ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") should be read in conjunction with Domtar Corporation's unaudited interim financial statements and notes thereto included in this Quarterly Report on Form 10-Q. This MD&A should also be read in conjunction with the historical financial information contained in our Annual Report on Form 10-K for the year ended December 31, 2020, filed with the Securities and Exchange Commission ("SEC") on March 1, 2021. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those discussed in forward-looking statements. Factors that might cause a difference include, but are not limited to, those discussed below under "outlook", "Forward-looking statements", as well as in Item 1A, Risk Factors, in Part II, of this report. Throughout this MD&A, unless otherwise specified, "Domtar Corporation," "the Company," "Domtar," "we," "us" and "our" refers to Domtar Corporation and its subsidiaries. Domtar Corporation's common stock is listed on the New York Stock Exchange and the Toronto Stock Exchange. Except where otherwise indicated, all financial information reflected herein is determined on the basis of accounting principles generally accepted in the United States.

The information contained on our website, www.domtar.com, is not incorporated by reference into this Form 10-Q and should in no way be construed as a part of this or any other report that we file with or furnish to the SEC.

In accordance with industry practice, in this report, the term "ton" or the symbol "ST" refers to a short ton, an imperial unit of measurement equal to 0.9072 metric tons. The term "metric ton" or the symbol "ADMT" refers to an air dry metric ton. In this report, unless otherwise indicated, all dollar amounts are expressed in U.S. dollars, and the term "dollars" and the symbol "$" refer to U.S. dollars. In the following discussion, unless otherwise noted, references to increases or decreases in income and expense items, prices, contribution to net earnings (loss), and shipment volumes are based on the three and nine months ended September 30, 2021 and September 30, 2020. The three month and nine month periods are also referred to as the third quarter and first nine months of 2021 and 2020. Reference to notes refers to footnotes to the consolidated financial statements and notes thereto included in Item 1 in this Form 10-Q.

This MD&A is intended to provide investors with an understanding of our recent performance, financial condition and outlook. Topics discussed and analyzed include:

- Overview
- Highlights for the three month and nine month periods ended September 30, 2021
- COVID-19 Update and Outlook
- Cost Reduction Program
- Review of Continuing Operations
- Discontinued Operations of our Personal Care Business
- Liquidity and Capital Resources

Paper Excellence to Acquire Domtar Corporation

On May 10, 2021, Domtar and Paper Excellence, a global diversified manufacturer of pulp and specialty, printing, writing, and packaging papers, entered into a business combination transaction (the "Paper Excellence transaction" or "transaction") under which the Paper Excellence group of companies will acquire all of the issued and outstanding shares of Domtar common stock for $55.50 per share, in cash. The all-cash transaction represents an enterprise value of approximately $3 billion. After the transaction closes, Paper Excellence intends to continue the operations of Domtar as a stand-alone business entity. As such, Domtar will continue to be led by its management team and Paper Excellence plans to retain its corporate and production locations. The transaction is expected to close in the fourth quarter of 2021, subject to receipt of the required regulatory approvals and other customary closing conditions. On July 29, 2021, Domtar's shareholders approved the transaction. During the three and nine months ended September 30, 2021, we recorded $5 million and $23 million, respectively, of transaction fees under Closure and restructuring costs on the Consolidated Statement of Earnings (Loss) and Comprehensive Income (Loss).

Restart of the paper machine at our Ashdown, Arkansas mill

On July 15, 2021, we announced our intention to restart the paper machine at our Ashdown, Arkansas mill to add an additional 185,000 tons per year of uncoated freesheet production capacity to our manufacturing network. The increase is necessary to meet growing customer demand as the economy recovers from the COVID-19 pandemic. The additional paper capacity will also result in a capacity reduction of 185,000 ADMT per year of baled SBSK pulp at the mill. However, it will not impact Ashdown's fluff pulp production capacity, or our commitment to serving our key hygiene customers around the world. Additionally, we have a dedicated team developing a kraft linerboard project for our Ashdown mill, and the decision to restart the paper machine will not impact our intention to produce containerboard and other packaging products at the facility. The machine is expected to resume full operation in January 2022 following a period of time to ramp up to full production. We estimate the restart will cost approximately $10 million.

Sale of Personal Care Business

On March 1, 2021, we completed the previously announced sale of our Personal Care business to American Industrial Partners for a purchase price of $920 million in cash, including elements of working capital of $130 million. We received a net amount of $897 million, which represents the selling price minus the settlements of the net indebtedness and other elements of working capital adjustments. For financial reporting purposes, our former Personal Care business is presented as a discontinued operation. For more information, refer to Item 1, Financial Statements and Supplemental Data, under Note 3, "Discontinued Operations".

OVERVIEW

We design, manufacture, market and distribute a wide variety of fiber-based products including communication papers, specialty and packaging papers. The foundation of our business is a network of wood fiber converting assets that produce paper grade, fluff and specialty pulp. Approximately 40% of our pulp production is consumed internally to manufacture paper, with the balance sold as market pulp. We are the largest integrated marketer of uncoated freesheet paper in North America serving a variety of customers, including merchants, retail outlets, stationers, printers, publishers, converters and end-users. To learn more, visit www.domtar.com.

We operate as a single reportable segment as described below, which also represents our only operating segment.

Pulp and Paper: Consists of the design, manufacturing, marketing and distribution of communication, specialty and packaging papers, as well as softwood, hardwood and fluff pulp and high quality airlaid and ultrathin laminated cores.

Our segment measure of profit (operating income (loss) from continuing operations) is used by management to evaluate performance and make operational decisions. Management believes that this measure allows for a better understanding of cost trends, operating efficiencies, prices and volume. Business segment operating income (loss) is defined as earnings (loss) from continuing operations before income taxes and equity losses, excluding corporate items, interest expense, net, and non-service components of net periodic benefit cost. Corporate expenses are allocated to our segment with the exception of certain discretionary charges and credits, which we present under "Corporate" and do not allocate to the segment.

Conversion of our Kingsport, Tennessee mill

We plan to enter the linerboard market with the conversion of our Kingsport paper machine. Once in full operation, the mill will produce and market approximately 600,000 tons annually of high-quality recycled linerboard and medium, providing us with a strategic footprint in a growing adjacent market. The conversion is expected to be completed by the end of 2022.

We estimate the conversion cost to be approximately $350 million. Once fully operational, the mill is expected to be a low-cost, first quartile recycled linerboard facility in North America. The converted mill is expected to directly employ approximately 160 employees. For the three months and nine months ended September 30, 2021, we recorded $9 million and $22 million, respectively, under Asset Conversion Costs on the Consolidated Statement of Earnings (Loss) and Comprehensive Income (Loss).

HIGHLIGHTS FOR THE THREE MONTH PERIOD ENDED SEPTEMBER 30, 2021

- Operating income and net earnings increased by 163% and 180%, respectively, from the third quarter of 2020
- We reported earnings from continuing operations of $74 million compared to a loss from continuing operations of $111 million in the third quarter of 2020
- Sales increased by 15% from the third quarter of 2020. Our net average selling prices for pulp and paper as well as our pulp volumes were up when compared to the third quarter of 2020
- Recognition of closure and restructuring charges and asset conversion costs of $5 million and $9 million, respectively, related mostly to the Paper Excellence transaction and our previously announced decision to repurpose assets at our Kingsport mill

HIGHLIGHTS FOR THE NINE MONTH PERIOD ENDED SEPTEMBER 30, 2021

- Operating income and net earnings increased by 206% and 221%, respectively, from the first nine months of 2020
- We reported earnings from continuing operations of $105 million compared to a loss from continuing operations of $129 million in the first nine months of 2020
- Loss from discontinued operations, net of taxes amounted to $23 million in the first nine months of 2021, including a net loss on disposition of discontinued operations of $33 million
- Sales increased by 9% from the first nine months of 2020. Our net average selling prices for pulp and paper were up as well as our pulp volume, while our manufacturing paper volumes were down from the first nine months of 2020
- Recognition of closure and restructuring charges and asset conversion costs of $33 million and $22 million, respectively, related mostly to the Paper Excellence transaction, our cost reduction program and our previously announced decision to repurpose assets at our Kingsport mill
- Repaid $605 million of outstanding indebtedness under our 4.4% Notes and Term Loan Agreement, including make-whole premium of $11 million and repurchased $238 million of our common stock

	Three months ended				Nine months ended			
			Variance				Variance	
FINANCIAL HIGHLIGHTS	**September 30, 2021**	September 30, 2020	$	%	**September 30, 2021**	September 30, 2020	$	%
(In millions of dollars, unless otherwise noted)								
Sales	**$ 1,031**	$ 899	*$ 132*	*15%*	**$ 2,985**	$ 2,732	*$ 253*	*9%*
Operating income (loss)								
Pulp and Paper	**108**	(140)	*248*	*177%*	**215**	(133)	*348*	*262%*
Corporate	**(12)**	(12)	*—*	*-%*	**(49)**	(24)	*(25)*	*(104%)*
Operating income (loss)	**96**	(152)	*248*	*163%*	**166**	(157)	*323*	*206%*
Earnings (loss) from continuing operations	**74**	(111)	*185*	*167%*	**105**	(129)	*234*	*181%*
Earnings (loss) from discontinued operations, net of taxes	**—**	19	*(19)*	*(100%)*	**(23)**	61	*(84)*	*(138%)*
Net earnings (loss)	**74**	(92)	*166*	*180%*	**82**	(68)	*150*	*221%*
Basic net earnings (loss) per common share (in dollars) [(a)]:								
Earnings (loss) from continuing operations	**$ 1.47**	$ (2.01)	*$ 3.48*		**2.04**	(2.33)	*$ 4.37*	
Earnings (loss) from discontinued operations	**$ —**	$ 0.34	*$(0.34)*		**(0.44)**	1.10	*$ (1.54)*	
Basic net earnings (loss)	**$ 1.47**	$ (1.67)	*$ 3.14*		**1.60**	**(1.23)**	*$ 2.83*	
Diluted net earnings (loss) per common share (in dollars) [(a)]:								
Earnings (loss) from continuing operations	**$ 1.46**	$ (2.01)	*$ 3.47*		**2.03**	(2.33)	*$ 4.36*	
Earnings (loss) from discontinued operations	**$ —**	$ 0.34	*$(0.34)*		**(0.44)**	1.10	*$ (1.54)*	
Diluted net earnings (loss)	**$ 1.46**	$ (1.67)	*$ 3.13*		**1.59**	**(1.23)**	*$ 2.82*	

	At September 30, 2021	At December 31, 2020
Total assets	**$ 3,947**	$ 4,856
Total long-term debt, including current portion	**$ 504**	$ 1,097

[(a)] See Note 6 "Earnings (Loss) per Common Share" of the financial statements in this Quarterly Report on Form 10-Q for more information on the calculation of net earnings (loss) per common share.

COVID-19 UPATE

First identified in people in late 2019, COVID-19 spread rapidly throughout the world and, in March 2020, the World Health Organization characterized COVID-19 as a pandemic. With the unprecedented and rapid spread of COVID-19 and social distancing measures implemented throughout the world due to the pandemic, this virus has had a profound impact on human health, the global economy and society in general. We are actively monitoring the impact of COVID-19 on all aspects of our business, including our employees, operations, customers, suppliers, liquidity and capital resources.

We took a variety of actions during 2020 and 2021 to help mitigate the financial impact, including a cost reduction program, reducing our capital spending, suspended our regular quarterly dividend, and proactively managing our working capital.

Our focus has been on the health and safety of our employees throughout the pandemic and we will continue to maintain the safety protocols we established. As guidance from authorities such as the U.S. Centers for Disease Control evolves, we will update our practices accordingly, as we have done throughout the pandemic.

Our operations are essential services in the jurisdictions where we operate. Certain of our paper products are used in the testing for COVID-19 as well as for personal protection medical gowns. Beginning in April 2020, we saw a significant decline in demand for our paper, largely due to work-from-home rules and the overall economic slowdown. Starting in the second quarter of 2021, there was an increase in demand for our paper as the economy continues to recover from the effects of the COVID-19 pandemic. In response to the increase in demand, on July 15, 2021, we announced the restart of the paper machine at our Ashdown, Arkansas mill, discussed above.

The Government of Canada created the Canada Emergency Wage Subsidy ("CEWS") to provide financial support for businesses during the COVID-19 pandemic and prevent large layoffs. For the nine months ended September 30, 2021, we recognized $7 million as a reduction of costs related to this program (CDN $9 million) ($6 million in Cost of sales (CDN $7 million) and $1 million in Selling, general and administrative (CDN $2 million)).

OUTLOOK

Paper demand is expected to remain strong in the fourth quarter, but shipments are anticipated to decline slightly due to lower capacity resulting from maintenance outages. Demand for paper grade pulp is expected to soften, while demand for fluff pulp grade is expected to remain strong. We expect to continue to experience challenging supply chain conditions. Paper prices are expected to continue to increase following recently announced price increases while paper grade pulp prices should continue to decline. Overall raw material costs are expected to increase mostly due to inflation.

COST REDUCTION PROGRAM

On August 7, 2020, we announced the implementation of a cost reduction program, targeting $200 million in annual run-rate cost savings to be realized by the end of 2021. In the second quarter of 2021, we achieved and closed our cost reduction program. The goal of the program was to build a stronger business operation, enhance our cost efficiency, improve operating margins and maximize productivity and cash flow. The costs saving initiatives included capacity reduction and asset closures, mill-level cost savings and rightsizing support functions.

Our cost reduction program included the permanent closure of the uncoated freesheet manufacturing at our Kingsport, Tennessee and Port Huron, Michigan mills, the remaining paper machine at our Ashdown, Arkansas mill and the converting center in Ridgefields, Tennessee. Additionally, on May 7, 2021, we announced the closure of our converting center in Dallas, Texas. These actions reduced our annual uncoated freesheet paper capacity by approximately 721,000 short tons and resulted in a workforce reduction of approximately 750 employees. Our Kingsport and Ashdown paper machines, which have been idled since April 2020, did not recommence operations. Our Ridgefields converting center ceased operations at the end of the third quarter of 2020, our Port Huron mill ceased operations in the first quarter of 2021 and our Dallas converting center ceased operations at the beginning of July 2021.

For the three and nine months ended September 30, 2021, we recorded $1 million and $8 million, respectively, of accelerated depreciation under Impairment of long-lived assets, $1 million and $5 million, respectively, of severance and termination costs, $1 million and nil, respectively, of pension settlement gain and nil and $4 million, respectively, of other costs under Closure and restructuring costs on the Consolidated Statement of Earnings (Loss) and Comprehensive Income (Loss).

REVIEW OF OPERATIONS

This section presents a discussion and analysis of our third quarter and first nine months of 2021 and 2020 sales, operating income (loss) and other information relevant to the understanding of our results of operations.

ANALYSIS OF NET SALES

	Three months ended				Nine months ended			
			Variance				*Variance*	
	September 30, 2021	September 30, 2020	$	%	**September 30, 2021**	September 30, 2020	$	%
Sales	**1,031**	899	*132*	*15%*	**2,985**	2,732	*253*	*9%*
Shipments								
Paper - manufactured (in thousands of ST)	**546**	550	*(4)*	*(1%)*	**1,641**	1,688	*(47)*	*(3%)*
Communication Papers	**449**	449	*—*	*-%*	**1,356**	1,384	*(28)*	*(2%)*
Specialty and Packaging papers	**97**	101	*(4)*	*(4%)*	**285**	304	*(19)*	*(6%)*
Paper - sourced from third parties (in thousands of ST)	**20**	16	*4*	*25%*	**56**	50	*6*	*12%*
Paper - total (in thousands of ST)	**566**	566	*—*	*-%*	**1,697**	1,738	*(41)*	*(2%)*
Pulp (in thousands of ADMT)	**438**	424	*14*	*3%*	**1,373**	1,305	*68*	*5%*

ANALYSIS OF CHANGES IN SALES

	Third quarter of 2021 versus Third quarter of 2020 % Change in Sales due to			First nine months of 2021 versus First nine months of 2020 % Change in Sales due to		
	Net Price	Volume / Mix	**Total**	Net Price	Volume / Mix	**Total**
Sales	14%	1%	**15%**	9%	-%	**9%**

Sales in the third quarter of 2021 increased by $132 million, or 15% when compared to sales in the third quarter of 2020. This increase in sales is mostly due to an increase in our net average selling prices for pulp and paper and an increase in our pulp sales volume.

Sales in the first nine months of 2021 increased by $253 million, or 9% when compared to sales in the first nine months of 2020. This increase in sales is mostly due to an increase in our net average selling prices for pulp and paper and an increase in our pulp sales volumes. This increase was partially offset by a decrease in our paper sales volumes as a result of work-from-home rules and the overall economic slowdown.

ANALYSIS OF CHANGES IN OPERATING INCOME (LOSS)

Third quarter of 2021 versus Third quarter of 2020

	$ Change in Operating Income (Loss) due to								
	Volume/Mix	Net Price	Input Costs [(a)]	Operating Expenses [(b)]	Currency	Depreciation/ Impairment [(c)]	Restructuring/ Conversion [(d)]	Other Income/ Expense [(e)]	**Total**
Pulp and Paper	—	123	(11)	(31)	(5)	113	57	2	**248**
Corporate	—	—	—	—	—	—	(3)	3	**—**
Operating income (loss)	—	123	(11)	(31)	(5)	113	54	5	**248**

(a) Includes raw materials (such as fiber and chemicals) and energy costs.
(b) Includes maintenance, freight costs, selling, general and administrative ("SG&A") expenses and other costs.
(c) Depreciation charges were lower by $3 million in the third quarter of 2021, excluding foreign currency impact and we recorded $1 million of accelerated depreciation under Impairment of long-lived assets. In the third quarter of 2020, we recorded $111 million of accelerated depreciation under Impairment of long-lived assets related to our cost reduction program.

(d) We recorded $5 million of restructuring charges in the third quarter of 2021 related to transaction fees for the Paper Excellence transaction, compared to $68 million in the third quarter of 2020 related to our cost reduction program. We also recorded $9 million of asset conversion costs at our Kingsport mill in the third quarter of 2021 as part of the conversion plan to a linerboard facility.

(e) Third quarter of 2021 other operating income/expense includes:
- Net gain on sale of property, plant and equipment ($3 million)
- Foreign currency gain on working capital items ($2 million)
- Environmental provision ($1 million)
- Other income ($1 million)

Third quarter of 2020 other operating income/expense includes:
- Foreign currency loss on working capital items ($1 million)
- Other income ($1 million)

Commentary – Third quarter of 2021 compared to Third quarter of 2020

Operating income in our Pulp and Paper segment amounted to $108 million in the third quarter of 2021, an increase of $248 million, when compared to operating loss of $140 million in the third quarter of 2020. Our results were positively impacted by:

- Higher net average selling prices for pulp and paper ($123 million)
- Lower depreciation/impairment charges ($113 million). Depreciation charges were lower by $3 million when compared to the third quarter of 2020. We recorded $1 million of accelerated depreciation under Impairment of long-lived assets in the third quarter of 2021 compared to $111 million of accelerated depreciation charges in the third quarter of 2020 related to our cost reduction program
- Lower restructuring and conversion charges ($57 million) in the third quarter of 2021. We recorded $1 million of restructuring charges compared to $67 million of restructuring charges in the third quarter of 2020 related to our cost reduction program. We also recorded $9 million of asset conversion costs at our Kingsport mill as part of the conversion to a linerboard facility in the third quarter of 2021.
- Higher other income ($2 million)

These increases were partially offset by:

- Higher operating expenses ($31 million) mostly due to higher maintenance in part due to the timing of some major maintenance, higher freight costs and higher salaries and wages. This increase was partially offset by higher production
- Higher input costs ($11 million) mostly related to higher costs of chemicals due to unfavorable market conditions and a business acquisition in the second quarter of 2020
- Negative impact of a stronger Canadian dollar on our Canadian dollar denominated expenses, net of our hedging program ($5 million)

OTHER FACTORS

Corporate

We incurred $12 million of corporate charges in the third quarter of 2021 compared to $12 million in the third quarter of 2020. We recorded $4 million of restructuring charges in the third quarter of 2021 related mostly to transaction fees for the Paper Excellence transaction compared to $1 million of restructuring charges in the third quarter of 2020 and offset by the proceeds from the sale of property in the third quarter of 2021. SG&A expenses were flat when compared to the third quarter of 2020.

Interest Expense, net

We incurred $7 million of net interest expense in the third quarter of 2021, a decrease of $7 million compared to net interest expense of $14 million in the third quarter of 2020. This was due to lower interest on the 4.4% Notes due to the early retirement in April 2021 as well as lower interest on the Term loan due to the early repayment in the March 2021.

Income Taxes

For the third quarter of 2021, our income tax expense was $22 million, consisting of a current income tax expense of $28 million and a deferred income tax benefit of $6 million. This compares to an income tax benefit of $52 million in the third quarter of 2020, consisting of a current income tax benefit of $10 million and a deferred income tax benefit of $42 million. We made income tax payments, net of refunds, of $17 million during the third quarter of 2021. The effective tax rate was 23% compared with an effective tax rate of 32% in the third quarter of 2020. Our tax provision for interim periods is determined using an estimate of our annual effective tax rate and then adjusting for discrete items arising in that quarter. In each interim quarter we update the estimate of the annual effective tax rate and, if the estimated annual tax rate changes, we make a cumulative adjustment in that quarter. The effective tax rate for the third quarter of

2020 was significantly impacted by such an adjustment, mainly due to a change in the mix of earnings or loss between jurisdictions. The effective tax rate for the third quarter of 2020 was also favorably impacted by the CARES Act, which granted companies the ability to carry back tax losses generated in the U.S. in 2020 to a tax year with a higher statutory tax rate.

First nine months of 2021 versus First nine months of 2020

By Business Segment

	$ Change in Segmented Operating Income (Loss) due to								
	Volume/Mix	Net Price	Input Costs [a]	Operating Expenses [b]	Currency	Depreciation/ Impairment [c]	Restructuring/ Conversion [d]	Other Income/ Expense [e]	Total
Pulp and Paper	(15)	259	(17)	(25)	(2)	115	35	(2)	**348**
Corporate	—	—	—	(8)	(1)	—	(21)	5	**(25)**
Operating income (loss)	(15)	259	(17)	(33)	(3)	115	14	3	**323**

(a) Includes raw materials (such as fiber and chemicals) and energy costs.

(b) Includes maintenance, freight costs, SG&A expenses and other costs.

(c) Depreciation charges were lower by $12 million in the first nine months of 2021, excluding foreign currency impact and we recorded $8 million of accelerated depreciation under Impairment of long-lived assets, related to our cost reduction program. In the first nine months of 2020, we recorded $111 million of accelerated depreciation under Impairment of long-lived assets related to our cost reduction program.

(d) We recorded $33 million of restructuring charges in the first nine months of 2021 consisting of $23 million of transaction fees for the Paper Excellence transaction and $5 million of severance and termination costs and $5 million of other costs mostly related to our cost reduction program, compared to $69 million of restructuring charges in the first nine months of 2020 related to our cost reduction program. We also recorded $22 million of asset conversion costs at our Kingsport mill as part of the conversion to a linerboard facility in the first nine months of 2021.

(e) First nine months of 2021 other operating income/ expense includes:
- Net gain on sale of property, plant and equipment ($3 million)
- Bad debt recovery ($2 million)
- Environmental provision ($2 million)
- Other income ($3 million)

First nine months of 2020 other operating income/ expense includes:
- Income from termination of non-production agreement ($7 million)
- Bad debt expense ($5 million)
- Environmental provision ($1 million)
- Other income ($2 million)

Commentary – First nine months of 2021 compared to first nine months of 2020

Operating income in our Pulp and Paper segment amounted to $215 million in the first nine months of 2021, an increase of $348 million, when compared to operating loss of $133 million in the first nine months of 2020. Our results were positively impacted by:

- Higher net average selling prices for pulp and paper ($259 million)
- Lower depreciation/impairment charges ($115 million). Depreciation charges were lower by $12 million when compared to the first nine months of 2020. We recorded $8 million of accelerated depreciation under Impairment of long-lived assets, related to our cost reduction program in the first nine months of 2021 compared to $111 million of accelerated depreciation charges in the first nine months of 2020 related to our cost reduction program.
- Lower restructuring and conversion charges ($35 million) in the first nine months of 2021. We recorded $11 million of restructuring charges mostly related to our cost reduction program compared to $68 million of restructuring charges in the first nine months of 2020 mostly related to our cost reduction program. We also recorded $22 million of conversion costs at our Kingsport mill to a linerboard facility in the first nine months of 2021.

These increases were partially offset by:

- Higher operating expenses ($25 million) mostly related to higher freight costs as well as higher salaries and wages and partially offset by lower maintenance costs in part due to the timing of some major maintenance and lower costs due to our 2020 cost reduction program.
- Higher input costs ($17 million) mostly related to higher cost of chemicals due to a business acquisition in the second quarter of 2020 and unfavorable market conditions as well as higher energy costs mostly due to severe weather issues in the first quarter of 2021 and unfavorable market conditions
- Lower volume and mix ($15 million)
- Lower other income ($2 million)

- Negative impact of our foreign currency hedging program partially offset by a stronger Canadian dollar on our Canadian dollar denominated expenses ($2 million)

OTHER FACTORS

Corporate

We incurred $49 million of corporate charges in the first nine months of 2021, an increase of $25 million compared to corporate charges of $24 million in the first nine months of 2020. This increase was mostly due to transaction fees incurred for the Paper Excellence transaction. SG&A expenses were higher in the first nine months of 2021 mostly due to higher variable compensation when compared to the first nine months of 2020. These increases were partially offset by the proceeds from the sale of property in the third quarter of 2021.

Interest Expense, net

We incurred $42 million of net interest expense in the first nine months of 2021, a decrease of $1 million compared to net interest expense of $43 million in the first nine months of 2020 as a results of lower interest on the 4.4% Notes and Term loan mostly due to their early retirements. This was partially offset by the $11 million in make-whole premium fees we paid in relation to the early retirement of the 4.4% Notes originally due March 2022.

Income Taxes

For the first nine months of 2021, our income tax expense was $38 million, consisting of a current income tax expense of $43 million and a deferred income tax benefit of $5 million. This compares to an income tax benefit of $60 million in the first nine months of 2020, consisting of a current income tax benefit of $15 million and a deferred income tax benefit of $45 million. We made income tax payments, net of refunds, of $18 million during the first nine months of 2021. The effective tax rate was 27% compared to an effective tax rate of 32% in the first nine months of 2020. The effective tax rate for the first nine months of 2021 was significantly impacted by certain transaction costs incurred during the period related to our potential acquisition by Paper Excellence which provide no tax benefit. The effective tax rate for the first nine months of 2020 was significantly impacted by the mix of earnings or loss in our major jurisdictions, by the recognition of additional tax credits in various jurisdictions, and by our ability to carry back U.S. tax losses generated in 2020 to a tax year with a higher statutory tax rate. These favorable impacts were partially offset by an increase in the valuation allowance related to the expected realization of certain U.S. state tax credits.

Economic conditions and uncertainties

The markets in which our pulp and paper business operate are highly competitive with well-established domestic and foreign manufacturers. Most of our products are commodities that are widely available from other producers as well. Because commodity products have few distinguishing qualities from producer to producer, competition for these products is based primarily on price, which is determined by supply relative to demand. We also compete on the basis of product quality, breadth of offering and service solutions. Further, we compete against electronic transmission and document storage alternatives. As a result of such competition, we are experiencing ongoing decreasing demand for most of our existing paper products. In addition, current global economic conditions are highly volatile due to the COVID-19 pandemic, resulting in both market size contractions in certain countries due to economic slowdowns and government restrictions on movement.

The pulp market is highly fragmented with many manufacturers competing worldwide. Competition is primarily on the basis of access to low-cost wood fiber, product quality and pricing of other pulp products.

The high degree of uncertainty and volatility day-to-day and the longer-term potential impacts of the economic slowdown remain unclear. Paper demand is expected to remain strong in the fourth quarter, but shipments are anticipated to decline slightly due to lower capacity resulting from maintenance outages. Demand for paper grade pulp is expected to soften, while demand for fluff pulp grade is expected to remain strong. We expect to continue to experience challenging supply chain conditions. Paper prices are expected to continue to increase following recently announced price increases while paper grade pulp prices should continue to decline. Overall raw material costs are expected to increase mostly due to inflation.

DISCONTINUED OPERATION

On March 1, 2021, we completed the sale of our Personal Care business. Its results of operations are reported as discontinued operations for all periods presented. For the first nine months of 2021, we reported a loss from discontinued operations, net of taxes, of $23 million (first nine months of 2020 – earnings from discontinued operations, net of taxes of $61 million). For more information, refer to Item 1, Financial Statements and Supplemental Data, under Note 3, “Discontinued Operations”.

STOCK-BASED COMPENSATION EXPENSE

For the first nine months of 2021, stock-based compensation expense recognized in our results from continuing and discontinued operations was $10 million for all outstanding awards which includes a mark-to-market recovery, net of hedging, related to liability awards of nil. This compares to a stock-based compensation expense of $4 million from continuing and discontinued operations for all outstanding awards which includes a mark-to-market recovery, net of hedging, related to liability awards of $9 million in the first nine months of 2020. Compensation costs for performance awards are based on management's best estimate of the final performance measurement.

LIQUIDITY AND CAPITAL RESOURCES

Our principal cash requirements are for ongoing operating costs, pension contributions, working capital and capital expenditures, as well as principal and interest payments on our debt and income tax payments. We expect to fund our liquidity needs primarily with internally generated funds from our operations and, to the extent necessary, through borrowings under our $700 million credit facility, of which $672 million is currently undrawn and available, or through our $150 million receivables securitization facility, of which $122 million is currently undrawn and available. Under adverse market conditions, there can be no assurance that these agreements would be available or sufficient. See "Capital Resources" below.

Our ability to make payments on the requirements mentioned above will depend on our ability to generate cash in the future, which is subject to general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control. Our credit and receivable securitization facilities and debt indentures impose various restrictions and covenants on us that could limit our ability to respond to market conditions, to provide for unanticipated capital investments or to take advantage of business opportunities.

A portion of our cash is held outside the U.S. by foreign subsidiaries. The earnings of the foreign subsidiaries reflect full provision for local income taxes. We remain indefinitely reinvested in the outside basis differences of our foreign subsidiaries.

Operating Activities

Our operating cash flow requirements are primarily for salaries and benefits, the purchase of raw materials, including fiber and energy, and other expenses such as income tax and property taxes.

Cash flows from operating activities, including discontinued operations, totaled $169 million in the first nine months of 2021, a $107 million decrease compared to cash flows from operating activities of $276 million in the first nine months of 2020. This decrease in cash flows from operating activities is primarily due to an increase in working capital requirements partially offset by an increase in profitability. We made income tax payments, net of refunds, of $18 million during the first nine months of 2021 compared to income tax refunds, net of payments, of $25 million in the first nine months of 2020.

Investing Activities

Cash flows provided from investing activities, including discontinued operations in the first nine months of 2021 amounted to $710 million, a $870 million increase compared to cash flows used for investing activities of $160 million in the first nine months of 2020.

The source of cash provided from investing activities in the first nine months of 2021 was attributable to the proceeds from the sale of our Personal Care business ($897 million) and proceeds from sale of property of $4 million and was partially offset by additions to property, plant and equipment of $191 million.

The use of cash in the first nine months of 2020 was attributable to additions to property, plant and equipment of $130 million and the acquisition of the Appvion Point of Sale Business in the second quarter of 2020 ($30 million).

Our annual capital expenditures for 2021 should increase mostly due to our Kingsport mill conversion and are expected to be between $310 million and $330 million.

Financing Activities

Cash flows used for financing activities, including discontinued operations, totaled $844 million in the first nine months of 2021 compared to cash flows provided from financing activities of $39 million in the first nine months of 2020.

The use of cash flows for financing activities in the first nine months of 2021, was mostly due from the early repayment of the Term Loan and 4.4% Notes, including the make-whole premium ($605 million) as well as for the repurchase of our common stock ($238 million) of which a $215 million payment was made under the ASR agreement.

The primary source of cash flows provided from financing activities was from proceeds of the Term Loan in the first nine months of 2020 ($300 million). This was partially offset by the decrease in borrowings under our credit facilities (revolver and receivables securitization) ($135 million), the repurchase of our common stock ($59 million), dividend payments ($51 million) and a decrease in bank indebtedness ($10 million).

Capital Resources

Net indebtedness, consisting of bank indebtedness and long-term debt, net of cash and cash equivalents, was $160 million as of September 30, 2021 compared to $788 million as of December 31, 2020.

Use of proceeds from the sale of our Personal Care business

On April 8, 2021, we redeemed the 4.4% Notes, originally due in March 2022, at a redemption price of 100% of the principal amount of $300 million, plus accrued and unpaid interest, as well as a make-whole premium of $11 million. The debt extinguishment as well as the related loss on debt extinguishment was recognized in the second quarter of 2021.

On March 11, 2021, we repaid $294 million remaining under our Term Loan Agreement that had an original maturity in May 2025. A write-off of $2 million of unamortized debt issuance costs is included in the Interest Expense line item on the Consolidated Statement of Earnings.

Revolving Credit Facility

We have an unsecured $700 million revolving credit facility (the “Credit Agreement”) with certain domestic and foreign banks that matures on August 22, 2023.

Borrowings by the Company under the Credit Agreement are guaranteed by our significant domestic subsidiaries. Borrowings by certain foreign subsidiaries under the Credit Agreement are guaranteed by the Company, our significant domestic subsidiaries and certain of our significant foreign subsidiaries.

Borrowings under the Credit Agreement bear interest at LIBOR, EURIBOR, Canadian bankers' acceptance or prime rate, as applicable, plus a margin linked to our credit rating. In addition, we pay facility fees quarterly at rates dependent on our credit ratings. The Financial Conduct Authority in the United Kingdom plans to phase out LIBOR by the end of 2021. We do not anticipate a significant impact to our financial position from the planned phase out of LIBOR.

The Credit Agreement contains customary covenants and events of default for transactions of this type, including two financial covenants: (i) an interest coverage ratio, as defined in the Credit Agreement, that must be maintained at a level of not less than 3 to 1 and (ii) a leverage ratio, as defined in the Credit Agreement, that must be maintained at a level of not greater than 3.75 to 1 (or 4.00 to 1 upon the occurrence of certain qualifying material acquisitions). At September 30, 2021 and September 30, 2020, we were in compliance with these financial covenants, and had no borrowings under the Credit Agreement (September 30, 2020 – nil). At September 30, 2021 and September 30, 2020, we had $28 million and $51 million, respectively, of outstanding letters of credit, leaving $672 million unused and available under this facility (September 30, 2020 – $649 million).

This agreement will terminate upon completion of the Paper Excellence transaction, to be replaced by other financing arrangements.

Receivables Securitization

Our $150 million receivables securitization facility was terminated in October 2021 ahead of its’ scheduled maturity date of November 12, 2021.

At September 30, 2021, we had no borrowings under the receivables securitization facility and $27 million of outstanding letters of credit under the program (September 30, 2020 – nil and nil, respectively). Upon termination, the letters of credit outstanding under the program were transferred to the Credit Agreement.

Common Stock

On May 5, 2020, due to the unprecedented market conditions caused by COVID-19, we suspended the payment of our regular quarterly dividend and stock repurchase program in order to preserve cash and provide additional flexibility in the current environment.

On February 11, 2021, we announced that we resumed our stock repurchase program. Our Board of Directors will continue to evaluate our capital return program based upon customary considerations, including market conditions.

On March 2, 2021, we entered into an ASR agreement under which we paid an aggregate of $200 million and received an aggregate initial share delivery of 4,430,906 shares of our common stock, which were immediately retired. The transaction was completed in September 2021, at which time we paid an additional $15 million to JPMorgan Chase Bank N.A. to settle the agreement. For more information, refer to item 1, Financial Statements and Supplemental Data, under Note 15, “Shareholders’ Equity”.

Due to the Paper Excellence transaction, we have discontinued further share repurchases.

During 2020, we declared one quarterly dividend of $0.455 per share, to holders of our common stock. Total dividends aggregating $25 million were paid on April 15, 2020 to shareholders of record as of April 2, 2020.

GUARANTEES

Indemnifications

In the normal course of business, we offer indemnifications relating to the sale of our businesses and real estate. In general, these indemnifications may relate to claims from past business operations, compliance with laws, the failure to abide by covenants and the breach of representations and warranties included in sales agreements. Typically, such representations and warranties relate to taxation, environmental, product and employee matters. The terms of these indemnification agreements are generally for an unlimited period of time. At September 30, 2021, we were unable to estimate the potential maximum liabilities for these types of indemnification guarantees as the amounts are contingent upon the outcome of future events, the nature and likelihood of which cannot be reasonably estimated at this time. Accordingly, no provision has been recorded. These indemnifications have not yielded significant expenses in the past.

Pension Plans

We have indemnified and held harmless the trustees of our pension funds, and the respective officers, directors, employees and agents of such trustees, from any and all costs and expenses arising out of the performance of their obligations under the relevant trust agreements, including in respect of their reliance on authorized instructions from us or for failing to act in the absence of authorized instructions. These indemnifications survive the termination of such agreements. At September 30, 2021, we have not recorded a liability associated with these indemnifications, as we do not expect to make any payments pertaining to these indemnifications.

RECENT ACCOUNTING PRONOUNCEMENTS

Refer to Note 2 “Recent Accounting Pronouncements,” of the financial statements in this Quarterly Report on Form 10-Q.

CRITICAL ACCOUNTING ESTIMATES AND POLICIES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates, assumptions and choices amongst acceptable accounting methods that affect our reported results of operations and financial position. Critical accounting estimates pertain to matters that contain a significant level of management estimates about future events, encompass the most complex and subjective judgments and are subject to a fair degree of measurement uncertainty. On an ongoing basis, management reviews its estimates, including those related to environmental matters and asset retirement obligations, impairment and useful lives of long-lived assets, closure and restructuring costs, intangible assets impairment, pension and other post-retirement benefit plans, income taxes and contingencies related to legal claims. These critical accounting estimates and policies have been reviewed with the Audit Committee of our Board of Directors. We believe these accounting policies, and others, should be reviewed as they are essential to understanding our results of operations, cash flows and financial condition. Actual results could differ from those estimates.

For more details on critical accounting policies, refer to our Annual Report on Form 10-K for the year ended December 31, 2020.

There has not been any material change to our policies since December 31, 2020. For more details, refer to Note 2 “Recent Accounting Pronouncements” of the financial statements in this Quarterly Report on Form 10-Q.

FORWARD-LOOKING STATEMENTS

The information included in this Quarterly Report on Form 10-Q contains forward-looking statements relating to trends in, or representing management's beliefs about, Domtar Corporation's future growth, results of operations, performance, liquidity and business prospects and opportunities. These forward-looking statements are generally denoted by the use of words such as "anticipate", "believe", "expect", "intend", "aim", "target", "plan", "continue", "estimate", "project", "may", "will", "should" and similar expressions. These statements reflect management's current beliefs and are based on information currently available to management. 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 and other factors that could cause actual results to differ materially from historical results or those anticipated. Accordingly, no assurances can be given that any of the events anticipated by the forward-looking statements will occur, or if any occur, what effect they will have on our results of operations or financial condition. These factors include, but are not limited to:

- continued decline in usage of fine paper products in our core North American market;
- our ability to implement our business diversification initiatives, including repurposing of assets and strategic acquisitions or divestitures, including facility closures;
- conversion costs in excess of our expectations and demand for linerboard;
- product selling prices;
- raw material prices, including wood fiber, chemical and energy;
- conditions in the global capital and credit markets, and the general economy, particularly in the U.S., and Canada;
- performance of our manufacturing operations, including unexpected maintenance requirements;
- the level of competition from domestic and foreign producers;
- cyberattacks or other security breaches;
- the effect of, or change in, forestry, land use, environmental and other governmental regulations and accounting regulations;
- the effect of weather and the risk of loss from fires, floods, windstorms, hurricanes and other natural disasters;
- transportation costs;
- the loss of current customers or the inability to obtain new customers;
- legal proceedings;
- changes in asset valuations, including impairment of long-lived assets, inventory, accounts receivable or other assets or other reasons;
- changes in currency exchange rates, particularly the relative value of the U.S. dollar to the Canadian dollar;
- the effect of timing of retirements and changes in the market price of Domtar Corporation's common stock on charges for stock-based compensation;
- performance of pension fund investments and related derivatives, if any;
- a material disruption in our supply chain, manufacturing, distribution operations or customer demand such as public health crises that impact trade or the general economy, including COVID-19 and other viruses, diseases or illnesses; and
- the other factors described under "Risk Factors", in item 1A of our Annual Report on Form 10-K, for the year ended December 31, 2020.

You are cautioned not to unduly rely on such forward-looking statements, which speak only as of the date made, when evaluating the information presented in this Quarterly Report on Form 10-Q. Unless specifically required by law, Domtar Corporation disclaims any obligation to update or revise these forward-looking statements to reflect new events or circumstances.