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Canfor Corporation

Quarter Two 2017 Results Conference Call

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CORPORATE PARTICIPANTS

Don Kayne
Canfor Corporation — Chief Executive Officer

Alan Nicholl
Canfor Corporation — Chief Financial Officer

CONFERENCE CALL PARTICIPANTS

Sean Steuart
TD Securities — Analyst

Paul Quinn
RBC Capital Markets — Analyst

PRESENTATION

Operator

Good morning ladies and gentlemen. 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 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 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 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

Thank you, Operator, and good morning, everyone. Thank you for joining the Canfor and the Canfor Pulp Quarter Two 2017 Results Conference Call this morning.

I'll make a few comments before I turn things over to Alan Nicholl, Chief Financial Officer for both Canfor Corporation and Canfor Pulp. Alan will provide a more detailed overview of our performance in Q2, and then we will take questions.

In addition to Alan, on the line with me today are Brett Robinson, President of Canfor Pulp; Peter Hart, Vice President of Pulp Sales; Wayne Guthrie, our Senior Vice President of Lumber Sales and Marketing; and Stephen Mackie, our Senior Vice President of Canadian operations.

I'll start out with just a few comments on the wildfire situation in British Columbia. Our Vavenby mill was shut for one week due to an evacuation order and the fire danger in the area. Several of our competitors were forced to take shuts in the Caribou and southern interior region, and nearly 40,000 people were evacuated from their homes.

Weather has been a factor here, and we are hoping firefighters get a break, though, we do recognize we have all of August ahead of us. We are seeing some breaks here lately in the weather, particularly the last week or so.

All of us at Canfor, the industry, and the Province of British Columbia are deeply appreciative of the many firefighters, contractors, and employees who have been on the frontline of this difficult fire season.

Moving on to our results, beginning with Canfor Pulp. Market demand continues to be strong, and the Company generated solid results in spite of significant planned seasonal maintenance downtime. The Company continues to be focused on operational performance and optimizing its sales mix.

Global demand was solid during the second quarter, but levelled off somewhat in June. With significant new softwood and hardwood capacity entering the market over the next several months, we do see some price risk later this year and on into 2018.

Yesterday, we announced two large capital projects at Northwood and Taylor totalling $105 million. These projects will further reduce our energy consumption and improve efficiencies at both mills. We expect both projects to be completed by the end of Q1 2019.

Finally, we completed a new four-year labour agreement with our pulp unions, which will ensure stability for our excellent labour force, as well as for our customers.

Switching to our lumber business, our operations ran well in the quarter and prices were up strongly overall for SPF. Southern yellow pine prices showed a more modest increase in the quarter, and overall our operating results continued to improve relative to the prior quarter.

North American demand continues to be strong in both new home construction and repair and remodel markets. Our view is that the current demand and supply situation going forward will continue to support solid price levels.

Our key offshore markets continued to be very strong in the second quarter, and our shipment volumes to China and Japan remained steady.

In terms of the softwood lumber agreement and in addition to the CVD rate of 20.26 imposed in May, Canfor was assessed an anti-dumping duty of 7.72 percent effective July 1st. We were not subject to a critical circumstances decision. As a result, we will not be required to make retroactive duty payments.

These duties are punitive and completely unwarranted; they are not based on fact, as I've said before, but are a result of protectionist efforts by the influential US lumber lobby aimed at artificially restricting supply for their own benefit at a significant expense ultimately to the US consumer.

We fully expect this determination by the Department of Commerce will be overturned by independent NAFTA and WTO panels, and that the duties will ultimately be rescinded and returned.

We have had excellent support and collaboration from the Canadian federal government and the BC provincial government, and know that our federal minister is working at the same time to negotiate an agreement that will bring certainty to our industry. We have every confidence that they will take all the appropriate steps to successfully fight these absolutely ridiculous and outrageous trade actions, as they have done so previously.

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

Alan Nicholl — Chief Financial Officer, Canfor Corporation

Thanks, Don, and good morning, everyone. As usual, my comments this morning will focus principally on our financial performance for the second quarter of 2017 by reference to the previous quarter.

Full details of our results are contained in the Canfor and Canfor Pulp news releases, both of which were issued yesterday.

As always, you will 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 2017, Canfor reported shareholder net income of $81 million, or $0.61 a share, up from net income of $66 million, or $0.50 a share, reported for the first quarter, and well up from net income of $36 million, or $0.27 a share, reported for the second quarter of 2016.

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 second quarter, these items included a $3 million foreign exchange gain on long-term debt, and a $26 million expense due to countervailing duty deposits.

After adjusting for the aforementioned items, shareholder net income for Q2 2017 was $104 million, or $0.78 a share, compared to an adjusted shareholder net income of $59 million, or $0.45, for the first quarter of 2017.

Results for the lumber segment are highlighted on Slide 5 of our presentation. The lumber segment reported operating income of $110 million for Q2, a $27 million increase from the prior quarter.

The increase principally reflected higher Western SPF, and to a lesser extent, Southern yellow pine prices and a 2 percent weaker Canadian dollar, as well as increased shipment volumes. These increases more than offset a $35 million expense related to the preliminary CVD rates.

Lumber shipments were up 7 percent in the quarter, reflecting a return to more normal levels following the weather-related transportation challenges experienced in the first quarter, while production was up slightly from the previous quarter.

Unit manufacturing costs were broadly in line as productivity gains and stable US south log costs offset market and weather-related increases in stumpage and purchased wood costs, respectively, in Western Canada.

Canfor's pulp and paper segment comprises the results of Canfor Pulp Products Inc. In the second quarter of 2017, the Company reported net income of $20 million, or $0.31 a share, compared to net income of $24 million, or $0.36, for the first quarter of 2017. And net income of $2 million, or $0.03 a share, for the second quarter of 2016.

As you will see on Slide 6 of our presentation, higher average pulp and paper sales realizations largely offset the impact of major scheduled maintenance outages on both costs and shipments in the period.

Improved NBSK and BCTMP pulp sales realizations largely reflect the strong pricing on shipments through most of the quarter combined with the weaker Canadian dollar.

Pulp shipments were down 18 percent from the prior quarter, reflecting the lower pulp production attributable to the scheduled maintenance outages at our Northwood and Taylor pulp mills in the current period. And to a lesser extent, a delayed 14,000-tonne vessel shipment that slipped from December into Q1. Higher unit manufacturing costs largely reflect the aforementioned maintenance outages, as well as market-related increases in fibre costs.

Operating income for the paper segment in Q2 was $7 million, which was broadly in line with the previous quarter. Sales realizations for paper were up slightly from the previous quarter, primarily reflecting the weaker Canadian dollar.

Capital spending in the second quarter totalled $62 million and included $41 million for the lumber business and $19 million in Canfor Pulp. The 2017 capital spend is currently projected to be approximately $170 million for Canfor and $70 million for Canfor Pulp.

Consistent with previous quarters, Canfor Pulp’s Board of Directors approved the continuance of a quarterly dividend of $0.0625 a share for the third quarter.

In the second quarter, Canfor Pulp spent approximately $7.5 million on its share repurchase program, with the Company purchasing close to 608,000 shares, or 0.9 percent of its common shares, at an average price of $12.30 a share.

At the end of the quarter, Canfor, excluding Canfor Pulp, had net debt of $179 million, with available liquidity of 359 million. Canfor Pulp had net cash of $42 million, with available liquidity of

$101 million. Net debt to total capitalization, excluding Canfor Pulp, was 9.9 percent, and on a consolidated basis was just under 7 percent.

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.

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 comes from Sean Steuart from TD Securities. Sean, please go ahead.

Sean Steuart — TD Securities

Thanks. Good morning, everyone.

Don Kayne

Hi, Sean.

Sean Steuart

A few questions; in the $240 million total CapEx budget for this year, how much of the 105 million for the pulp energy projects is in that number?

Alan Nicholl

Yeah. Good morning, Sean. The number's close to 20 million out of that number, and so the bulk of the spend will be in 2018 and will be reflected in 2018's numbers. And just to give you some … a little bit more context there, we're projecting around $100 million of capital spend to take account of that additional spend on those two projects.

Sean Steuart

And, Alan or Don, can you go through the economics of the projects in terms of expected returns, payback periods, that sort of stuff?

Alan Nicholl

Yeah. No, for sure, Sean. So consistent with other long-term energy-related investments, we're guiding to returns of 15 to 20 percent, just to put it in perspective.

Sean Steuart

Got it. And wondering on lumber pricing if you can offer some thoughts on the spreads between Western Canadian and Southern Pine pricing? A lot of it, I suppose, is the fire season this year, but any other thoughts on how you expect spreads to normalize over the midterm as we've seen some volatile trends recently?

Don Kayne

Yeah. For sure, Sean. I'll let Wayne comment on that, but just, I guess, just at the outset a couple of quick things. I mean ultimately, some of the things we're seeing, despite the impact of the fire and so forth, I think we are—longer term we would say and we certainly believe that the spreads between Yellow Pine and SPF, which I think you're referring to, will get back to some of the kind of back-to-normal numbers, maybe even a little slightly lower in that 50 to $75 range.

And we're basing that partly on the fact that we do expect SPF over time here, Sean, to reduce in terms of production out of British Columbia because of the beetle. And we do see some upticks in Southern Yellow Pine production going forward. Certainly we're seeing some of that already. So I think that the spreads that we've seen here in the last 12 to 18 months where they got quite high—as no doubt you're aware—we see that moving back to more typical levels over the longer term here, so.

Sean Steuart

Okay. That's all I have for right now. Thanks, guys.

Don Kayne

Thanks, Sean.

Operator

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

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

Paul Quinn — RBC Capital Markets

Yeah. Thanks very much. There's an announcement yesterday by a competitor in acquiring a number of sawmills in the US South. Just wonder if you guys were part of that auction process? And what you thought of the asset quality?

Don Kayne

Sure, Paul. I mean, yeah, so first of all, congratulations to our competitor. It's certainly a good acquisition, and so congrats to Ted and the West Fraser guys. I assume from our standpoint, yeah, we were in that early on, for sure, like probably a bunch were.

From our standpoint, though, we thought that we have other … I guess other priorities that we thought fit our strategy more longer term that we've talked about a bit in the past, but more so than this particular acquisition.

The other—so I mean ultimately, there's that. And also some of the current valuations that are out there and being tossed around we're a bit concerned about that. So in terms of how we are looking at it now, probably there's three areas. I mean clearly it's the organic growth opportunity within the Company that certainly we're aggressively working on, and you'll hear more of that here going forward.

Just straight M&A itself, which again is concerning because of the valuation piece that we see increasing, like I mentioned. And then the greenfield/brownfield options, which we've talked about a bit in the past, but I think that's another area there that certainly warrants more consideration as well, and will be warranting more consideration. So that's how we looked at it.

Certainly from our standpoint strategically we're focused a lot on the fibre piece and being able to be in areas that really, significantly differentiates us from a fibre and a market product mix opportunity, right? And so that's a bit of a colour around that from Canfor's standpoint and from our standpoint, Paul.

Paul Quinn

Okay. And then just one of the characteristics of those six sawmills is that they really handle a small log diet. Do you see that as a benefit? Or is—you guys seem to be more weighted to the larger log, wider width in the US South, and I suspect you're thinking that the historical premium will return to that area. Is that true?

Don Kayne

Yeah. I mean I think there's arguments, of course, for profile and narrow profiles and wider profiles. And our belief is that we're probably more heavily weighted to the wider profiles because it gives us additional flexibility that we think will be prudent longer term here in terms of flexibility of product mix and opportunities potentially offshore and so forth. So that's really—and also higher-quality logs, too, typically, you get into when you get into the wider diameter fibre.

So that's—but everybody has different strategies, and that would be more closely aligned with ours, though, the larger log strategy.

Paul Quinn

Sure. And maybe you could just make a general comment on M&A opportunities and what those valuation metrics have looked like in the last six months post sort of preliminary duties on countervailing and anti-dumping? Have valuations moved up significantly because the US owners think they can—their assets are worth a lot more, given the current duty structure?

Don Kayne

Yeah. I think one thing for certain in this industry, everybody thinks their assets are worth more than everybody talks about. But we’re certainly seeing that down there, without question, and we’ve commented on that before that I mean the last 12 to 18 months I think it would safe to say that valuations, in general, in the south continue to increase.

And a lot of these guys have taken the approach, the wait-and-see ‘til what happens when the softwood lumber agreement’s in place. There’s a view that that would accelerate—or not accelerate, but increase the valuations even more so. So those are all reasons. So I think right as we sit today there’s probably less than there usually is in terms of interest from the American producers in the south to sell.

Paul Quinn

Okay. And then just maybe turning to that softwood lumber file, there’s lots of rumours out there on an imminent deal and a handshake agreement, et cetera. How do you guys view the current talks right now? And has there been any change in the US side who the Canadian government's talking to as we try to negotiate an agreement?

Don Kayne

No, I don't think so. I mean the things dripping along here, as it has been for quite a long time. I think that there's been some progress. I do think that the federal government—and I know they are—they're in discussions with the US side. We've been real clear on our position in Canada and also from a British Columbia standpoint.

I think that there is some—I think there's some urgency perhaps to try to see if there's a deal that can be done before the NAFTA starts to kick into place here, but time will tell on that. But I think clearly I think from just speaking from Canfor and BC a perspective that we've been very, very clear with both the federal government and the provincial government in terms of what might constitute a fair deal, if there is to be a deal. And if we have to go to the wall on this deal, we'll do that, too. It just completely depends on what agreement is in place.

One of the things that we're very, very solid on here is—in British Columbia—is to make sure, number one, that we get the interprovincial allocation that we feel we deserve in British Columbia for all the work that we have done and continue to do on offshore market development.

It's significant, it's taken a lot of resources the last 15 years, and there's lots more opportunity going forward, but we need to get recognized for that. So that's one of a few areas that are extremely important to us.

Paul Quinn

Okay. And just lastly, it sounds like you're characterizing the federal government is winding—feeling—I don't know, maybe I'm putting too strong words on it—but feeling a little bit under pressure to try to get a deal before the NAFTA negotiations start on the 16th of August. How does Canfor feel about—do you—are you nervous about—do you feel compelled to get a deal? Or you feel pretty strong with the legal case that we have on the file?

Don Kayne

We feel absolutely strong on the case we have on the file, for sure, and without question. And like we've said before, if we can't get the right deal we're not interested in a deal, and we'll go to the wall, like I mentioned. Period.

So yeah, there's not—I mean I just feel that the federal government is definitely engaged. They've been engaged for some time here, and I think they're doing what they need to do. And what we've got on the table is I think fair, for sure, and we'll see what happens. So it's hard to—I can't really comment any more than that. I mean that's kind of where we're at. It's dynamic, it's evolving, there's lots of conversation on a regular basis, but we'll have to see how this thing ends up here.

Paul Quinn

Okay. And just lastly maybe a clarification. You sort of expensed 26 million for the preliminary countervailing duties in Q2; if I normalize that for a full quarter of countervailing duties and add in the anti-dumping duties, are you around the 50 million per quarter run rate based off the prices that we saw in Q2?

Don Kayne

Alan?

Alan Nicholl

Yeah. So, yeah so, Paul, on that one I think you're fairly close. I mean ultimately it depends on prices and exchange and so on, but I'd say guiding rule of thumb, 70 million to 75 million for 10 percent duties is kind of rule of thumb on an annual basis, so you can work from that, but ultimately depending on the price.

Paul Quinn

Excellent. Thanks for the help, guys. Best of luck.

Don Kayne

Thanks, Paul. See you.

Operator

Thank you. There are no further questions at this time. Please proceed, Mr. Kayne.

Don Kayne

All right. Thanks, Operator, and thanks, everyone, for participating. And we look forward as always to talk in October.

Thank you.

Operator

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

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