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# FINAL TRANSCRIPT

## Canfor Corporation

## Second Quarter Analyst Call

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## PRESENTATION

**Operator**

Good morning, ladies and gentlemen, and welcome to the Canfor and Canfor Pulp Second Quarter Analyst Call.

A recording and transcript of the call will be available on the Canfor and Canfor Pulp websites. 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 each 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 meeting over to Don Kayne, Canfor and Canfor Pulp's Chief Executive Officer. Please go ahead, sir.

**Don Kayne** — President and Chief Executive Officer, Canfor Corporation

Thank you, Operator, and good morning, everyone, and thank you for joining the Canfor and Canfor Pulp Q2 2016 results conference call this morning. I'll make a few brief opening comments about the quarter and our outlook before I turn things over to Alan Nicholl, our Chief Financial Officer for both Canfor and Canfor Pulp. Alan will provide a more detailed overview of our performance in Q2 and then we will take questions from analysts.

In addition to Alan, with me today are Brett Robinson, President of Canfor Pulp; Mardy Grossman, our Director of Sales for Canfor Pulp; and Wayne Guthrie, our Senior VP of Sales and Marketing.

As we noted on our last call, Canfor Pulp had significant planned regulatory and maintenance shuts in the second quarter. Outages at all three of the Prince George craft mills made for a challenging quarter, but all work was completed successfully with total production down approximately 42,000 tonnes. With the outages behind us and the mills ramped back up to full rates, the team is focused on returning to normal productivity levels at all of our mills.

Pulp markets showed positive momentum in Q2 due to the seasonal shuts and increased buying, particularly from China. Softwood pulp markets are stable and inventories are at the lower end of balanced. The risk to pulp pricing continues to be the addition of new capacity, and we expect to see more production coming online over the next several quarters from previously announced investments. That being said, we expect that our low-cost structure and high value and quality focus will continue to benefit the Company and carry us through any temporary periods of oversupply.

Turning to the lumber side of our business. In the second quarter, we continued to see the benefits of our US South business and our specialty product mix. Pricing was stable for our high-value products, and spreads for our wider profile of products improved over the previous quarter, a trend we expect to continue in Q3. Our operations in the US South have performed well and the mills we have acquired over the last three years continue to exceed our expectations.

Our Canadian mills also continued to perform well in Q2 with another solid operational quarter, and increased benchmark Western SPF pricing across most grades boosted profitability for that region.

We continue our ramp-up to full capacity and with the inclusion of our latest acquisition of Wynndel, I believe that by the end of 2017, we should be producing roughly an additional 200 to 250 million board feet of lumber, the vast majority of that in the US South.

In terms of offshore markets, particularly China and Japan, we've seen steady demand in the quarter, and we continue to diversify our product offerings to those markets.

In North America, we continue to expect a gradual recovery through the balance of the year. Our major customers in the homebuilding and repair and remodeling businesses are seeing strong demand so far in 2016. And with inventories relatively lean, we expect that business to continue to be strong.

Later this week, we will be completing the final phase of our purchase of Scotch Gulf Lumber, as we acquire the remaining 50 percent. These mills have been strong contributors to our bottom line.

And finally, we continue to monitor the discussion around a new softwood lumber agreement with the United States. We remain hopeful that a deal can be completed before the end of the standstill period, but we are well prepared for all potential outcomes.

So with that, I will turn the call over to Alan Nicholl to provide an overview of our financial results.

Alan Nicholl#Canfor Corporation#Chief Financial Officer

Well, thanks, Don, and good morning to everyone.

As usual, my comments this morning will focus principally on our financial performance for the second quarter of 2016 by reference to the previous quarter. Full details of our results are contained in the Canfor Pulp and Canfor news releases, both of which were issued yesterday.

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

For the second quarter of 2016, Canfor reported shareholder net income of $36 million or $0.27 a share, up from net income of $26 million or $0.20 a share reported for the first quarter of 2016, and net income of $11 million or $0.08 a share reported for the second quarter of 2015.

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

In the second quarter of 2016, the most significant adjustments were for a legal settlement, again related to our pellet business of $7 million or $0.05 a share and a positive mark-to-market adjustment on derivative instruments of $2 million or $0.02 a share.

After taking account of these adjustments, the second quarter adjusted shareholder net income was $27 million or $0.20 a share, compared to similarly adjusted net income of $21 million or $0.16 a share for the first quarter.

Results for the lumber segment are highlighted on Slide 5 of our presentation. The lumber segment recorded operating income of $72 million, a $39 million increase from the $33 million operating income reported for the previous quarter. Excluding the aforementioned legal settlement, again, operating income was $56 million, up 23 million versus Q1.

The increase reflected improving US dollar-denominated benchmark lumber prices, net of a stronger Canadian dollar. Solid price gains were seen across most grades of Western SPF and Southern Yellow Pine, with price increases for wide dimensional products of Southern Yellow Pine, in particular, seeing strong gains.

Overall, unit manufacturing costs were in line with the previous quarter and up slightly compared to the same quarter of 2015, primarily due to the high value product mix produced at our recently acquired facilities, offset in part by improved productivity.

Our shipment and production volumes remained in line with the prior quarter, and compared to the second quarter of 2015, shipments were slightly lower, reflecting record offshore ship volumes to China after the US West Coast port strike in the first quarter of 2015.

Canfor's pulp and paper segment comprises the results of Canfor Pulp Products Inc. As you can see on Slide 6 of our presentation, Canfor Pulp reported net income of $2 million or $0.03 a share, compared to net income of $23 million or $0.34 a share for the first quarter and net income of $18 million or $0.25 a share for the second quarter of 2015.

Canfor Pulp's operating results are summarized on Slide 7. The lower pulp and paper segment operating income reflected maintenance outages, as Don mentioned, at all three NBSK pulp mills, which reduced our production by approximately 40,000 tonnes compared to the first quarter.

Pulp sales realizations were slightly lower in the quarter, reflecting a stronger Canadian dollar and a higher proportion of shipments earlier in the quarter, both of which more than offset moderate US dollar price increases and an increased proportion of our sales volume into North America during the quarter.

Total pulp shipments were 10 percent lower than the previous quarter, for the most part reflecting timing of shipments and the aforementioned maintenance shuts. Higher manufacturing costs were also principally attributable to the scheduled maintenance outages.

Results in the paper segment were down $3 million from the previous quarter, largely as a result of the stronger Canadian dollar and to a lesser extent increased shipments to China. Unit manufacturing costs were relatively flat.

Capital spending in the second quarter totalled $66 million, of which 46 million was in the lumber business and 19 million for Canfor Pulp. 2016 capital spend is currently projected to be around $160 million for Canfor and $75 million for Canfor Pulp, with similar amounts currently anticipated for 2017.

As Don mentioned, we'll also be closing the purchase of our remaining 50 percent of Scotch Gulf business on July the 29th, at an estimated cost of $50 million US.

During the second quarter, Canfor Pulp repurchased approximately 1.8 million of its common shares at an average price of $10.60 per common share. There were no shares repurchased by Canfor, recognizing the Company's continued focus on debt reduction through 2016 after the significant growth that was undertaken in 2015.

For the first quarter, Canfor Pulp's Board of Directors also approved the continuance of a quarterly dividend of $0.0625 per share.

At the end of the quarter, Canfor, excluding Canfor Pulp, had net debt of $386 million with available liquidity of 221 million. Canfor Pulp had net debt of $25 million with available liquidity of just over $100 million. Net debt-to-total-cap, excluding Canfor Pulp, was 22 percent, for Canfor Pulp it was 5 percent, and on a consolidated basis it approximated to 20 percent.

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

**Don Kayne**

All right. Thanks, Alan, and Operator, we'll now open the call up for questions.

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## Q&A

**Operator**

Thank you, sir. We will now take questions from financial analysts. If you have a question, please press *, 1 on your telephone keypad. And if you're using a speaker phone, please lift your receiver and then press *, 1. If at any time you wish to cancel your question, please press *, 2. You may now press *, 1 if you have a question.

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

**Sean Steuart** — TD Securities

Thanks. Good morning, everyone. A few questions. You mentioned, Alan, that you noted that you hadn't bought stock back at the Canfor Corp. level and you're focused on deleveraging this year. How do you think about capital allocation at the Canfor Corp. level, I guess beyond this year? You have a reasonably strong balance sheet probably exiting this year. How much of your capital allocation decisions are dependent on the trade file and some clarity on that front? And how do you think about things beyond this year?

**Alan Nicholl**

Okay. Well, good morning, Sean. So to your point, I think we're pleased with the cash flow that we generated through Canfor Corp. And to your point, we didn't make any share repurchasing. And as I mentioned, that's principally as a result of our debt reduction focus. And clearly some of our cash flow reflected the seasonal reduction in harvesting activities and crystallizing some of our working capital if you will. And we're still committed to that debt reduction focus. I think we've guided before to 20 percent. It's at the higher end of where we typically want to be in terms of debt-to-cap, and we're still a little bit above that for Canfor Pulp.

To your other question around just guidance on capital allocation. As we've said a good number of times now, sustaining our mills at the top quartile is priority number 1, and we're continued and committed to continuing our investment in our facilities both north and south of the border. To that end, the US South growth, as you will have noted, we've still got about $100 million of committed money there to close the purchases, or sort of get 100 percent of Scotch Gulf and Beadles and Balfour in the next 12 months as well.

So I expect our balance sheet will be stronger at the end of the year, but I also expect that our focus will continue to be on the aforementioned areas. And I'd like to think that despite the uncertainties around the trade file, that we'll remain committed to those end goals, and the strength of our balance sheet will support that end goal as well.

**Sean Steuart**

Thanks for that. And further to those comments, can you give us some qualitative commentary, Don, with respect to the sawmill M&A environment right now? One of your competitors suggested that things have slowed down a little bit, at least in terms of the opportunities out there. Is that consistent with what you're seeing, and are you guys still considering further M&A opportunities in the sawmill side?

**Don Kayne**

Yeah. For sure, Sean. I mean after—just to add on what Alan spoke about, and aside from the continued focus on just our debt reduction. In terms of the M&A side, I mean yeah, I would say that—I would probably say—make a similar comment that there's not, certainly the activity level is decreased quite a bit. And it's not to say that we're not getting the odd inquiry and so forth, but right now, and I'd expect that probably over the next little while, it'll probably be in the same situation here for probably the next 6 to 12 months. But certainly it's quieter than it's been for sure.

So we're—going back a little bit to what Alan said, definitely our priority now is we've got such great assets we believe, and they're performing well, and we've got a real focus here to make sure that when we have excess cash, that we're using that money as much as we can on making sure that the mills we've got, we sustain that top quartile status. Because we really believe that we've pretty much achieved that now, and the opportunities just with inside the Company we see as very, very strong. So anyway that's, that would be comments on that, Sean.

**Sean Steuart**

Thanks very much. That's all I have. Thanks, guys.

**Don Kayne**

Okay, thanks.

**Operator**

Thank you. Your next question will be from Ketan Mamtora at BMO Capital Markets. Please go ahead.

**Ketan Mamtora** — BMO Capital Markets

Thanks. Morning, Don, Alan.

**Don Kayne**

Morning.

**Alan Nicholl**

Morning.

**Ketan Mamtora**

First question for Alan. Alan, can you if possible quantify what was the EBITDA impact from maintenance in the second quarter in the pulp business? You mentioned about 40,000 tonnes?

**Alan Nicholl**

Yep. Yeah, so, Ketan, good morning to you. So I think when I look at the operating performance for Q2 relative to Q1 I would say, just to kind of give you some perspective on a little bit, about two-thirds of that gap that you see would be largely attributable to our scheduled maintenance effort there, and the other third would really be tied to shipments and the stronger Canadian dollar. So hopefully that helps you to get a little bit more context on the order of magnitude.

**Ketan Mamtora**

Yes, it does. That's very helpful. Second question, Alan. What do you have kind of for log cost inflation in the second half, both for BC and US South?

**Alan Nicholl**

Yeah. So I think we're—today we're sort of expecting to see a 4 to 5 percent increase year over year, Ketan. So we're obviously focused on annual costs as well as just any quarterly movements there. But to just give you some guidance, in Western SPF around 4 to 5 percent year over year in terms of log costs. I think in the US South, it's pretty much flat, just simply put.

**Ketan Mamtora**

Got it. And then last question for Don. In your press release just looking, just seeing your comments on the softwood trade agreement, it seemed like you pointed to discussions have been progressing. Any sort of talks, colour? It looked a little more positive than I thought it might have been. So any thoughts, colour might be helpful.

**Don Kayne**

Just want to make sure I—with respect to the softwood lumber agreement?

**Ketan Mamtora**

Yes. That's right.

**Don Kayne**

Yeah.

**Ketan Mamtora**

In the press release, you point to discussions have been progressing?

**Don Kayne**

Right. Yeah. I guess what I would say there, other than what I mentioned in the initial comments, it's just that I guess what we're encouraged by is that definitely there's been some solid communication between the province and the feds and also between government and industry and the US side also. So I mean, certainly there's a long way to go. I mean I think we're—I guess to some degree, we're encouraged that they're still speaking. But there's, like I say, there's a lot of ground to cover yet and whether we're able to get a solid, fair agreement in place, we're certainly prepared for the possibility that it doesn't occur. And I guess we're very well prepared for that also. So we'll see what happens. But above and beyond that, I can't really comment more than that. But there is one good thing; there is still some good communication that's being conducted between the two governments, so.

**Ketan Mamtora**

That's helpful. Do you expect these discussions to slow down as the US moves into the election season?

**Don Kayne**

You know, perhaps. I mean at the end of the day, though, I think that we've got enough. So far, the engagement has been solid on both sides, and so from what we understand, that they're expecting that this can continue right through into October. But again, it is a risk and we'll see what happens, but so far we haven't heard that indicated. We haven't encountered that issue.

**Ketan Mamtora**

Okay. That's very helpful. I'll turn it over. Good luck in the back half.

**Don Kayne**

All right, thanks very much. Appreciate it.

**Operator**

Thank you. Your next question will be from David Quezada at Raymond James. Please go ahead.

**David Quezada** — Raymond James

Thanks. Morning, guys. My first question, just on demand in the US, and we know that the US housing market is gradually getting better. I wonder if you could provide just a little bit of commentary on how the other end markets are looking, such as industrial and repair and reno?

**Don Kayne**

Yeah. For sure, David. I'll turn it over maybe to Wayne, and he can give you some good colour around on our key markets, and Wayne, maybe I can turn it over to you?

**Wayne Guthrie** — Senior Vice President, Sales and Marketing, Canfor Corporation

Sure. Thank you. Good morning. If you look at US consumption, total US lumber consumption, it's actually up more than the housing start number for sure and even the single-family housing start number. So that would indicate that the repair and remodel and industrial segments are actually growing even a little bit faster than the housing. Really good news to broad-based lumber consumption recovery down there, so a little bit ahead of our expectations. Talking to our customers, expect that trend to continue through the second half of the year. So industrial, which has historically been quite flat, is stable to a little bit better. Repair and remodel is definitely better than we expected going into 2016.

**David Quezada**

That's great. Thank you very much. I guess my only other question was, I know it seems like the Chinese market demand has been pretty solid lately. What is your sense of how inventories are over there? And are other regions, like you hear about more supply from Russia. Is that filling up the supply chain there at all?

**Don Kayne**

Wayne, why don't you continue on with that one as well?

**Wayne Guthrie**

Sure. So the—to answer it two ways, the SPF inventory is very, very in good shape. It's not heavy at all. It's a little bit light compared to historical, although maybe consumption's a little bit lighter on the SPF side. So we think that's in balance. We're not concerned at all about the SPF inventory.

The Russian import volume has definitely been more than we thought it would be. They are taking more market share, no doubt about it. Not sure, I think those export numbers from Russia are subject to a lot of revisions, so you kind of have to take a little bit of a longer-term view there. I think you'll see that on the low-grade side, we can still compete. On the high-grade side, we can still compete. Russia will take some of the mid-grade volume, and a lot of that volume will likely end up in the US. So I think—I don't think we'll see the rate of increase from Russia anymore, but I think you'll continue to see them over the short term here, over the next while, continue to maintain that market share that they've got.

**David Quezada**

That's good. That's very helpful. Thanks, Wayne. That's all I had.

**Don Kayne**

All right. Thanks, David.

**Operator**

Thank you. Next question will be from Hamir Patel at CIBC. Please go ahead.

**Hamir Patel** — CIBC

Hi. Good morning.

**Don Kayne**

Morning.

**Hamir Patel**

Don, you guys announced a Licella biofuels JV about two months ago. Can you help us understand what you guys are doing there? And it sounds like it's sort of a multiyear initiative, but maybe what's the sort of option value upside associated with that?

**Don Kayne**

Yeah. For sure, Hamir, and we're certainly excited about that, and we're looking forward to that opportunity going forward. But what I think maybe the best there, to give you a bit better colour or more colour, at least, for sure, is Brett. And maybe, Brett, you could speak to Hamir a little bit about Licella and what your views are there?

**Brett Robinson** — President, Canfor Pulp Products Incorporated, Canfor Corporation

Sure. Good morning, Hamir. So Licella is really in early stages of the development. We're focused on regulatory design and offtaking for our technology. We're pretty excited about it, but this is a scale-up and we're a ways away from actually starting to break ground on this.

**Hamir Patel**

Okay. Fair enough. Thanks, Brett. And just a final question I had for Wayne. We've seen some reports in random lengths of BC's lumber mix tilting more to two-by-six in recent months with mills cutting more hem and hem-fir and fir. Have you seen that play out in your business, and can you remind us what your grade distribution is in BC between two-by-four, two-by-six, and some of the wide widths?

**Wayne Guthrie**

I'm not sure we disclose that in detail. I can say we really haven't seen any material change for us in our split between two-by-four and two-by-six. The spread that you saw— the negative spread for two-by-six you saw last quarter was certainly wider than we anticipated it being. The fir one is good speculation. It's potentially having an impact.

I would suggest, maybe, that there was a bit more two-by-six. Two and better went to China earlier last year and even in the first quarter, and some of that came back due to stronger prices in the US, and maybe put a little bit more volume into the US than we were anticipating. Wasn't able then—the two-by-six price in the US wasn't able to keep up with the two-by-four, if you follow—do you follow what I'm saying?

**Hamir Patel**

Yes.

**Wayne Guthrie**

So I think that's kind of straightened it out. Seasonally, two-by-six closes the gap on two-by-four in the third quarter. Whether or not that'll go right back to where we've seen it even go to a premium, I doubt that this year. We doubt that this year, but we do think the spread will narrow as we go into the second half of the year.

**Hamir Patel**

Okay. Thanks…

**Wayne Guthrie**

A lot of moving parts there.

**Hamir Patel**

Thanks, Wayne. That's helpful. I'll turn it over.

**Operator**

Thank you. Next question will be from Paul Quinn at RBC Capital. Please go ahead.

**Paul Quinn** — RBC Capital

Yeah. Good morning, guys. Just a couple—well, just really one easy question. Just with the final 50 percent acquisition of Scotch and Gulf and then also the remaining piece of Beadles and Balfour, can you give us some help on the incremental financial benefit you'll see from those in the balance of the year?

**Don Kayne**

Alan, why don't you take a shot at that one?

**Alan Nicholl**

Well, typically we don't go into that level of detail, although, Paul, you'll be aware that because we control both those entities today we do show their contribution in EBITDA and operating income. Of course the minority interest comes out before we take our earnings-per-share component. But suffice it to say, as Don mentioned earlier, we're really pleased with both acquisitions delivering very strong margin and ahead of our targets.

**Paul Quinn**

Okay. That's all I had. Best of luck, guys.

**Don Kayne**

All right. Thanks, Paul. See you.

**Operator**

Thank you. Next question will be from Stephen Atkinson at Dundee Capital Markets. Please go ahead, sir.

**Stephen Atkinson** — Dundee Capital Markets

Thank you. Good morning. In terms of the—and you may have touched on it a bit. But as you know, the Asian market was very weak at the beginning of the year. Can you talk about how things are now in Japan and in China?

**Don Kayne**

For sure. Wayne, why don't you give Stephen an update there on China and Japan?

**Wayne Guthrie**

Sure. I'll do Japan first. Not much to report there other than we've been able to maintain our shipments. We actually think we'll see a little bit of an uptick here in Q3, modest, but a little bit of an uptick. At the end of the year, in talking to our customers and in looking at the order files over there for housing and as well as some of the new products we've been able to make, we think our volume there will be the same this year as it was last year, and maybe even up a little bit next year. So with some of the work we're doing on diversification, we're pretty happy with what we're seeing out of Japan.

On the China side of the business, as we've said, we are actually going to make a little bit less low-grade, as we reported last quarter, because we've got a little bit better log going through our sawmills, so our volume to China will be down a little bit. And there is some competition for sure out of Russia.

That said, though, as I mentioned earlier, the inventory's in good shape on SPF. Our customers are looking for a very modest Q3, so it's really rainy there. We're having a difficult rainy season, but there's some optimism for Q4 in China that that business will start to pick back up again, and consumption will start to pick back up again. So very cautious on our outlook on China, but I think the reduction that we've seen out of Canada going into China, that's probably as far as we're going. I think you'll see steady volumes going forward there in the next year.

**Stephen Atkinson**

That's great. Thank you for that insight. In terms of the product line, though, I guess you have changed your market to some extent?

**Wayne Guthrie**

In China?

**Stephen Atkinson**

Yeah.

**Wayne Guthrie**

Yeah. So China will—we're really focusing on higher-end products going into the domestic furniture business as well as other high-end applications for lumber. What we're trying to do is, quite frankly, find markets where we don't have to compete head to head with that increase in Russian volume that's going down.

**Stephen Atkinson**

Okay. And in terms of the South and your acquisitions there, do you still have to spend more money or are you happy where you are, if you know what I mean?

**Don Kayne**

You're talking, Stephen, more on—you're talking capital-wise?

**Stephen Atkinson**

Well, in terms of both capital and also the mills. Like obviously you had to come in and fix—should we say, optimize their operations. And to my understanding, you've done a great—well, obviously you've done a great job in Canada. I was wondering whether there was more required for the South.

**Don Kayne**

Yeah. I think I'll let Alan talk too, but I think on this one, clearly the—we put some capital into those mills, for sure, but they were also—for the most part, the ones that we purchased were in pretty darn good shape, frankly, and in most cases, real, real good shape. But we have spent some money particularly on kilns and the CDKs, the continuous dry kilns, particularly, and a few other projects, and that'll—and we'll continue to do that to make sure we sustain them at that top quartile margin that we've been speaking about continually.

But for the most part, those mills are all performing really, really well for us with the focus that we've had on the overall value side of it and the margin side, because clearly they're able to produce a lot of higher-value-type products. So overall though, there'll probably be—I don't know, Alan, if we—I'm not with you there, but I'm not sure if we actually separate that in terms of BC or Canada versus the United States in terms of total CapEx going forward?

**Alan Nicholl**

No. We don't disclose it, but to pick up on what you were saying there, Don, and for your benefit, Stephen. The mills and operations we've acquired are really solid operations, and as I mentioned earlier, we're very pleased with the contribution they're making and how they're running. The opportunities on the capital side are more incremental, smaller-type projects that will just help with our margin focus.

And to Don's earlier point, we see a number of opportunities to get not insignificant volume, additional volume, but not at the expense of margins. So overall, as I say, lots of smaller opportunities but no major overhauls or no major capital upgrades that we're contemplating or need to contemplate.

**Stephen Atkinson**

That's great. Thank you so much.

**Don Kayne**

All right. Thanks, Stephen.

**Operator**

Thank you. And at this time, Mr. Kayne, we have no other questions, so I would like to turn the call back over to you for your closing remarks.

**Don Kayne**

All right. Thank you very much, Operator, and thanks, everybody that participated, and enjoy the rest of the summer and look forward to talking to you in Q3. Thank you.

**Operator**

Thank you. Ladies and gentlemen, this concludes your conference today. Thank you for participating, and you may now disconnect.

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