consistent, and they expect it to be a solid year for them. So we're not seeing any headwinds at this point whatsoever from our standpoint, so.

Sean Steuart

Okay. So similar growth rates to what we've seen in recent years continuing?

Don Kayne

Yep.

Alan Nicholl

Yep.

Don Kayne

For sure.

Sean Steuart

Okay. And on the single-family new home construction side in the States, the slump we've seen, a lot of it feels like it's probably weather. How much of it do you think is weather versus structural headwinds, whether it's labour shortages? Land availability shortages? Yeah. Can you handicap the slump we've seen in recent months there how much do you think's weather versus more structural issues?

Don Kayne

Yeah. And I'll let Kevin talk about some of the details on that. But I mean, just overall, Sean, we've guided before, and I think we still believe that the demand's going to increase between 1 billion and 2 billion board feet annually overall. Now retail, as we mentioned, is going to be a big part of that, but on the housing side, there's no question that precipitation, everywhere we go, we hear more and more about that. I was down in the South last week and saw it firsthand, even in April, so it's definitely real.

I think the one number that—there's lots of different numbers to look at—but the one number we do look at, if you look at permits versus starts, there is a gap there. What gives us at least some comfort that as you look forward there there is some pent-up demand here that has to happen, And from what we've heard from our guys in the South—never mind customers from our own operations—that it has been a difficult situation getting to the job sites with the trucks and so forth.

And going forward, Kevin, you've had lots of conversations with some of the builders. What are they telling you?

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

Yeah. Yeah. I think to that point, Don, we are seeing a little bit more positive activity in the future for the balance half of the year. And a lot of it is, maybe more land will be developed for housing, which could be a potential headwind that we experience in Q1. So that would be a positive.

And the other ones we're actually seeing is a pretty dramatic increase in mortgage applications, which is the highest it's been in nine years, so another positive indicator. And of course, I think some of the affordability issues that were addressed in Q4, that overhang into Q1, played some role there, Sean. And with the easing of monetary policy there, that thing is going to support some of the affordability challenges that were always a bit of a potential headwind on housing.

Sean Steuart

Thanks for that detail. I'll get back in the queue.

Don Kayne

Yeah. All right. Thanks, Sean.

Kevin Pankratz

Yeah. Thanks, Sean.

Operator

Thank you. Ladies and gentlemen, as a reminder, should you have a question, please press *, followed by 1.

Your next question is from Paul Quinn from RBC Capital Markets. Paul, please go ahead.

Paul Quinn — RBC Capital Markets

Yeah. Thanks very much. Good morning, guys.

Don Kayne

Can't hear you, Paul.

Kevin Pankratz

Yeah. Good morning, Paul.

Paul Quinn

Is this better?

Don Kayne

Yeah. Better.

Paul Quinn

Okay. Good. Let's start on the pulp side. Just that Northwood Turbo Generator project—what's the financial contribution that you'll get from that going forward?

Don Kayne

Alan, you go.

Alan Nicholl

Yeah. So good morning, Paul. So cheers—I mean, we say $65 million, and we're actually under budget, which is good and heartening to see. (unintelligible) question, we're expecting north of $10 million annually from that project as our contribution.

Paul Quinn

Wow. Nice. Are you locked up in a long-term energy agreement with BC government over that? Or is that just the expectation from, I guess, reduced energy purchases?

Alan Nicholl

Yeah. So the project, clearly, is going to drive a lot of efficiencies in different areas, as well as provide us the opportunity to sell additional power over the grid. So it's a combination there, but we have contracts in place, yes.

Paul Quinn

Okay. And then, Alan, you seemed mildly optimistic on pulp markets, although I'm still seeing prices falling. Like I think you described it as somewhat stable. What gives you that confidence that it is actually stable going forward?

Alan Nicholl

Well, I chat to my sales guys regularly, Paul. But I mean, I think I'll maybe start, and then I'll pass over to Brian on that.

I mean, I think clearly, we see some challenges as we work through the inventories, particularly in China. And I think we have to accept that there will be a kind of moderation, if you will, of a price recovery over the next few months. But the outlook's certainly looking out to medium term and longer term, I think is still positive. And that give us solid grounds for optimism.

And then maybe I'll just ask Brian to expand a little bit more what we're seeing in terms of China specifically.

Brian Yuen — Director, Asia Pulp Sales, Canfor Corporation

Sure. Thanks, Alan. Good morning, Paul. Yeah. Over to China, the market's relatively stable. We saw some modest pricing improvement over margins in April. They have seen some prices correct closer to where they were earlier in the year. Bottom line is that global pulp inventories are on the high side.

However, the March World-20 data released last week (phon) indicates that we are trending in the right direction. Both hardwood and softwood inventories fell by three days. Annual spring maintenance will definitely help correct inventories to a better supply/demand balance as well. And we're optimistic that we'll see an uptick in the market for the second half of the year (unintelligible) picks up, and we'll see some reduced Kraft supply due to conversions to dissolving pulp.

Alan Nicholl

Yeah.

Paul Quinn

Yeah. Maybe you could—I know there's a couple mills that are converting to dissolving. Maybe you could give me some detail around that?

Brian Yuen

Yeah. The two big ones, they total 900,000 tonnes: The Stora mill in Sweden; we've got ARAUCO-Valdivia in Chile, predominantly, Paul.

Paul Quinn

Great. Okay. Then just switching to the lumber side, I know you guys have—you've taken some temporary downtime. When does it make sense to shut down a mill permanently in BC?

Don Kayne

Yeah. Good question, Paul, and I think that's something that I think everybody's evaluating. I mean, look, the numbers that we've said—and we still believe them 100 percent—is that we expect that there needs to be, with the imbalances between supply and demand today and with the cutbacks on AAC around 2 billion board feet that needs to be out of the market. And I think what you're seeing here recently, especially in the last six or eight weeks, is a pretty good indication of the type of difficult situation that we're all in in British Columbia, as a result of the competitive situation related to log cost and log availability.

And so going forward, right, I guess just speaking for us, is that that's something we're obviously continuing to evaluate. And I think as we move forward, we will have more to say about that. But at this point, we are just looking at temporary shutdowns at this point, and we'll continue to evaluate those on a weekly basis, based on price levels and market levels for fibre, et cetera.

Paul Quinn

Okay. Then just following up on Ketan's question on policy changes by the BC government. I mean, for me, that came from left field, in that we have this declining AAC in the province. Obviously, mills need to shut, and then they come up with Bill 22 which, in my mind, just makes it significantly harder to transfer tenure, and you don't know whether you're getting full value for the tenure you're transferring and whether government's going to reallocate.

Is that something that the government discussed with industry before they came out with Bill 22? Because my understanding is that at the COFI conference, I mean, the premier was pretty up-front saying we're going to work together going forward, and this seemed to come out of left field. Is that true?

Don Kayne

I think, Paul, what I'll say there is that I think it's fair to say that the government recognizes that rationalization needs to take place in British Columbia, first of all. I think that that's something that's been developing over time here. But I do believe that they absolutely understand, now, some of the real difficult situations that we're all facing in British Columbia related to some of those competitive issues for sure.

In terms of the impact that Bill 22 is going to have on our ability to rationalize as an industry or as a company, we're expecting that with the right business case to do that that we'll be able to do that and make progress on that, absolutely. It has to happen. There's no shortcuts there.

And so right now, it's just a question of once those start to happen, putting together the right business case and explaining that well. And we would expect, 100 percent, that if we do that, all those—all that and meet that criteria, that we'll be successful. I mean, I can't really say any more than that, Paul. So time will tell and a test will come here probably soon.

Paul Quinn

Okay. And then just, I guess, lastly, I mean, we've seen BC Interior overall operations, yours included, go from sort of top quartile in North America to where they sit right now as almost the highest-cost jurisdiction in North America. What are the major things that's got to change to get the BC industry competitive again?

Don Kayne

Rationalization. I mean, there's no—at the end of the day, log costs are 70 percent of our costs, roughly. And that's what has to happen. And we've got 2 billion feet that have to come out of the market, like I mentioned, out of production, and that's probably going to end up being, hopefully, front-ended loaded; some urgency around that, just because of the AAC cutbacks that we're going to be facing.

But to me, or I think to us, that until we see that rationalization occur, it's going to be extremely difficult, if not impossible, to become where we need to be, which is the most competitive region in the world. And we got to recognize that if we're competing on a global scale for sure now, not just within BC, and that's getting, I think, recognized more and more, but hey, that's what we're facing. That's reality, and so we all need to get our act together here and start to move through this whole piece, so that we do become competitive with the rest of the world, and we can continue to invest and do some of the things that we want to do because we've been in BC a long time. We intend on staying here and moving forward. It's a great location and close to markets and so forth, so.

Paul Quinn

All right. Thanks very much. Best of luck.

Alan Nicholl

Thanks, Paul.

Don Kayne

Thanks, Paul. Good to talk to you. See you.

Operator

Thank you. We have a follow-up question from Sean Steuart from TD Securities. Sean, please go ahead.

Sean Steuart

Thanks. Just a couple of easy ones for you. On the pulp mills, can you give us a sense of what percentage of the fibre right now is whole-log chipping? Where you see that trending over the next few years? And if you can remind us of the cost differential for log chipping versus chips from your sawmills?

Alan Nicholl

Well, yeah. I think there's a few questions there, that not all of which totally can be answered in the short time frame we have here, so happy to chat a little bit more offline. But in terms of a couple of points I would make, I think clearly, in light of the curtailment we've seen, we've obviously been doing more whole-log chipping, and as well as moving product further. And so we've been incurring higher transportation costs as well.

Typically, what we used to guide to is close to 5/6 or 80 percent of our product is more sawmill residual based, and I think it's fair to say that over the next few years, pending rationalization, that number could change. And we're fully expecting whole-log chipping in the future to increase in the percentage of wood that we process.

The benefit we have from being a vertically integrated company is that we've got a lot of that supply coming from our parent, so feeling confident but not complacent.

Sean Steuart

Thanks, Alan. The last question, the acquisition agreement you have for the 125,000 cubic metres of fibre. Can you tell us where that is in the province?

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

Yeah. Good morning, Sean. It's Stephen here.

So no, I don't want to—I'm not going to disclose where that is in the province, but we're pleased to have been able to enter into that agreement. We enter into similar long-term fibre supply agreements all over our operations. This one's not different or unique in that regard, just a little bit different structure to the deal that required an up-front advance of payment, so that's why it got disclosed. But we're pleased to have that fibre supply supporting our operations.

Sean Steuart

Got it. Thanks, Stephen. That's all I had, guys.

Don Kayne

Great. Thanks, Sean.

Alan Nicholl

Yeah. Thanks, Sean.

Operator

Thank you. Ladies and gentlemen, this concludes your conference call today. We thank you for participating and ask that you please disconnect your lines.