DOMTAR INC /CANADA
Form 40-F
April 01, 2004

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U.S. Securities and Exchange Commission

Washington, D.C. 20549

Form 40-F

o REGISTRATION STATEMENT PURSUANT TO SECTION 12 OF THE SECURITIES EXCHANGE ACT OF 1934

OR

x ANNUAL REPORT PURSUANT TO SECTION 13(a) OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2003 Commission File Number 9682

Domtar Inc.

(Exact name of Registrant as specified in its charter)

Not Applicable

(Translation of Registrant s name into English (if applicable))
Canada

(Province of other jurisdiction of incorporation or organization)
2621

(Primary Standard Industrial Classification Code-Number (if applicable))
Not applicable

(I.R.S. Employer Identification Number (if applicable))
395 de Maisonneuve Blvd. West, Montreal, Quebec, Canada H3A 1L6 (514) 848-5400

(Address and telephone number of Registrant s principal executive offices)
CT Corporation System, 111 Eighth Avenue, New York, N.Y. 10011, (212) 664-1666

(Name, address (including zip code) and telephone number (including area code) of agent for service in the United States)
Securities registered or to be registered pursuant to Section 12(b) of the Act.

Title of each class	Name of each exchange on which registered
Common Shares no par value	New York Stock Exchange

Securities registered or to be registered pursuant to Section 12(g) of the Act.

Not Applicable

(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act.

8 ¾% Notes due 2006, 9 ½% Debentures due 2016, 7.875% Notes due 2011, 5.375% Notes due 2013

(Title of Class)

For annual reports, indicate by check mark the information filed with this Form:

o	Annual Information form	x	Audited annual financial statements

Indicate the number of outstanding shares of each of the issuer s classes of capital or common stock as of the close of the period covered by the annual report.

Common Shares 228,868,629 shares

Indicate by check mark whether the Registrant by filing the information contained in this form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934 (the Exchange Act). If Yes is marked, indicate the file number assigned to the Registrant in connection with such Rule.

Yes ______________ 82- ____________________ No_______X_______

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the last 90 days.

Yes_______X_______ No______________

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FORWARD-LOOKING STATEMENTS

This annual report on Form 40-F contains forward-looking statements, including, without limitation, those regarding expectations for market growth and developments; expectations for growth and profitability; and statements preceded by believes , expects , anticipates , foresees , or similar expressions, are forward-looking statements. Since these statements are based on current plans, estimates and projections, they involve risks and uncertainties, which may cause actual results to materially differ from those expressed in such forward-looking statements. These risks and uncertainties include, but are not limited to: (1) operating factors such as continued success of manufacturing activities and the achievement of efficiencies therein, continued success of product development, acceptance of new products or services by targeted customers, success of the existing and future collaboration arrangements, changes in business strategy or development plans or targets; (2) industry conditions, such as strength of product demand, intensity of competition, prevailing and future global market prices for products and the pricing pressures thereto, financial condition of the customers and competitors, the potential introduction of competing products and technologies by competitors; and (3) general economic conditions such as rates of economic growth in the Company s principal geographic markets or fluctuations in exchange and interest rates.

Figures prior to 2002 have been restated to account for the adoption of the amended Canadian Institute of Chartered Accountants recommendations regarding foreign currency translation.

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Domtar Inc.

April 1, 2004

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DISCLOSURE CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

In accordance with the rules of the Securities and Exchange Commission, Domtar maintains a system of disclosure controls and procedures that is designed to ensure that information required to be disclosed by Domtar is accumulated and communicated to management, including the Chief Executive Officer and the Chief Financial Officer, in a timely manner. Under the supervision and with the participation of its management, including its Chief Executive Officer and Chief Financial Officer, Domtar has evaluated the effectiveness of the design and operation of these disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, Domtar s Chief Executive Officer and Chief Financial Officer concluded that Domtar s system of disclosure controls and procedures is effective.

Change in Internal Controls over Financial Reporting

Domtar maintains a system of internal controls over financial reporting. There were no changes in Domtar s internal controls that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, Domtar s internal control over financial reporting.

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38 Management s Discussion and Analysis

MD&A

Montreal, Quebec
March 1, 2004

Management s Discussion and Analysis (MD&A) relates to the financial condition and results of Domtar s operations. Throughout this MD&A, unless otherwise specified, Domtar , we , us and our refer to Domtar Inc., its subsidiaries, a well as its joint ventures, and the Corporation refers to Domtar Inc. and its subsidiaries. Domtar s common shares are listed on the Toronto and New York stock exchanges. Except where otherwise indicated, all financial information reflected herein is determined on the basis of Canadian generally accepted accounting principles (Canadian GAAP). This MD&A should be read in conjunction with Domtar s consolidated financial statements and notes thereto.

In accordance with industry practice, in this MD&A, the term ton or the symbol ST refers to a short ton, an imperial unit of measurement equal to 0.9072 metric tons, and the term tonne or the symbol MT refers to a metric ton. In this MD&A, unless otherwise indicated, all dollar amounts are expressed in Canadian dollars, as are the term dollars and the symbols $ and CAN$. The term U.S. dollars and the symbol US$ refer to United States dollars.

Forward-Looking Statements

This MD&A contains statements that are forward-looking in nature. Statements preceded by the words believe , expect , anticipate , aim , target , plan , intend , continue , estimate , may , will , should and similar e forward-looking statements. Forward-looking statements are necessarily based upon a number of estimates and assumptions that, while considered reasonable by management, are inherently subject to known and unknown risks and uncertainties such as, but not limited to, general economic and business conditions, product selling prices, raw material and operating costs, changes in foreign currency exchange rates, our ability to integrate acquired businesses into our existing operations, and other factors referenced herein and in Domtar s continuous disclosure filings. Therefore, Domtar s actual results may be materially different from those expressed or implied by such forward-looking statements.

2003 Overview

In 2003, we had to cope with difficult market conditions, in particular the rapid 12% decline in the year-over-year average value of the U.S. dollar when compared to the Canadian dollar, which decreased our net sales, given that most of our products are priced directly or indirectly in U.S. dollars. In fact, within the year 2003, the spot rate declined 22% from January 1, 2003 to December 31, 2003. At the same time, we also had to face a decline in demand for some of our products as well as a soft pricing environment, particularly for copy and offset papers. These difficult market conditions also led us to record an impairment loss on the book value of property, plant and equipment at our Lebel-sur-Quevillon pulp mill and to shut down one of the two paper machines at our Vancouver mill. We are, however, pleased with the performance of our four U.S. mills acquired in 2001. They have enhanced our ability to service customers and mitigated the effect of currency fluctuations by improving our geographical balance and increasing our operational flexibility.

While we experienced a difficult year in 2003, we are determined to improve our profitability. In order to do so, we have announced plans to strengthen our profitability improvement programs by further increasing the competitiveness of our Canadian mills as well as our operational flexibility. These plans are expected to entail a thorough review of our Canadian pulp and paper operations to enable them to remain profitable when the Canadian dollar is valued at 75 cents to the U.S. dollar and prices are at cycle-low levels.

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Our Business

Domtar s reporting segments correspond to the following business activities: Papers, Paper Merchants, Wood and Packaging.

Papers

We are the third largest integrated manufacturer and marketer of uncoated freesheet paper in North America. We operate six pulp and paper facilities in Canada and five in the United States, with an annual paper production capacity of approximately 2.7 million tons of paper, complemented by strategically located warehouses and sales offices. Over 50% of our paper production capacity is located in the United States and approximately 90% of our paper sales are made to customers in the United States. Uncoated and coated freesheet papers, our principal products, are used for business, commercial printing and publication, and technical and specialty applications. The chart below illustrates our principal paper products and our annual paper production capacity.

We sell paper primarily through a large network of owned and independent merchants that distribute our paper products from over 350 locations throughout North America. We also sell our products to a variety of customers, including business offices, office equipment manufacturers, retail outlets, commercial printers, publishers and converters. In addition, we sell pulp in excess of our own internal requirements. We also purchase pulp to optimize paper production and freight costs. At December 31, 2003, our net market pulp position (shipments less purchases) was approximately 640,000 tons.

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40 Management s Discussion and Analysis

Our Papers business is our most important segment, representing 58% of our consolidated net sales in 2003, or 64% when including sales of Domtar paper through our own Paper Merchants business.

Paper Merchants

Our Paper Merchants business comprises the purchasing, warehousing, sale and distribution of various products made by us and by other manufacturers. These products include business and printing papers, graphic arts supplies and certain industrial products. Our Canadian paper merchants operate a total of eight branches in eastern Canada (three by Buntin Reid in Ontario, two by JBR/La Maison du Papier in Quebec and three by The Paper House in the Atlantic Provinces), while our U.S. paper merchant (RIS Paper) services a large customer base from 20 locations in the Northeast, Midwest and Mid-Atlantic regions of the United States. Our Paper Merchants business represented 23% of our consolidated net sales in 2003, or 17% when excluding sales of Domtar paper.

Wood

Our Wood business comprises the manufacturing and marketing of lumber and wood-based value-added products, as well as the management of forest resources. We operate 11 sawmills, one planer mill and one remanufacturing facility, with an annual capacity of 1.2 billion board feet of lumber. We also have investments in three businesses that produce wood products. We seek to optimize 22 million acres of forestland for which we are responsible in Canada and the United States through efficient management and the application of certified sustainable forest management practices such that a continuous supply of wood is available for future needs. Our Wood business represented 7% of our consolidated net sales in 2003.

Packaging

Our Packaging business comprises our 50% ownership interest in Norampac Inc. (Norampac), a joint venture between Domtar Inc. and Cascades Inc. The Board of Directors of Norampac is composed of four representatives each from Domtar Inc. and Cascades Inc. The Chairman of the Board is a Domtar Inc. representative, while the President and CEO is a Cascades Inc. representative. Norampac s debt is non-recourse to Domtar Inc. As required by Canadian GAAP, we account for our 50% interest in Norampac using the proportionate consolidation method.

Norampac s network of 24 corrugated packaging plants, strategically located across Canada and the United States, provides full-service packaging solutions and produces a broad range of products. These facilities are fully integrated on a direct or indirect basis with Norampac s eight containerboard mills (located in Ontario, Quebec, British Columbia, New York State and northern France) for a combined annual capacity of more than 1.6 million tons. Our Packaging business represented 12% of our consolidated net sales in 2003.

Business Strategy

Our overall strategic objective is to be a world leader in the paper industry, particularly in the fine paper segment. We have developed our business strategies around three pillars: meeting and anticipating the ever-changing needs of ***customers***, providing our ***shareholders*** with attractive returns, and fostering a dynamic and creative environment for our ***employees*** in which shared human values and personal commitment prevail.

Our business strategies are to continue to:

meet the needs of our customers in order to enhance customer loyalty;

- improve the productivity of our mills and the quality of our products and services;
- broaden our distribution capabilities;
- grow through acquisitions and alliances within our area of expertise;
- maintain strict financial discipline;
- support the personal growth and participation of employees; and
- maintain our good citizenship.

Through these strategies, we aim to be one of the most attractive investments in the North American basic materials sectors by providing superior returns to our shareholders.

Summary of Financial Results

Financial highlights Years ended December 31		**2003**	**2002**	**2001**
(In millions of Canadian dollars, unless otherwise noted)				
Net sales		**4,777**	5,490	4,377
EBITDA[1]		**516**	809	607
Excluding unusual items[2]		**519**	845	607
Operating profit (loss)[1]		**(92)**	384	313
Excluding unusual items[2]		**135**	447	313
Net earnings (loss)		**(190)**	141	140
Excluding unusual items[2]		**5**	183	101
Net earnings (loss) per share (basic)		**(0.84)**	0.62	0.72
Excluding unusual items[2]		**0.02**	0.80	0.52
Net earnings (loss) per share (diluted)		**(0.84)**	0.61	0.72
ROE[3] (%)		**(8)**	6	7
Excluding unusual items[3] (%)			7	6
Operating profit (loss) excluding unusual items per segment[2]:				
Papers		**135**	346	246
Paper Merchants		**20**	25	17
Wood		**(66)**	2	(46)
Packaging		**48**	74	82
Corporate		**(2)**		14
Total		**135**	447	313
Selling price index[4] before the impact of lumber duties (%)		**92**	92	97
Shipments to capacity ratio for papers (%)		**91**	95	93
Average exchange rates	CAN	**1.401**	1.570	1.549
	US	**0.714**	0.637	0.646
Total assets (at end of year)		**5,855**	6,847	7,055
Total long-term debt, including current portion (at end of year)		**2,059**	2,514	2,921
Dividends per share:				
Series A preferred shares		**2.25**	2.25	2.25
Series B preferred shares		**0.86**	0.75	1.18
Common shares		**0.22**	0.14	0.14

1 EBITDA (earnings before interest (financing expenses), taxes and amortization) is a non-GAAP measure and is determined by adding back amortization expense, including portions related to unusual items (impairment losses and write-downs), to the operating profit. Operating profit is also a non-GAAP measure that is calculated within the body of our financial statements. We focus on EBITDA and operating profit as these measures enable us to compare our results between periods without regard to debt service or income taxes (for operating profit) and without regard to

amortization (for EBITDA). As such, we feel it would be useful for investors and other users to be aware of these measures so they can better assess our performance. Our EBITDA and operating profit measures have no standardized meaning prescribed by GAAP and are not necessarily comparable to similar measures presented by other companies and therefore should not be considered in isolation.

2 See Unusual items affecting results and non-GAAP measures .

3 See return on average shareholders equity (ROE) discussion and ROE Reconciliation table.

4 Selling price index is derived from transaction prices for the majority of our products, weighted for production capacity, in relation to trend pricing. Trend pricing is based on a consensus of analysts of normalized pricing as at November 30, 2003. See Sensitivity Analysis .

Unusual items affecting results and non-GAAP measures

Our operating results include unusual items affecting the comparability of our results. To measure our performance and that of our business segments from period to period without variations caused by special or unusual items, we focus on EBITDA excluding unusual items, operating profit excluding unusual items, net earnings excluding unusual items, net earnings per share excluding unusual items, and other such measures excluding unusual items. Unusual items are defined as items such as charges for: impairment of assets, facility or machine closures, changes in income tax legislation, debt restructuring, and other significant items of an unusual or non-recurring nature.

EBITDA excluding unusual items, operating profit excluding unusual items, net earnings excluding unusual items, net earnings per share excluding unusual items and other such measures excluding unusual items are non-GAAP measures. We believe that it is useful for investors and other users to be aware of the unusual factors that adversely or positively affected our GAAP results, and that these non-GAAP measures provide investors and other users with a measure of performance to compare our results between periods without regard to these unusual items. These measures have no standardized meaning prescribed by GAAP and are not necessarily comparable to similar measures presented by other companies and therefore should not be considered in isolation.

The following table reconciles our net earnings (loss) and net earnings (loss) per share, determined in accordance with GAAP, to our net earnings excluding unusual items and net earnings per share excluding unusual items, and reconciles our EBITDA and operating profit (loss) to our EBITDA excluding unusual items and operating profit excluding unusual items:

Unusual items	**2003**				**2002**				**2001**	
	EBITDA	**Operating profit (loss)**	**Net earnings (loss)**	**Net earnings (loss) per share**	**EBITDA**	**Operating profit**	**Net earnings**	**Net earnings per share**	**Net earnings**	**Net earnings per share**
(In millions of Canadian dollars, except per share amounts)										
As per GAAP[1]	**516**	**(92)**	**(190)**	**(0.84)**	809	384	141	0.62	140	0.72
Unusual items:										
Impairment loss[(i)]		**201**	**135**	**0.59**						
Change in income tax legislation[(ii)]			**31**	**0.14**					(39)	(0.20)
Closure costs[(iii)]	**1**	**24**	**16**	**0.07**	36	63	42	0.18		
Refinancing expenses[(iv)]			**12**	**0.05**						
Write-off of deferred transaction costs[(v)]	**2**	**2**	**1**	**0.01**						

	3	**227**	**195**	**0.86**	36	63	42	0.18	(39)	(0.20)
Excluding unusual items	**519**	**135**	**5**	**0.02**	845	447	183	0.80	101	0.52

1 Except for EBITDA and operating profit (loss) which are non-GAAP measures. See note 1, page 41.

(i) In the fourth quarter of 2003, we conducted an impairment study of the long-lived assets at our Lebel-sur-Quevillon pulp mill as a result of past operating losses at this facility and our assessment of the impact of a weaker U.S. dollar and market trends on this facility. Following this study, we recorded an impairment loss of $201 million ($135 million net of income taxes or $0.59 per common share) on the net book value of property, plant and equipment of this mill.

(ii) In the fourth quarter of 2003, income tax expense was increased by $31 million ($0.14 per common share) as a result of an increase in statutory enacted future income tax rates and a corresponding revaluation of future income tax assets and liabilities.

In 2001, our results included an income tax benefit of $39 million ($0.20 per common share) pertaining to a reduction in enacted income tax rates and a corresponding revaluation of future income tax assets.

(iii) In the first quarter of 2002, we recorded a $45 million ($30 million net of income taxes or $0.13 per common share) charge reflecting a $14 million write-down of property, plant and equipment pertaining to the closure of our St. Catharines paper mill, and a $31 million provision for other commitments and contingencies related to the closure. Furthermore, the fourth quarter 2002 results included a charge of $18 million ($12 million net of income taxes or $0.05 per common share) reflecting a $13 million write-down of property, plant and equipment pertaining to the closure of our Daveluyville and Sault Ste. Marie wood products facilities, and a $5 million provision for other commitments and contingencies related to these closures. However, our third quarter 2003 results included a $5 million ($3 million net of income taxes or $0.01 per common share) reversal of certain costs pertaining to the closure of our St. Catharines paper mill, largely as a result of changes to the initial approach to dismantling the mill.

In the fourth quarter of 2003, we decided to permanently shut down one of the two paper machines at our Vancouver mill. The decision to close the paper machine resulted in a charge of $29 million ($19 million net of income taxes or $0.08 per common share), including $23 million pertaining to the write-down to the estimated net realizable value of property, plant and equipment, a provision of $5 million for severance and related costs (for 85 employees) that were contractual obligations at the time of the decision and a $1 million charge related to the write-off of certain inventory items and spare parts to their net recoverable amounts. The closure will also require further costs in 2004 and 2005, which will be recognized as incurred, related to equipment removal estimated at $2 million net of salvage proceeds and other employee related costs estimated at $1 million for an additional $3 million ($2 million net of income taxes or $0.01 per common share). The total of the 2003 to 2005 costs is estimated to be $32 million ($21 million net of income taxes or $0.09 per common share). As at December 31, 2003, the balance of the provision was $5 million.

(iv) In the fourth quarter of 2003, we wrote off $7 million ($5 million net of income taxes or $0.02 per common share) of deferred financing costs. These deferred financing costs were initially capitalized in connection to upfront fees and costs related to our bank term loan. With the partial repayment of this bank term loan following a US$350 million senior debt offering under a shelf registration statement in November 2003, the related deferred financing fees and costs were written off in proportion to the repayment. In the second quarter of 2003, an additional $10 million ($7 million net of income taxes or $0.03 per common share) charge was recorded following the refinancing of substantially all of Norampac s credit facilities and long-term debt.

(v) In the fourth quarter of 2003, our results included a $2 million ($1 million net of income taxes or $0.01 per common share) charge relating to the write-off of costs incurred with respect to a potential joint venture transaction with Tembec Inc. that was not completed.

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Net sales of $4.8 billion

Net sales in 2003 totaled $4,777 million, down $713 million or 13% from net sales of $5,490 million in 2002. This decrease was mainly attributable to the effect of a 12% rapid decline in the year-over-year average value of the U.S. dollar when compared to the Canadian dollar (approximate $490 million impact, net of the effect of our hedging program) on both our domestic and export sales, and to lower shipments for all of our principal products, except corrugated containers, caused primarily by weak demand (approximate $150 million impact). In addition, the results for 2002 were impacted by the reversal of a $28 million provision, of which $8 million was recorded in the first quarter of 2002 and $20 million was recorded in the second half of 2001 for countervailing and antidumping duties pertaining to the Canada-U.S. softwood lumber dispute. Overall, our U.S. dollar denominated transaction prices for 2003 remained low at 92% of trend[1] prices, unchanged in comparison to 2002. Within Canada, however, the decline of the U.S. dollar negatively impacted our Canadian dollar denominated prices, which are derived from U.S. dollar denominated prices.

Operating loss of $92 million

Cost of sales decreased by $374 million or 9% in 2003 compared to 2002. This decrease was mainly due to the impact of a weaker U.S. dollar on our U.S. dollar denominated operating expenses, lower shipments and the impact of our quality and profitability improvement programs. These factors were partially offset by higher energy costs, as well as by the inclusion of fewer investment tax credits related to research and development expenses of current and prior years in 2003 ($10 million) compared to 2002 ($16 million).

Sales, general and administrative (SG&A) expenses decreased by $11 million or 3% (or $13 million or 4% when excluding unusual items of $2 million pertaining to the write-off of transaction costs) in 2003 compared to 2002. This mainly reflected the impact of a weaker U.S. dollar on our U.S. dollar denominated costs and the inclusion of a $6 million mark-to-market gain on certain foreign exchange contracts not considered as hedges for accounting purposes. Lower employee profit-sharing expenses in 2003 compared to 2002 and other cost reduction initiatives also contributed to the decrease in SG&A. These factors were partially offset by an increase in stock-based compensation and pension expenses.

Operating loss was $92 million in 2003 compared to an operating profit of $384 million in 2002. When excluding unusual items, operating profit amounted to $135 million in 2003, down $312 million or 70% from an operating profit excluding unusual items of $447 million in 2002. This decrease was largely due to the $222 million impact of the weaker U.S. dollar on both domestic and export sales net of U.S. dollar costs and net of the effect of our hedging program, lower shipments for all our principal products except corrugated containers, higher energy costs, and higher countervailing and antidumping duties on our softwood lumber exports to the U.S. However, the positive impact of our quality and profitability improvement programs, when excluding the impact of lower shipments, allowed us to more than offset the impact of inflation on salaries and benefits.

[1] Based on a consensus of analysts of normalized pricing as at November 30, 2003. See Sensitivity Analysis .

Variance analysis 2003 vs 2002

(In millions of Canadian dollars)		
2002 operating profit excluding unusual items		**447**
Selling prices, net of purchased fiber costs		29
Impact of weaker U.S. dollar (net of hedging)*		(222)
Quality and profitability improvement programs (Q&P):		
Shipments	(63)	
Mix and cost reductions (net of inflation)	12	
Total Q&P		(51)
Net impact of softwood lumber duties		(34)
Energy costs		(34)
2003 operating profit excluding unusual items		**135**

* Includes the effect of the weakening U.S. dollar on our Canadian dollar denominated prices, given that these are derived from U.S. dollar denominated prices.

As a result of the above-mentioned factors, EBITDA for 2003 amounted to $516 million (or $519 million when excluding unusual items) compared to $809 million (or $845 million when excluding unusual items) in 2002.

Quality and profitability improvement programs

In 2002, we launched a quality and profitability improvement program aimed at achieving $100 million of savings by the end of 2003 through higher efficiencies, an improved customer base and product offerings, and reduced operating costs. Unfortunately, the success of this program in 2003 was hampered by difficult market conditions, including a significant drop in shipments ($63 million) caused by weak economic conditions, our decision to adjust production to customer needs and end the practice of selling papers that did not meet our quality standards (seconds), and the impact of labor disruptions and the August 2003 power outage. Nonetheless, the cost reduction initiatives undertaken have allowed us to more than offset the impact of inflation on salaries and benefits.

In January 2004, we announced plans to strengthen our quality and profitability improvement programs in order to increase our competitiveness and counteract the impact of difficult market conditions. More specifically, we will:

- undertake a full review and rationalization of our Canadian pulp and paper operations to ensure that they are profitable when the Canadian dollar is valued at 75 cents to the U.S. dollar and prices are at cycle-low levels;

- accelerate our efforts to ensure that multiple facilities can manufacture our most in-demand products;

- continue the implementation of new business processes and an integrated enterprise resource planning (ERP) system designed to optimize production capacity and improve our just-intime customer delivery service; and

- outsource the logistics of our pulp and paper product delivery.

We expect these measures to increase our operational flexibility and enhance the competitiveness of our Canadian mills. We further anticipate that they will mitigate the impact of rising costs, particularly in the areas of energy and fiber, the latter having also been affected by the Canada-U.S. softwood lumber dispute.

Net loss of $190 million

Net loss for 2003 amounted to $190 million ($0.84 per common share) compared to net earnings of $141 million (or $0.62 per common share) in 2002. When excluding unusual items, net earnings

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totaled $5 million ($0.02 per common share) in 2003, down $178 million from net earnings when excluding unusual items of $183 million ($0.80 per common share) in 2002. This year-over-year deterioration in net earnings was attributable to the factors mentioned above, partially offset by a decrease in financing expenses due to lower interest rates, the positive impact of a weaker U.S. dollar on our U.S. interest expense and lower debt levels, and lower income taxes.

ROE[1] of negative 8%

One of the measures we use to assess shareholders return is ROE. Our objective is to achieve a 15% ROE under normal market conditions. In 2003, our ROE was negative 8% compared to a positive 6% in 2002. When excluding unusual items, ROE in 2003 was at break-even (see ROE Reconciliation table below) and at 7% in 2002. This decrease in ROE is explained by the above-mentioned factors.

Achieving a 15% ROE target remains a challenge, given current market conditions (weakness of the U.S. dollar, cycle-low prices for copy and offset papers, weak demand, and the ongoing Canada-U.S. softwood lumber dispute). We expect the rationalization programs we are initiating and the implementation of strategic tools such as new business processes and an ERP system to partially offset the impact of difficult market conditions and improve our return to shareholders.

ROE Reconciliation

(In %)	
2002 ROE	**6**
Unusual items	1
	—
2002 ROE, when excluding unusual items	**7**
Selling prices, net of purchased fiber costs	1
Impact of weaker U.S. dollar (net of hedging)	(6)
Q&P programs:	
Shipments	(2)
Mix and cost reductions (net of inflation)	1
Net impact of softwood lumber duties	(1)
Energy costs	(1)
Financing expenses	1
	—
2003 ROE, when excluding unusual items	
Unusual items	(8)
	—
2003 ROE	**(8)**

Free cash flow[2]

Despite difficult market conditions, we generated free cash flow (cash flows from operating activities less net additions to property, plant and equipment) of $123 million in 2003 compared to $454 million in 2002. Free cash flow generated in 2003 was applied primarily to debt reduction and the payment of dividends.

1 Return on average common shareholders equity (ROE) is a non-GAAP measure and is calculated as net earnings, after dividend payments on preferred shares, to total average common shareholders equity. The ratio excluding unusual items is calculated by removing unusual items incurred in the specific year from total average common shareholders equity. We use this measure in assessing the returns we provide to our shareholders and, as such, feel it would be useful for investors and other users to be aware of this measure so they can better assess our performance. ROE has no standardized meaning prescribed by GAAP and is not necessarily comparable to similar measures presented by other companies and therefore should not be considered in isolation.

2 Free cash flow is a non-GAAP measure that we define as the amount by which cash flows from operating activities, as determined in accordance with GAAP, exceeds net additions to property, plant and equipment, as determined in accordance with GAAP. We use free cash flow in evaluating our ability and that of our business segments to service our debt and, as such, feel it would be useful for investors and other users to be aware of this measure so they can better assess our performance. Our free cash flow measure has no standardized meaning prescribed by GAAP and is not necessarily comparable to similar measures presented by other companies and therefore should not be considered in isolation.

Papers

Selected information Years ended December 31		2003	2002
(In millions of Canadian dollars, unless otherwise noted)			
Net sales		**2,791**	3,234
Operating profit (loss)		**(90)**	301
Operating profit excluding unusual items		**135**	346
Shipments:			
Paper (in thousands of ST)		**2,499**	2,613
Pulp (in thousands of ADST)		**769**	789
Paper shipments product offering (%):			
Copy and offset grades		**54**	51
Uncoated commercial printing & publication and premium imaging grades		**24**	25
Coated commercial printing & publication grades		**11**	13
Technical & speciality grades		**11**	11
Total		**100**	100
Benchmark nominal prices[1]:			
Copy 20 lb sheet	(US$/ton)	**768**	776
Offset 50 lb rolls	(US$/ton)	**628**	692
Coated publication, no. 3, 60 lb, rolls	(US$/ton)	**804**	767
Pulp NBSK US market	(US$/ADMT)	**553**	491
Pulp NBHK Japan market[2]	(US$/ADMT)	**470**	427
Selling price index[3] Papers segment (%)		**92**	91

1 Source: Pulp & Paper Week. As such, these prices do not necessarily reflect our transaction prices.
2 Based on Pulp & Paper Week s Southern Bleached Hardwood Kraft pulp prices for Japan, increased by an average differential of US$15/ADMT between Northern and Southern Bleached Hardwood Kraft pulp prices.
3 Selling price index is derived from transaction prices for the majority of our products, weighted for production capacity, in relation to trend pricing. Trend pricing is based on a consensus of analysts of normalized pricing as at November 30, 2003. See Sensitivity Analysis .

Sales and operating profit

Net sales in our Papers business amounted to $2,791 million in 2003, a decrease of $443 million or 14% in comparison to 2002. This decrease was primarily due to the unfavorable impact of a weaker U.S. dollar on both domestic and export sales and lower shipments for both paper and pulp. These factors were partially offset by overall higher selling prices, as decreases in the selling prices for copy, offset and uncoated paper products were more than offset by increases in the selling prices for coated and technical and specialty paper products, as well as for hardwood and softwood pulp.

Operating loss in our Papers business totaled $90 million in 2003 (or an operating profit of $135 million when excluding unusual items of $225 million pertaining to an impairment charge and closure costs) compared to an operating profit of $301 million in 2002 (or $346 million when excluding unusual items of $45 million pertaining to closure costs). This $211 million decrease in operating profit when excluding unusual items stems primarily from the negative impact of a weaker U.S. dollar, lower shipments for both paper and pulp, and higher energy and purchased fiber costs, partially offset by higher selling prices and the benefits stemming from our quality and profitability improvement programs.

Pricing environment

In our Papers business, our average transaction prices, denominated in U.S. dollars, increased in 2003 compared to 2002. Within Canada, however, the decline of the U.S. dollar negatively impacted our Canadian dollar denominated prices, which are derived from U.S. dollar denominated prices.

Our average transaction prices for 20 lb copy sheets (business papers) and 50 lb offset rolls (uncoated commercial printing & publication papers), which represented 43% of our paper sales in 2003, decreased by an average of US$32/ton in 2003 compared to 2002. We have announced a US$60/ton price increase for both copy papers and offset rolls, effective March 1, 2004.

Our Northern Bleached Softwood Kraft (NBSK) and our Northern Bleached Hardwood Kraft (NBHK) pulp transaction prices increased by US$53/tonne and US$44/tonne, respectively, in 2003 compared to 2002. We have announced a US$20/tonne price increase for softwood pulp, effective February 1, 2004.

Operations

Our paper shipments to capacity ratio stood at 91% for 2003 compared to 95% in 2002. Our Papers business was impacted by weak economic conditions, our decision to curtail production to match customer demand and end the practice of selling seconds, and the impact of production disruptions caused by the mid-August 2003 power outage in the eastern United States and eastern Canada as well as labor issues.

In the third quarter of 2003, new six-year labor agreements were signed with PACE union members at our Port Huron, Port Edwards, and Nekoosa mills.

In November 2003, employees at our Vancouver paper mill went on strike after rejecting our offer for the renewal of their collective agreement. In January 2004, the strike was resolved and a new five-year labor agreement was signed with CEP union members. The mill resumed operations in early-February 2004.

Certain collective agreements for the Cornwall, Ottawa-Hull, Espanola, Lebel-sur-Quevillon and Wisconsin mills are due for renewal in 2004.

In January 2004, we proceeded with our plans to reorganize production activities at our Vancouver paper mill to better meet customer demands and increase the mill s profitability. Accordingly, we shut down one of the mill s two paper machines and restructured the activities of the other to optimize manufacturing of our Domtar Luna coated paper. This process resulted in the permanent curtailment of 45,000 tons of paper manufacturing capacity and the termination of 85 employees. These steps are expected to increase product quality and availability, expand our market share of coated papers, improve the mill s efficiency and better respond to Asian competition.

Paper Merchants

Selected information Years ended December 31	2003	2002
(In millions of Canadian dollars)		
Net sales	**1,074**	1,193
Operating profit	**20**	25

Sales and operating profit

Our Paper Merchants business generated net sales of $1,074 million in 2003, a decrease of $119 million or 10% in comparison to 2002. This decrease was due to the negative impact of a weaker U.S. dollar and a reduction in overall tons sold compared to the prior year.

Operating profit in 2003 totaled $20 million (reflecting an operating margin of 1.9%) compared to $25 million in 2002 (reflecting an operating margin of 2.1%). This decrease in operating profit and related margin was mainly attributable to a decrease in warehouse shipments, which generate higher gross profit than direct mill shipments, and to the negative impact of a weaker U.S. dollar.

Wood

Selected information Years ended December 31	2003	2002
(In millions of Canadian dollars, unless otherwise noted)		
Net sales	**342**	462
Operating loss	**(68)**	(16)
Operating profit (loss) excluding unusual items	**(66)**	2
Shipments (millions of FBM)	**999**	1,037
Shipments product offering (%):		
Random lengths	**39**	42
Studs	**37**	36
Value-added	**18**	16
Industrial	**6**	6

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