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Canfor Pulp Products Inc.

Canfor and Canfor Pulp Fourth Quarter Analyst Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen. Welcome to the Canfor and Canfor Pulp Fourth Quarter Analyst Call. A recording and transcript of the call will be available on the 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 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 Pulp Products Inc.

All right. Thanks, Operator, and good morning, everyone. Thanks for joining the Canfor and Canfor Pulp Q4 2017 results conference call this morning. I'll make a few comments before I turn things over to Alan Nicholl, our Chief Financial Officer for both Canfor Corporation and Canfor Pulp. Alan will provide a more detailed overview of our performance in Q4 and for 2017 overall, and then we will take questions.

Joining Alan and I today are Brett Robinson, President of Canfor Pulp; Peter Hart, Vice President of Pulp Sales; Kevin Pankratz, our Senior Vice President of Lumber Sales and Marketing; and Stephen Mackie, our Senior Vice President of Canadian Operations.

So taking a look at our results. Beginning with Canfor Pulp, the Company generated a record high quarterly operating income of 67.25 million, surpassing the previous high by $14 million. Demand for pulp was very strong in the last half of the year, driven in part by China and its new restrictions on the import of recycled paper.

After an unexpected 11,000 tonne outage in November, the mills ran well in December, and production was in line with the previous quarter. The pulp market appears well positioned for the remainder of the first quarter and into the standard spring maintenance period in Q2. We continue to be cautious around incremental pulp supply but are encouraged by good demand from most regions.

Moving to the lumber business. Our operations ran well but faced a number of transportation issues and weather challenges that impacted production and also shipments at year-end. North American demand was strong, and supply constraints kept prices high through most of the quarter. In our view, the gap between SPF and Southern Yellow Pine will be lower than we've seen historically, due to the continuing reduction in supply from Canada.

Offshore markets were particularly good in Japan, and Canfor had a record year in Japan in 2017. China continues to be stable with increasing volumes of higher value products. Our outlook for 2018 is for continued slow improvement in market demand and at a rate that will offset incremental supply in the US South. Challenges to new capacity additions and better-than-expected demand will result in strong prices going forward.

And finally, yesterday we announced that our Board of Directors has approved construction of a greenfield sawmill in Washington, Georgia. Late last night, we were advised by our contractor of a previous commitment that may prevent them from constructing the mill. Clearly, it will take some more time to get a fuller understanding of the situation, but we remain fully committed to building a greenfield mill. The impact of this event, in terms of timing, could not be quantified at this time, but we will provide further updates as they become known.

I will now turn it over to Alan to provide an overview of our financial results.

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

Thanks, Don, and good morning, everyone. As usual, my comments will focus principally on our financial performance for the fourth quarter of 2017 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 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. The presentation highlights consolidated and segmented results, and I'll be referring to this presentation during my comments.

For the fourth quarter of 2017, Canfor reported shareholder net income of $132 million or $1.02 a share, up from net income of $66 million or $0.51 a share reported for the third quarter of 2017, and net income of $38 million or $0.29 a share reported for the fourth quarter of 2016.

On Slide 3 of our presentation, we highlight various nonoperating items net of tax on noncontrolling interests, which affect the comparability of our results between the quarters. In the fourth quarter, these items totaled $17 million, the largest item relating to recovery with respect to countervailing and antidumping duty deposits. After adjusting for the aforementioned items, shareholder net income for Q4 was $115 million, or $0.89 a share, compared to $85 million, or $0.65 for the third quarter.

As highlighted on Slide 5 of our presentation, the lumber segment reported operating income of $155 million for Q4. That was up $62 million from the previous quarter. The increase reflected both solid lumber demand and CVD, ADD true-up adjustments in the fourth quarter.

US and Canadian housing starts were both up from the previous quarter, and the improving market conditions translated into increasing Western SPF and Southern Yellow Pine sales realizations, which more than offset a 9 percent decline in lumber shipments due to capital-related downtime in the US South and weather-related production and transportation challenges in Western Canada.

As you can see on Slide 6 of our presentation, adjusted operating income included a $45 million recovery of countervailing and antidumping duty deposits. This recovery was comprised of two components: firstly, the adjustment of CVD and ADD preliminary deposit rates from 20.26 and 7.72 percent respectively, to final determination rates of 13.24 and 7.28 percent; and secondly, a subsequent true-up of the ADD accrual rate from 7.28 percent to 1.1 percent, to reflect current 2017 sales and cost data versus the 2015- '16 period of review.

Of the $45 million net recovery, $60 million pertain to the fourth quarter. Unit manufacturing costs were moderately higher than the previous quarter, with the severe weather conditions contributing to higher purchased wood and log-hauling costs as well as lower productivity.

Canfor's Pulp and Paper segment comprises the results of Canfor Pulp Products Inc. As highlighted on Slide 7 of our presentation, the Company reported a record high net income of $45 million, or $0.69 a share in Q4 2017, compared to net income of $13 million, or $0.19 a share for the third quarter, and net income of $10 million, or $0.15 a share, for the fourth quarter of 2016. Adjusted shareholder net income for Q4 is $48 million, or $0.73 a share, compared to $13 million or $0.19 for the third quarter.

As you'll see on Slide 8 of the presentation, Canfor Pulp's results reflected the continued strong demand for global softwood pulp in Q4, in part reflecting new Chinese government restrictions on imports of recycled mixed paper. The average China NBSK pulp list price was up 29 percent from the previous quarter, resulting in improved sales realizations quarter over quarter.

Pulp shipments were broadly in line with the previous quarter, with the benefit of a 14,000-tonne vessel shipment slippage from late September being cancelled out by a vessel delay at the end of December due to the adverse weather. Pulp production was also in line with the previous quarter, as improved productivity later in Q4 largely offset an unscheduled outage of the Northwood Mill due to a tube leak in the Number 5 recovery boiler. Unit manufacturing costs were consistent with the previous quarter.

Operating income for the paper segment in Q4 was $7 million, up $3 million from the previous quarter, with increased paper sales realizations and shipments more than offsetting higher slush pulp costs.

Capital spending in the fourth quarter totaled approximately $94 million, including 65 million for the lumber business and $28 million in Canfor Pulp. Our total 2017 capital spend was approximately $170 million for Canfor and $80 million, including major maintenance, for Canfor Pulp.

For 2018, after taking account of our announced greenfield sawmill, we anticipate capital spending for lumber will be in the region of $340 million, and for Canfor Pulp, about $90 million.

Consistent with the prior quarters, Canfor Pulp's Board of Directors yesterday approved the continuance of a quarterly dividend of $6.25 per share. Also in the fourth quarter of 2017, Canfor spent about $16 million on a share repurchase program, purchasing approximately 633,000 shares at an average price of $24.80.

At the end of 2017, Canfor, excluding Canfor Pulp, had net debt of $174 million with available liquidity of 356 million, and Canfor Pulp had net cash of $77 million with available liquidity of $101 million. Net debt to total capitalization, excluding Canfor Pulp, was just over 9 percent and on a consolidated basis, 4.6 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. Thank you.

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 Hamir Patel from CIBC Capital Markets. Hamir, please go ahead.

Hamir Patel — CIBC Capital Markets

Hi. Good morning.

Don Kayne

Good morning.

Hamir Patel

Don, I was wondering how much flexibility do you have in the South to maybe modify some of your mills to make more 2x4, given the pricing premium versus the wides?

Don Kayne

Yup. I think it was a good question, Hamir. I think for the most part, we've got a fair bit of flexibility. And we've sort of built and focused hard on trying to work on diversifying our production to incorporate not only 2x4, but some of the wider widths too because we—in a lot of cases, it provides a lot more opportunity for more of the higher value products. So that's what we've tended to do. But yeah, we can make more 2x4 if we choose to, but at this point, the balance that we have today is probably pretty close to where we will be—what we will be seeing in the future too, so.

Hamir Patel

Okay. Fair enough. And I wanted to touch about exports. It looked like, I think in the annual report that they were up year over year. Just curious, given the strong pricing we're seeing in the US. How do you think about where those export volumes trend? And then maybe what's the opportunity to grow exports out of the US South?

Don Kayne

First of all, I think on the second part of the question, I think there's opportunities—or I know Kevin may want to talk about this a bit more here with you now or later. But yeah, certainly we think a big part of what we're doing down in the South is, in terms of where we've been trying to locate our mills; a good consideration has been to be close to tide water because we do believe that there's a significant opportunity.

In the past, what we've found is in the US, there's not or hasn't been an awful lot of folks on offshore and export business. But clearly, with India starting to become a bit bigger factor and some of the opportunities in Asia, we do believe there's a material opportunity to increase shipments over there more and more.

Hamir Patel

Thanks, Don. That's helpful. And I just wanted to ask you about some of the labour constraints we're seeing in the US. I know we've seen some of the builders explore factory-built homes. Just curious how you're maybe positioning yourself to serve that segment of the market? And maybe how big is that, in terms of overall demand?

Don Kayne

Yeah. I think that's—I think that's the next transformation that's going to take place in the industry frankly, Hamir, over the next 5 to 10 years. I mean clearly driven by labour and the difficulties that currently exist, but also more importantly, whether they're going to get even worse in our view down the road here, so.

So in the construction business in the US, I think certainly the major builders have recognized that themselves. And I believe that we're going to see more and more of them researching and actually developing more of the prefab plants and more industrial plants that will produce wall panels or trusses and so forth.

I think that's a longer-term deal; that's probably over the next one, two, to five years. But it is something—that model is in existence in Japan and most other countries, frankly. And so our belief is that that will continue to increase as we move forward, as the construction industry transforms into more factory-built housing.

Hamir Patel

Great. Thanks, Don. That's all I had. I'll turn it over.

Don Kayne

Okay. Thanks, Hamir.

Operator

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

Sean Steuart — TD Securities

Thanks. Good morning, everyone.

Don Kayne

Good morning, Sean.

Sean Steuart

A couple questions, guys. I feel like we come back to this one every couple of quarters, but broader capital allocation question. Canfor Pulp is trading less than 4 times trailing enterprise value to EBITDA. And I appreciate we're at the—arguably close to the peak of the pulp cycle, but can you explain your thinking on allocating capital between discretionary growth in your lumber business, whether it's the greenfield mill or organic CapEx of the existing asset base, versus buying Canfor Pulp back in at the Canfor level?

Don Kayne

Yeah. Sure, Sean. We've been talking an awful lot about that, as you can imagine, over the last several months here. Maybe Alan, why don't you speak to Sean a little bit and the detail there, he might find interesting?

Alan Nicholl

Yeah. Yeah. No, for sure. Good morning, Sean. So clearly, as you will have detected from our recent press releases and just some of our general commentary, we're fairly keen to grow our lumber platform, most recently with a nice greenfield site. So yes, that clearly is a key focus for us, as too is preserving our top quartile performance right across our whole fleet of assets in North America. So the lumber business and related activities is clearly a big focus for Canfor and takes a higher priority than the other one I just highlighted.

And I mean in terms of Canfor Pulp, clearly, I think all of us has been pleasantly surprised by just how strong the markets have been, even in the last six months. So even as we look out, quite frankly, for the next couple of quarters—so our cash position is much better, quite frankly, than we forecast even 6 or 12 months ago. And we're very motivated to make that cash work.

And so we're very keen now to look more closely at growth acquisitions. We believe our balance sheet could support those quite comfortably today, whereas we may have had a few more reservations, say even 12 months ago. So I think we're feeling pretty good about growth for both our lumber and our pulp businesses, and that's really the priority for us today, Sean.

Sean Steuart

Are you guys seeing pulp mills come to market for acquisition?

Alan Nicholl

Right now we're not hearing a lot of that. But our view is—our view—I mean there's not a whole lot of really high-calibre pulp mills. We've talked about this before in previous calls. But listen, the way I look at it, Sean, is we've got an excellent cash position, and we are keen to look more closely, particularly as we go through maybe some softness here in the back half of the year, then that's something that may come into play.

The other thing that's relevant too, of course, is the energy side of things. We've done well there in terms of our investment. We're very pleased with what we've done, and we do believe that there could be potentially more energy plays that we want to look at more closely, particularly in the next 12, 18 months.

Sean Steuart

Okay. Thanks for that, Alan. And a question on the greenfield project in Georgia, and it seems like this is maybe a developing topic for you guys. But could you speak any recourse you might have with your contractor with respect to potential delays? Any insight you can provide there?

Don Kayne

Yeah. Sean, it is real fresh. I mean, this was late last evening, as I think we might have mentioned or maybe not in our press release. But yeah, no, there's nothing more that I can clue you in on at this stage. I mean, clearly, we're looking into it further as we speak. But all I will say though is as we learn more about it, we will definitely communicate it to everyone, exactly our position. But right now, I can't really shed too much more on it right now, just frankly because we're still trying to make sure we've got all the right facts here, so.

Sean Steuart

Understood. That's all I have for now. I'll get back in the queue. Thanks, guys.

Operator

Thank you.

Don Kayne

Thanks.

Operator

Your next question is from Mark Wilde from BMO. Mark, please go ahead.

Mark Wilde — BMO Capital Markets

Morning, Don.

Don Kayne

Morning, Mark.

Mark Wilde

I'm wondering, just coming back to the greenfield down in Washington. Is that a—like can you give us some sense? Is that like a national or international contract? I mean, would they have issues with being able to do that work in another location, if you moved to like a plan B site?

Don Kayne

Yeah. I mean potentially, but I mean I think that the contractor for sure operates and supplies equipment internationally. I think if we chose to move—we're not even saying that we'll move yet. At the end of the day, we're still trying to understand the situation 100 percent first. But I think the contractor may have other—there may be other commitments elsewhere.

But at this point literally, Mark, and I'm not trying to dance around the question, but we really got aware—we became aware of this late last night. So we really—and with this call early first thing this morning, we really haven't got all the details here, frankly. But we will have them shortly, and Pat or Alan will certainly update all of you as they become known here in the next little while.

Mark Wilde

Yeah. Well, can I just go back to sort of the original decision to kind of site there? And can you just give us a sense of sort of what were the critical factors for you in that location?

Don Kayne

Yeah, for sure. And there's three really, I mean, or two main ones. But the two factors that are clearly the key considerations, and that we did the most due diligence on—a significant due diligence, and it's why it took us so long to come to a conclusion—is number one is residuals and residual offtakes, because that's been a huge challenge for some companies down there, and so we recognize that. So we wanted to make sure wherever we went, that we had that offtake or at least a solid plan for that.

The other one is obviously people, right, as you've probably heard, maybe not. And I—down there, that's getting tough everywhere, and no different down there. So we wanted to make sure we were in a location that was close to major metro areas, if possible, where we had a larger base to draw from. That's why we chose where we did, right? So those were the two main ones.

Of course, the other one that we always have anchored any acquisition on is the fibre, quality, and volume sustainability. There was a bunch of smaller ones like I mentioned earlier, I think, around access to tide water and those sorts of things. But clearly the residual piece and the employment piece and availability of human resources are probably the two key ones.

Mark Wilde

Yeah. Well, I mean I can see where you would be very good for both residuals and for people because you're pretty close to the University of Georgia there as well as to Augusta.

Don Kayne

For sure.

Mark Wilde

I wonder though, Don, in regard to that site. I mean we just had an announcement Tuesday night that Georgia Pacific was going to build an even bigger sawmill about 35 miles away. Can you talk about sort of what impact that would have just in sort of fibre supply in that basket?

Don Kayne

Yeah. For sure. And for us, we began the work basically—well first of all, we knew that mill was there. We weren't sure what was going to happen there, but clearly we built that into everything in terms of our planning there, Mark. We felt and still feel that there's significant fibre of the quality and the size that we believe we need to run the mill, so we weren't concerned about that at all, and we're still not. 100 percent.

Mark Wilde

Okay.

Don Kayne

That's a really significant area for fibre, and we actually—we've made a trip down, well, several trips down there, but actually we're down there a couple of weeks ago with a couple of our board members too, and we had a chance to see some of it firsthand, but there's clearly a lot of it down there. And that's where we put a lot of effort into that, the last six to nine months, assuming that there could be some changes there that actually materialized two days before we announced.

Mark Wilde

Yeah. Okay. All right. And then I wonder if we can just toggle over to Western Canada, and you can give us some sense of kind of where the log costs, you think, are going to be moving in 2018? I'm just curious here. We know that supply has become more of an issue in the BC interior, yet at the same time, we know there's probably going to be a lot of salvage logging that takes place after the fires. And I just wondered if you could kind of help us as we think about the puts and takes there?

Don Kayne

Yeah, for sure, Mark. Well, you know what I'll do? I'll pass it over to Stephen because I know that him and his folks are putting a lot of work into that exact question and concern and so forth. So, Stephen, why don't you update, if you don't mind, Mark, around that?

Stephen Mackie — Senior Vice President, Canadian Operations, Canfor Pulp Products Inc.

Yeah. Sure. Okay. Good morning, Mark. So yeah, obviously as we've seen, and you can see in our results, we've continued to experience log cost escalation in BC as a result of some of the fibre supply constraints in a post-mountain pine beetle area, as well as the implications of the worst forest fire season we've seen in BC.

And we see some others reaching out into our traditional operating areas and some significant pressure on purchase wood, as well as lots of constraints related to weather and trucking capacity. There's been some significant challenges through Q4 in getting fibre supply to our operations, and those challenges have persisted through Q1. And we would anticipate continued upward pressure on log cost in British Columbia through the balance of 2018.

Mark Wilde

Okay. And then, Stephen, if I could. Just the big uptick that we've seen in like SPF pricing. To what degree has that thrown a lifeline to some marginal mills, mills that you might have expected to exit the market over the next year or two?

Stephen Mackie

Yeah. So a good question, Mark, for sure. And I think our position would be that there is certainly, there's a need for capacity rationalization in British Columbia to better align with the available sustainable fibre supply. Obviously, the market conditions that we've got today in the US, and quite frankly in every market around the world, are supporting operations and allowing people to reach out further, go further to get fibre supply and pay more. And we're seeing that in some of the extreme bidding behaviour in the province of BC. So I think generally, everybody is making money today and has profitable operations, so that is going to create some challenges, obviously, and have people operating longer. So it certainly has changed the picture.

Don Kayne

We would still—we would still, Stephen, say now though that our belief would still be consistent that we think over the next two, three, four years here—and it's kind of increasing this focus here—that six to eight mills are going to need to shut here at some point.

Stephen Mackie

Yeah. Absolutely, Don. The fibre supply won't support the capacity that we have today, but it's going to drag it out for a while.

Mark Wilde

Yeah. Okay. Yeah. That's what I was getting at. Last question I had for right now. Just, Alan, can you give us some sense in '18 here what we are looking at, for both kind of a reported tax rate as well as where you think your cash tax rate's going to come in?

Alan Nicholl

Yeah. So I think, without getting into a whole lot of detail—we can maybe deal a little bit with this offline, Mark—but it's very consistent with where you expect to go in light of the recent tax changes, both in Canada and the US. So effective rate is around 25 percent, something like that, just …

Mark Wilde

Okay. And then the cash rate?

Alan Nicholl

Yeah. Roughly, it's something in that order of magnitude as well.

Mark Wilde

Okay. That's helpful. I'll jump back in the queue. Thanks, guys.

Don Kayne

Thanks, Mark.

Operator

Thank you. 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

Good morning, Paul.

Paul Quinn

Hey. Just a question on pulp. Sounds—reading through the press release, said you're slightly optimistic over the next couple quarters. What do you—what do you see in the longer term for softwood in terms of capacity ads? Because I'm not seeing a lot, and I think the market could last a little bit longer than a couple of quarters.

Don Kayne

For sure, Paul. Brett, why don't you take that?

Brett Robinson — President, Canfor Pulp Products Inc.

We see some capacity coming on in Q2. And then looking further out, there's not a lot of growth other than creep in the existing mills, so pretty low growth, to answer your question.

Paul Quinn

And on that subject of creep. What are you guys using as an assumption? Is that 1 percent? Is that what you're seeing in the Canfor mills?

Brett Robinson

Well, obviously, we want to grow anything we see as a good opportunity, high-return project. But typically over history, that's about what we've seen, yes.

Paul Quinn

Okay. And then just flipping over to the lumber side on the growth idea and M&A opportunities. We saw a pretty high benchmark valuation last year with the Gilman transaction. Has that caused some of the potential sellers to ask for the moon at this point? Or is there still opportunities out there?

Brett Robinson

Yeah. For sure, it's had an impact. I mean, I think that maybe folks that weren't interested before have come back and say well, if you're willing to do this or that, they might be more interested. But frankly, we've always had a position here, we're not overpaying. Period. We're—and which also caused us to look at other opportunities such as greenfield, right, Paul?

And so we're going to—we'll keep looking at it. But right now, we think the valuations are high and at this point, right, so we're just continuing to—we're not—and there's no rush here. Hopefully, the greenfield that we're talking about will come to fruition here, of course, and plus you add to that the organic growth, and we think we can build it a bit more economically through those channels than possibly on M&A.

Although there's things—we're still looking at M&A as it comes up, right? And there's still the odd thing that pops up here and there, but nothing at this point that I could fill you in on anymore, around any pending deal or so forth, right, so. But clearly they've gone up, the multiples, for sure.

Paul Quinn

Okay. Then you guys mentioned India's a growing destination. What kind of volumes did you sell into India in '17? And what do you think you could do in like five years?

Don Kayne

I'll let Kevin talk about that. He was just there for the last couple of weeks. And so maybe, Kevin, why don't you fill everyone in on it?

Kevin Pankratz — Senior Vice President, Lumber Sales and Marketing, Canfor Pulp Products Inc.

Sure, Paul. Thanks. Yeah. I mean volumes have been quite limited to date, but what we see, there's some really good opportunity in a lot of different segments, be it furniture, doors, and even some wood frame construction. So we're quite optimistic about it in a five-year time period, but still lots of work to do there. We're seeing that softwood lumber and logs are starting to make a little bit more of an impact, compared to five years ago. And we see that trend continuing, and we remain optimistic about the opportunities in India.

Paul Quinn

All right. That's all I had. Thanks, guys.

Don Kayne

Thanks, Paul.

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 joining the call. We appreciate your interest in Canfor, and we look forward to talking to you at the end of Q1. Have a good day. See you.

Operator

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

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