FORTRESS PAPER LTD

Q2 2012

FOR THE THREE AND SIX MONTHS ENDED

June 30, 2012

Please visit www.sedar.com for Fortress Paper company filings
This Management’s Discussion and Analysis (“MD&A”) of the financial condition and results of operations of Fortress Paper Ltd. (“we”, “our”, “us”, “Fortress” or the “Company”) has been prepared based on information available as at August 7, 2012. The MD&A should be read in conjunction with the unaudited consolidated financial statements and the notes thereto for the six month period ended June 30, 2012 (available on SEDAR at www.sedar.com). This MD&A provides a review of the significant developments that have impacted the Company’s performance during the quarter ended June 30, 2012 relative to the previous quarter and prior year comparative quarter. The financial information contained herein has been prepared in accordance with International Financial Reporting Standards (“IFRS”), which as of January 1, 2011 is the required reporting framework for Canadian publicly accountable enterprises.

This MD&A contains certain forward-looking statements that reflect the current views and/or expectations of the Company with respect to its expectations, beliefs, assumptions, estimates and forecasts about its business and the industry and markets in which it operates. The reader is cautioned that forward-looking statements are not guarantees of future performance and involve known and unknown risks, uncertainties, assumptions and other factors which are difficult to predict and that may cause actual results or events to differ materially from those anticipated in such forward-looking statements. Accordingly, readers should not place undue reliance on forward-looking statements. Examples of such forward-looking statements that may be contained in this document include: growth and future prospects of our business; the market conditions for dissolving pulp; expected returns on certain business segments; availability of funds for debt allocation; our perceptions of the industry and markets in which we operate and anticipated trends in such markets and in the countries in which we do business; benefits that may accrue to the Company as a result of certain acquisitions; and the anticipated benefits of acquisitions and projects. Assumptions underlying the Company's expectations regarding forward-looking statements or information contained in this MD&A include, among others: that the Company will be able to effectively market its products; the ability of the Company to complete the ramp-up of its dissolving pulp production at the Fortress Specialty Cellulose mill to reach maximum capacity; that dissolving pulp will experience continued and improved demand in the marketplace at anticipated prices; that the Landqart mill will continue operating on a consistent and regular basis in order to produce and deliver on its reinstated banknote order; the general stability of the economic and political environments within the countries where the Company conducts operations; the ability of the Company to obtain financing (if necessary) on acceptable terms; that interest and foreign exchange rates will not vary materially from current levels; that all necessary approvals and arrangements will be obtained and/or finalized in a satisfactory manner in order to proceed with the Fortress Global Cellulose mill project; and that our equipment will operate at expected levels. Persons reading this MD&A are cautioned that forward-looking statements or information are only predictions, and that the Company’s actual future results or performance are subject to certain risks and uncertainties including, without limitation: those relating to potential disruptions to production and delivery, including as a result of equipment failures, labour issues, the complex integration of processes and equipment and other factors; labour relations; failure to meet regulatory requirements; changes in the market; potential downturns in economic conditions; fluctuations in the price and supply of required materials; foreign exchange fluctuations; dependence on major customers; and other risk factors detailed in our filings with Canadian securities regulatory authorities. These risks, as well as others, could cause actual results and events to vary significantly. The Company does not undertake any obligation to release publicly any revisions for updating any voluntary forward-looking statements, except as required by applicable securities law.

Throughout this discussion, reference is also made to EBITDA (defined as net income before interest, income taxes, depreciation, amortization, non-operating income and expenses, and stock based compensation), which the Company considers to be an indicative measure of operating performance and a metric to evaluate profitability. Reference is also made to adjusted net income (loss) (calculated as net income (loss) less specific items affecting comparability with prior periods – for the full calculation, see reconciliation included in the tables titled “Net Income (Loss) to Adjusted Net Loss Reconciliation”) and adjusted net income (loss) per share (calculated as adjusted net income (loss) divided by the weighted average number of shares outstanding in the period). EBITDA, adjusted net income (loss) and adjusted net income (loss) per share are not generally accepted earnings measures and should not be considered as an alternative to net income (loss) or cash flows as determined in accordance with IFRS. As there is no standardized method of calculating these measures, the Company’s EBITDA, adjusted net income (loss) and adjusted net income (loss) per share may not be directly comparable with similarly titled measures used by other companies. Reconciliations of EBITDA and adjusted net income (loss) to net income (loss) reported in accordance with IFRS are included in this MD&A.

All financial references are in Canadian dollars unless otherwise noted.
Market and industry data contained in this MD&A is based upon information, surveys or studies conducted by independent third parties and independent industry or general publications and the Company's knowledge of, and experience in, the markets in which it operates. The Company has no reason to believe that such information is false or misleading in any material respect, however market and industry data is subject to variation and cannot be verified with complete certainty due to limits on the availability and reliability of raw data, the voluntary nature of the data gathering process and other limitations and uncertainties inherent in any statistical survey. This information has not been independently verified by the Company, or any of its respective directors, officers or representatives or any other person involved in the MD&A and no representation is given as to the accuracy of any of the data from third party sources referred to in this MD&A.

Description of Business

The Company was incorporated on May 30, 2006 under the laws of the Province of British Columbia. The Company operates internationally in three distinct business segments: the Dissolving Pulp Segment, the Specialty Papers Segment and the Security Paper Products Segment. The Company operates its dissolving pulp business at the Fortress Specialty Cellulose mill located in Canada which is also in the process of expanding into the renewable energy generation sector with the construction of a cogeneration facility. The Company is also seeking to expand its dissolving pulp capacity with the recent acquisition of the Fortress Global Cellulose mill ("Fortress Global") located at Lebel-sur-Quévillon, Québec, which the Company intends to convert into a dissolving pulp mill and re-start the cogeneration facility. The Company operates its specialty papers business at the Dresden mill located in Germany, where it is a leading international producer of specialty non-woven wallpaper base products. The Company operates its security paper products business at the Landqart mill located in Switzerland, where it produces banknote, passport, visa and other brand protection and security papers, and at its high security production and research facility (the “Fortress Optical Facility”) located in Canada, where it manufactures optically variable thin film material (“OTM”). The segmentation of the Company’s manufacturing operations is based on a number of factors, including production, production processes, and economic characteristics. Fortress’ business segments were re-classified in 2012 given changes in the nature of products being produced. For the purposes of previous year comparative financial information contained in this MD&A, Fortress’ business segments were classified as follows: the Pulp Segment, Security and Specialty Papers Segment and Wallpaper Base Segment.

Overall Performance

Fortress reported 2012 second quarter EBITDA of $2.3 million. For the first quarter of 2012, EBITDA loss was $1.8 million and for the second quarter of 2011, EBITDA was $4.6 million.

Excluding corporate costs, the three business segments’ combined EBITDA was $3.6 million in the 3 months ended June 30, 2012. The Specialty Papers Segment contributed $10.5 million EBITDA while the Dissolving Pulp Segment and the Security Paper Products Segment generated EBITDA losses of $0.7 million and $6.2 million, respectively. Corporate costs contributed to EBITDA loss in the amount of $1.3 million.

Net income for the second quarter of 2012 was $12.5 million or basic and diluted net income of $0.87 per share. In the prior quarter net loss was $10.5 million or diluted loss per share of $0.73. In the prior year comparative period, net income was $2.9 million or diluted net income per share of $0.19. The much improved current period result was primarily due to the gain realized on the sale of certain non-core assets in the Security Paper Products Segment (see “Management’s Outlook”).

Production of dissolving pulp commenced in early December 2011. Commercial production for accounting purposes, with the equipment operating as intended by management, began on March 18, 2012. After such date all sales and cost of sales have been included in the operating results. The Dissolving Pulp Segment improved operating results gradually throughout the quarter.

The Specialty Papers Segment continued its strong performance in the second quarter. Margins remain strong and the order log is healthy. Contributing to the positive results were continued production efficiency, relatively lower pulp prices, full utilization of the Company's new dry waste plant and strong sales tonnage and realized prices.

The Security Paper Products Segment experienced another difficult quarter. Unfortunately, the continued postponement of several major currencies has resulted in optimization challenges due to low volumes. As announced in June 2012,
Landqart had a material banknote order reinstated, the benefits of which are expected to be realized in the second half of 2012 at the earliest. Although the Company continues to pursue opportunities with other customers, there can be no assurance that new orders will be secured nor certainty as to when or whether all remaining postponed orders will be reinstated.

Management’s Outlook

Dissolving Pulp Segment

The Fortress Specialty Cellulose mill continued to ramp up dissolving pulp production during the second quarter of 2012 and achieved approximately 75% average capacity in June and 70% for the quarter. Previously it was anticipated that full capacity would be achieved by the end of June 2012; however, additional planned and unplanned downtime was incurred to address remaining process deficiencies.

All process areas have operated for extended periods at or above design levels and process efficiency and reliability continues to improve. The remaining issues to achieve full capacity center on pulp dryer causticising and optimization are now focal points for the mill team. The new digester plant is performing well.

Dissolving pulp quality continues to progress with further reductions in off-specification product in the second quarter of 2012. Currently, we remain fully sold through the third quarter.

With the completion of the Lebel-sur-Quévillon acquisition, Fortress plans to increase its overall dissolving pulp production capacity to approximately 450,000 metric tonnes per year. Detailed engineering and process design has commenced for the conversion to dissolving pulp. In addition, the site workforce is ramping up and commencing rebuilding work to bring the asset to full operational condition.

Specialty Papers Segment

Following the paper machine upgrade in 2011, production speed reached 450 m/min, as planned, which translated to an increased capacity of approximately 56,000 tonnes per year of non-woven wallpaper base at the Dresden mill. The Specialty Papers Segment has experienced a record first half of 2012 and is expected to continue generating positive returns as it maximizes this increased capacity.

Security Paper Products Segment

The unexpected delay in the production and delivery of a significant order that occurred in the fourth quarter of 2011 and continued into the first and second quarters of 2012 was reinstated in June 2012. The delay contributed to a temporary disruption in the production schedule and impacted results negatively in the first half of 2012. It is anticipated that this reinstated order will allow Landqart to better optimize the overall mill. Production for this order began in July 2012.

The Company continues to assess strategic options for this segment, including sales of non-core assets. In May 2012, the Landqart mill completed the sale of its hydropower assets and associated real estate with a Swiss utility company for proceeds of CHF 18 million. In order to maintain the supply of its operational power requirements, the Landqart mill concurrently entered into a long term power purchase agreement with the same utility company at competitive rates. Of the proceeds from the sale, CHF 4.9 million was included in restricted cash. It is anticipated that full amount will become unrestricted in the third quarter of 2012, of which approximately CHF 3.1 million will be allocated towards debt repayment with the remainder available to the Landqart mill.

Significant Developments

Effective June 13, 2012, Fortress completed the acquisition, through its wholly owned subsidiary, Fortress Global, of the Fortress Global Cellulose mill from Domtar Inc., pursuant to which Fortress Global acquired the buildings, equipment and other ancillary property relating to the mill, including a 30 megawatt non-operating cogeneration facility. 9109-3294 Québec Inc., a wholly owned subsidiary of the Québec Ministère du Développement économique, de l’Innovation et de l’Exportation (“9109”), acquired the lands relating to the mill. The Company paid a nominal cash amount and agreed to
make contributions pursuant to a trust agreement in escalating tranches over the next five years of an aggregate of $7.5 million and an additional contingent amount of $2.5 million only in the event of a permanent closing of the Fortress Global Cellulose mill in respect of environmental remediation costs (see “Critical Accounting Estimates”). The Company intends to invest estimated capital expenditures of approximately $222 million over the next two to three years to convert this operation into a low cost, high quality dissolving pulp operation initially targeting viscose fibre products, and to restart the cogeneration facility which will produce green energy and result in material net energy savings (income). The Company has also identified certain modifications to the cogeneration facility that are expected to increase the power to 34 megawatts. The Fortress Global Cellulose mill is planned to have an annual production capacity of viscose grade dissolving pulp of approximately 250,000 air dried metric tonnes ("ADMT").

Concurrent with the completion of the acquisition, the Company finalized a $132.4 million project financing loan with Investissement Québec ("IQ"), comprised of two tranches. The first tranche of $102.4 million has a term of 10 years and the second tranche of $30 million has a term of three years. The loan is secured by the capital assets of Fortress Global and accrues interest at a fixed rate of 5.0% per annum for the first five years, followed by a rate not to exceed 5.5% per annum for the remaining five years. Equity compensation in the form of 715,000 share purchase warrants of the Company (the "IQ Warrants"), exercisable at a price of $21.52 per common share on the earlier of December 31, 2014 and the date on which the loan has been fully disbursed, and expiring on December 31, 2017, was also provided to IQ in connection with the loan. The Company also issued an unsecured convertible debenture in the aggregate principal amount of $25 million (the "FSTQ Debenture") to Fonds de Solidarité FTQ ("FSTQ"), which matures in five years and bears interest at a rate of 7% per annum. The FSTQ Debenture is convertible, in whole or in part, into Common Shares at a conversion price of $32.28.

**Subsequent Events**

In July 2012, the Company completed a bought deal short form prospectus offering (the “2012 Debenture Offering”) of 7.0% convertible unsecured subordinated debentures, including the exercise in full of the underwriters’ over-allotment option, resulting in aggregate gross proceeds of $69 million. The debentures are listed and posted for trading on the Toronto Stock Exchange under the symbol “FTP/DB.A”. Holders of debentures may, at their option, convert debentures into common shares at any time prior to December 31, 2019 at a price of $31.00 per share.
## Selected Quarterly Information

(thousands of dollars, except per share amounts, exchange rates and shares outstanding, unaudited)

<table>
<thead>
<tr>
<th></th>
<th>Q2 2012</th>
<th>Q1 2012</th>
<th>Q4 2011</th>
<th>Q3 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>84,023</td>
<td>61,368</td>
<td>49,524</td>
<td>83,995</td>
</tr>
<tr>
<td>Operating (loss)</td>
<td>(3,075)</td>
<td>(6,220)</td>
<td>(5,607)</td>
<td>(4,876)</td>
</tr>
<tr>
<td>EBITDA</td>
<td>2,343</td>
<td>(1,813)</td>
<td>(1,491)</td>
<td>(758)</td>
</tr>
<tr>
<td>Net (loss) income</td>
<td>12,462</td>
<td>(10,493)</td>
<td>(9,171)</td>
<td>(7,237)</td>
</tr>
<tr>
<td>Basic net (loss) income per share</td>
<td>$0.87</td>
<td>(0.73)</td>
<td>(0.64)</td>
<td>(0.51)</td>
</tr>
<tr>
<td>Diluted net (loss) income per share</td>
<td>$0.83</td>
<td>(0.73)</td>
<td>(0.64)</td>
<td>(0.51)</td>
</tr>
<tr>
<td>Weighted average shares outstanding Basic (thousands)</td>
<td>14,322</td>
<td>14,306</td>
<td>14,298</td>
<td>14,260</td>
</tr>
<tr>
<td>Weighted average shares outstanding Diluted (thousands)</td>
<td>15,118</td>
<td>14,306</td>
<td>14,298</td>
<td>14,260</td>
</tr>
<tr>
<td>Average Swiss/Canadian exchange rate(^{(1)})</td>
<td>1.0784</td>
<td>1.0871</td>
<td>1.1216</td>
<td>1.1911</td>
</tr>
<tr>
<td>Average Euro/Canadian exchange rate(^{(1)})</td>
<td>1.2956</td>
<td>1.3129</td>
<td>1.3790</td>
<td>1.3843</td>
</tr>
</tbody>
</table>

(thousands of dollars, except per share amounts, exchange rates and shares outstanding, unaudited)

<table>
<thead>
<tr>
<th></th>
<th>Q2 2011</th>
<th>Q1 2011</th>
<th>Q4 2010</th>
<th>Q3 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>89,905</td>
<td>85,489</td>
<td>83,467</td>
<td>86,972</td>
</tr>
<tr>
<td>Operating income (loss)</td>
<td>617</td>
<td>(3,100)</td>
<td>(10,399)</td>
<td>5,932</td>
</tr>
<tr>
<td>EBITDA</td>
<td>4,599</td>
<td>951</td>
<td>3,647</td>
<td>8,800</td>
</tr>
<tr>
<td>Net (loss) income</td>
<td>2,905</td>
<td>(5,727)</td>
<td>(12,790)</td>
<td>5,232</td>
</tr>
<tr>
<td>Basic net (loss) income per share</td>
<td>$0.20</td>
<td>(0.43)</td>
<td>(1.01)</td>
<td>$0.44</td>
</tr>
<tr>
<td>Diluted net (loss) income per share</td>
<td>$0.19</td>
<td>(0.43)</td>
<td>(1.01)</td>
<td>$0.39</td>
</tr>
<tr>
<td>Weighted average shares outstanding Basic (thousands)</td>
<td>14,232</td>
<td>13,417</td>
<td>12,626</td>
<td>12,003</td>
</tr>
<tr>
<td>Weighted average shares outstanding Diluted (thousands)</td>
<td>15,145</td>
<td>13,417</td>
<td>12,626</td>
<td>13,482</td>
</tr>
<tr>
<td>Average Swiss/Canadian exchange rate(^{(1)})</td>
<td>1.1147</td>
<td>1.0476</td>
<td>1.0397</td>
<td>1.0085</td>
</tr>
<tr>
<td>Average Euro/Canadian exchange rate(^{(1)})</td>
<td>1.3937</td>
<td>1.3497</td>
<td>1.3760</td>
<td>1.3438</td>
</tr>
</tbody>
</table>

\(^{(1)}\) Source – Bank of Canada (average noon rate for the period)

Fluctuations in quarterly results reflect significant transactions and developments within the Company. Specifically, in the second quarter of 2010, the Company acquired the Fortress Specialty Cellulose mill which resulted in a significant gain on acquisition and represented the entry into an entirely new business segment with a new sales revenue stream. The Fortress Specialty Cellulose mill was re-started in May 2010 and the second quarter of 2010 reflects a full month of sales of NBHK pulp in June 2010. The third quarter of 2010 reflects a full quarter of sales of NBHK pulp. In the fourth quarter of 2010, the Landqart mill significantly increased its bank-note and security paper production capacity from 2,500 tonnes to 10,000 tonnes and exited the specialty paper market. The expansion of security paper production capability which resulted in downtime at the Landqart mill as part of the final phase of the papermachine no.1 ("PM1") rebuild, combined with a special bonus payment to the Chief Executive Officer (the “CEO”) of the Company were significant factors impacting results for the referenced quarter.

In the second quarter of 2011, the Pulp Segment realized significantly higher prices for specialty pulp relative to the first and third quarters of 2011. In the fourth quarter of 2011 the Pulp Segment was re-defined as the Fortress Specialty Cellulose mill transitioned from a NBHK and specialty pulp producer to a dissolving pulp producer. Results were impacted by the mill being in either shut-down or ramp-up mode for much of the fourth quarter of 2011 with production of dissolving pulp commencing in December 2011. Ramp-up continued through the first quarter of 2012 with all dissolving pulp revenue and costs for production from December 2011 through March 18, 2012 being capitalized in property, plant and equipment for accounting purposes. In the second quarter of 2012 the dissolving pulp segment
continued improvement to production rates throughout the quarter albeit at a slower pace than first anticipated. Product mix, high raw material prices, pricing pressure, a strong Swiss currency, and less than optimal production efficiency at the Landqart mill contributed to disappointing and difficult 2011 for the Security Paper Products Segment which materially impacted the Company’s quarterly results throughout 2011 and the first half of 2012.

**Second Quarter 2012 Earnings Review**

**Three Months Ended June 30**

**Overview**

Reported EBITDA for the Company was $2.3 million for the three months ended June 30, 2012. For the three months ended March 31, 2012, EBITDA loss was $1.8 million and for the three months ended June 30, 2011 EBITDA was $4.6 million.

**Selected Financial Information and Statistics**

<table>
<thead>
<tr>
<th>(thousands of dollars, except shipments, unaudited)</th>
<th>Q2 2012</th>
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<tr>
<td>Sales</td>
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<td>EBITDA(^{(1)})</td>
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<td>Operating (loss) income</td>
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<td>617</td>
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<tr>
<td>Net income (loss)</td>
<td>12,462</td>
<td>(10,493)</td>
<td>2,905</td>
</tr>
<tr>
<td>Adjusted net loss(^{(2)})</td>
<td>(5,024)</td>
<td>(9,087)</td>
<td>(984)</td>
</tr>
<tr>
<td>Paper shipments (tonnes)(^{(3)})</td>
<td>16,556</td>
<td>15,290</td>
<td>14,670</td>
</tr>
<tr>
<td>Pulp shipments (tonnes)</td>
<td>35,679</td>
<td>35,682</td>
<td>54,384</td>
</tr>
</tbody>
</table>

\(^{(1)}\) See Net Income (Loss) to EBITDA Reconciliation.
\(^{(2)}\) See Net Income (Loss) to Adjusted Net Loss Reconciliation.
\(^{(3)}\) Includes shipments of security and specialty paper products by the Landqart and Dresden mills.

**Net Income (Loss) to Adjusted Net Loss Reconciliation:**

<table>
<thead>
<tr>
<th>(thousands of dollars, except per share amounts, unaudited)</th>
<th>Q2 2012</th>
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<tr>
<td>Net income (loss)</td>
<td>12,462</td>
<td>(10,493)</td>
<td>2,905</td>
</tr>
<tr>
<td>Foreign exchange loss (gain)</td>
<td>1,811</td>
<td>(1,209)</td>
<td>(3,889)</td>
</tr>
<tr>
<td>Gain on sale of property, plant and equipment</td>
<td>(19,297)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term debt prepayment penalty</td>
<td>-</td>
<td>2,615</td>
<td>-</td>
</tr>
<tr>
<td>Adjusted net loss</td>
<td>(5,024)</td>
<td>(9,087)</td>
<td>(984)</td>
</tr>
<tr>
<td>Basic net income (loss) per share</td>
<td>0.87</td>
<td>(0.73)</td>
<td>0.20</td>
</tr>
<tr>
<td>Diluted net income (loss) per share</td>
<td>0.83</td>
<td>(0.73)</td>
<td>0.19</td>
</tr>
<tr>
<td>Adjusted net loss per share, basic and diluted</td>
<td>(0.35)</td>
<td>(0.64)</td>
<td>(0.07)</td>
</tr>
</tbody>
</table>
Net Income (Loss) to EBITDA Reconciliation:
(thousands of dollars, unaudited)

<table>
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</tr>
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<tbody>
<tr>
<td>Net income (loss)</td>
<td>12,462</td>
<td>(10,493)</td>
<td>2,905</td>
</tr>
<tr>
<td>Income tax</td>
<td>(290)</td>
<td>678</td>
<td>740</td>
</tr>
<tr>
<td>Foreign exchange loss (gain)</td>
<td>1,811</td>
<td>(1,209)</td>
<td>(3,889)</td>
</tr>
<tr>
<td>Net finance expense</td>
<td>2,239</td>
<td>4,804</td>
<td>861</td>
</tr>
<tr>
<td>Amortization</td>
<td>4,920</td>
<td>3,997</td>
<td>3,394</td>
</tr>
<tr>
<td>Stock based compensation</td>
<td>498</td>
<td>410</td>
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<tr>
<td>Gain on sale of property, plant and equipment</td>
<td>(19,297)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>EBITDA</td>
<td>2,343</td>
<td>(1,813)</td>
<td>4,599</td>
</tr>
</tbody>
</table>

Fortress reported an adjusted net loss of $5.0 million, or basic adjusted loss per share of $0.35 for the second quarter of 2012 on sales of $84.0 million. In the first quarter of 2012, the Company reported an adjusted net loss of $9.1 million or basic adjusted loss per share of $0.64 on sales of $61.4 million and for the second quarter of 2011 adjusted net loss of $1.0 million or basic loss per share of $0.07 on sales of $89.9 million.

Cost of products sold were $73.1 million or 87.0% of sales for the three months ended June 30, 2012 compared to $52.9 million or 86.2% of sales for the three months ended March 31, 2012. In the second quarter of 2011, cost of products sold were $76.1 million or 84.6% of sales.

Sales and cost of products sold were higher in the second quarter of 2012 compared to the prior quarter due to all dissolving pulp revenue and costs for production from December 2011 through March 18, 2012 having been capitalized in property, plant and equipment for accounting purposes. In the prior year comparative period, Fortress Specialty Cellulose was in full operation producing specialty pulp.

Selling, general and administrative (“SG&A”) expenses were $8.6 million for the second quarter of 2012 compared to $10.3 million for the first quarter of 2012. The prior year comparative period SG&A was $9.2 million. The decreased level of SG&A relative to the prior periods was in part due to the successful acquisition of the Fortress Global Cellulose mill, whereby related acquisition costs of $1.4 million were capitalized as part of the purchase.

Stock-based compensation expense was $0.5 million during the period compared to $0.4 million in the first quarter of 2012. The prior year comparative period stock-based compensation was $0.6 million.

Operating Results by Business Segment

Dissolving Pulp Segment

<table>
<thead>
<tr>
<th></th>
<th>Q2 2012</th>
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<tbody>
<tr>
<td>Sales</td>
<td>35,097</td>
<td>10,435</td>
<td>39,961</td>
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<tr>
<td>Operating (loss) income</td>
<td>(2,816)</td>
<td>(4,697)</td>
<td>3,316</td>
</tr>
<tr>
<td>Shipments (tonnes)</td>
<td>35,679</td>
<td>35,682</td>
<td>54,384</td>
</tr>
</tbody>
</table>

The second quarter of 2012 showed gradual improvement to our Dissolving Pulp Segment, compared to the prior quarter during which we ramped-up our dissolving pulp production at the Fortress Specialty Cellulose mill. In the prior quarter, approximately $7.1 million net costs were capitalized to property, plant and equipment through to mid-March and product shipped included approximately 10,521 tonnes of specialty pulp. In the prior year comparative period, the Dissolving Pulp Segment was producing specialty pulp full-time.
**Specialty Papers Segment**

<table>
<thead>
<tr>
<th>(thousands of dollars, except for shipments, unaudited)</th>
<th>Q2 2012</th>
<th>Q1 2012</th>
<th>Q2 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>40,814</td>
<td>37,658</td>
<td>36,566</td>
</tr>
<tr>
<td>Operating income</td>
<td>9,626</td>
<td>8,563</td>
<td>6,804</td>
</tr>
<tr>
<td>Shipments (tonnes)</td>
<td>15,789</td>
<td>14,295</td>
<td>13,357</td>
</tr>
</tbody>
</table>

Shipment volume in the second quarter of 2012 was higher than the prior quarter and significantly higher than the prior year comparative quarter due to continued strength in our markets. Included in shipments in the first and second quarters of 2012 were 825 tonnes and 536 tonnes of commissioned sales not produced at the Dresden Mill (“Commissioned Sales”), respectively. In the prior year comparative period, shipments include 261 tonnes of Commissioned Sales. Operating income improvement relative to the prior quarter has generally followed the increase in sales. The improvement relative to the prior year comparative period is due primarily to improved mill efficiency and product mix.

The order book at the Dresden mill remains strong.

**Security Paper Products Segment**

<table>
<thead>
<tr>
<th>(thousands of dollars, except for shipments, unaudited)</th>
<th>Q2 2012</th>
<th>Q1 2012</th>
<th>Q2 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>8,112</td>
<td>13,275</td>
<td>13,379</td>
</tr>
<tr>
<td>Operating loss</td>
<td>(8,121)</td>
<td>(7,182)</td>
<td>(6,779)</td>
</tr>
<tr>
<td>Shipments (tonnes)</td>
<td>767</td>
<td>995</td>
<td>1,313</td>
</tr>
</tbody>
</table>

Results in the second quarter, similar to the comparative periods, reflect continued headwinds of a strong Swiss franc, high raw material costs, and less than optimal production efficiency on the paper machines at the Landqart mill, in part as a result of the postponement of several major currencies.

Delays in implementing a significant bank order continued in the quarter until reinstatement late in the quarter. Production began on this order in July and it is anticipated that the mill will be producing with much greater efficiency on its paper machines and that the capacity of both machines will be required to meet demands. The Company continues to assess other strategic options at the Landqart mill, including sales of non-core assets and seeking new customers.

Fortress Optical generated sales of $0.5 million in the second quarter of 2012 compared to $ nil in the first quarter of 2012 and $0.3 million in the second quarter of 2011. Fortress Optical produces security material for the security threads used in banknotes at the Fortress Optical Facility.
### Six Months Ended June 30

**Selected Financial Information and Statistics for the Six Months Ended:**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>145,391</td>
<td>175,394</td>
</tr>
<tr>
<td>EBITDA(^{(1)})</td>
<td>530</td>
<td>5,550</td>
</tr>
<tr>
<td>Operating (loss) income</td>
<td>(9,296)</td>
<td>(2,483)</td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>1,968</td>
<td>(2,822)</td>
</tr>
<tr>
<td>Adjusted net (loss) income</td>
<td>(14,111)</td>
<td>(6,589)</td>
</tr>
<tr>
<td>Total assets</td>
<td>529,115</td>
<td>387,359</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>196,148</td>
<td>52,498</td>
</tr>
<tr>
<td>Paper shipments (tonnes)(^{(3)})</td>
<td>31,846</td>
<td>30,138</td>
</tr>
<tr>
<td>Pulp shipments (tonnes)</td>
<td>71,361</td>
<td>110,745</td>
</tr>
</tbody>
</table>

\(^{(1)}\) See Net Income (Loss) to EBITDA Reconciliation.
\(^{(2)}\) See Net Income (Loss) to Adjusted Net (Loss) Income Reconciliation.
\(^{(3)}\) Includes shipments of security and specialty paper products by the Landqart and Dresden mills.

### Net Income (Loss) to Adjusted Net Loss Reconciliation:

<table>
<thead>
<tr>
<th>(thousands of dollars, except per share amounts, unaudited)</th>
<th>June 30, 2012</th>
<th>June 30, 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income (loss)</td>
<td>1,968</td>
<td>(2,822)</td>
</tr>
<tr>
<td>Foreign exchange loss (gain)</td>
<td>1,811</td>
<td>(3,767)</td>
</tr>
<tr>
<td>Gain on sale of property, plant and equipment</td>
<td>(19,297)</td>
<td>-</td>
</tr>
<tr>
<td>Long-term debt prepayment penalty</td>
<td>2,615</td>
<td>-</td>
</tr>
<tr>
<td>Adjusted net (loss) income</td>
<td>(14,111)</td>
<td>(6,589)</td>
</tr>
<tr>
<td>Basic net income (loss) per share</td>
<td>0.14</td>
<td>(0.20)</td>
</tr>
<tr>
<td>Diluted net income (loss) per share</td>
<td>0.13</td>
<td>(0.20)</td>
</tr>
<tr>
<td>Adjusted net (loss) per share, basic and diluted</td>
<td>(0.99)</td>
<td>(0.48)</td>
</tr>
</tbody>
</table>

### Net Income (Loss) to EBITDA Reconciliation:

<table>
<thead>
<tr>
<th>(thousands of dollars, unaudited)</th>
<th>June 30, 2012</th>
<th>June 30, 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net (loss) income</td>
<td>1,968</td>
<td>(2,822)</td>
</tr>
<tr>
<td>Income tax</td>
<td>388</td>
<td>2,276</td>
</tr>
<tr>
<td>Foreign exchange (gain) loss</td>
<td>603</td>
<td>(3,767)</td>
</tr>
<tr>
<td>Gain on sale of property, plant and equipment</td>
<td>(19,297)</td>
<td>-</td>
</tr>
<tr>
<td>Net finance expense</td>
<td>7,042</td>
<td>1,830</td>
</tr>
<tr>
<td>Amortization</td>
<td>8,917</td>
<td>6,902</td>
</tr>
<tr>
<td>Stock based compensation</td>
<td>909</td>
<td>1,131</td>
</tr>
<tr>
<td>EBITDA</td>
<td>$530</td>
<td>$5,550</td>
</tr>
</tbody>
</table>

**Overview**

EBITDA for the Company was $0.5 million for the six months ended June 30, 2012 on sales of $145.4 million compared to $5.6 million in the six months ended June 30, 2011 on sales of $175.4 million. Record six month results for the Specialty Papers Segment were offset by the challenges experienced in the Security Paper Products Segment. See "Operating Results
by Business Segment", below. In the Dissolving Pulp Segment, the Fortress Specialty Cellulose mill has transitioned to a dissolving pulp producer with meaningful improvements in production throughout the period.

Excluding corporate costs, the three business segments’ combined EBITDA was $4.3 million and $9.8 million in the six month periods ended June 30, 2012 and 2011, respectively. The Specialty Papers Segment contributed $19.9 million EBITDA which was significantly higher than the previous period at $15.2 million. The Security Paper Products Segment generated significant losses in the first six months of 2012 ($11.4 million EBITDA loss) compared to the prior year ($9.6 million EBITDA loss). The Dissolving Pulp Segment generated an EBITDA loss of approximately $4.2 million in the first six months of 2012 compared to $4.1 million EBITDA in the prior year comparative period. Corporate costs reduced EBITDA by $3.8 million and $4.1 million in the six months ended June 30, 2012 and 2011, respectively.

Adjusted net loss for the six month period ended June 30, 2012 was $14.1 million or $0.99 per share basic. Adjusted net loss for the prior comparative period was $6.6 million or $0.48 per share basic.

Total shipments of paper products from the Specialty Paper and Security Paper Products Segments were higher compared to the prior comparative period due primarily to increases in the Specialty Papers Segment partially offset by lower sales in the Security Paper Products Segment (see “Operating Results by Business Segment”, below).

Total pulp shipments were significantly lower in the six months ended June 30, 2012 relative to the prior period as the Dissolving Pulp Segment was in ramp up mode gradually increasing and improving production over the period. Commercial production for accounting purposes, with the equipment operating as intended by management, began on March 18, 2012. After such date all sales and cost of sales have been included in the operating results. In the prior year comparative period the Dissolving Pulp Segment was producing specialty pulp full time.

Cost of products sold was $125.9 million or 86.6% of sales for the six months ended June 30, 2012 compared to $151.3 million or 86.3% in the six months ended June 30, 2011. The percentage of cost of products to sales is comparative, however, cost of products sold as well as sales were impacted downward as a result of the capitalization of sales and cost of sales at the Fortress Specialty Cellulose mill for the period from January 1, 2012 through March 18, 2012.

Both SG&A and stock based compensation were in line with the prior comparative periods. SG&A was $18.9 million compared to $18.5 million in the periods ended June 30, 2012 and 2011, respectively. Stock compensation was $0.9 million in the six months ended June 30, 2012 compared to $1.1 million in the previous comparative period.

Foreign exchange gains and losses relate primarily to translation losses or gains on foreign denominated debt.

Operating Results by Business Segment

**Dissolving Pulp Segment**

<table>
<thead>
<tr>
<th>(thousands of dollars, except for shipments, unaudited)</th>
<th>Six Months Ended</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>June 30, 2012</td>
</tr>
<tr>
<td>Sales</td>
<td>45,532</td>
</tr>
<tr>
<td>Operating (loss) income</td>
<td>(7,513)</td>
</tr>
<tr>
<td>Shipments (tonnes)</td>
<td>71,361</td>
</tr>
</tbody>
</table>

Results for the period ended June 30, 2012 reflect a continued ramp up period of dissolving pulp production.

Results for the period ended June 30, 2011 reflect efforts made to produce specialty pulp to maximize returns prior to completing equipment upgrades required for the conversion of the Fortress Specialty Cellulose mill to a dissolving pulp mill.
Specialty Papers Segment

<table>
<thead>
<tr>
<th></th>
<th>Six Months Ended</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>June 30, 2012</td>
<td>June 30, 2011</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>78,472</td>
<td>73,567</td>
<td></td>
</tr>
<tr>
<td>Operating income</td>
<td>18,189</td>
<td>13,810</td>
<td></td>
</tr>
<tr>
<td>Shipments (tonnes)</td>
<td>30,084</td>
<td>27,338</td>
<td></td>
</tr>
</tbody>
</table>

Tonnes shipped in the six months ended June 30, 2012 were 10.0% higher than the comparable prior year period due to the completion of capital programs resulting in increased capacity. Included in shipments in the first half of 2012 and 2011 were 1,361 tonnes and 301 tonnes of Commissioned Sales, respectively. Realized pricing and margins also improved relative to the prior year comparative period assisted by declining waste rates.

Security Paper Products Segment

<table>
<thead>
<tr>
<th></th>
<th>Six Months Ended</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>June 30, 2012</td>
<td>June 30, 2011</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>21,387</td>
<td>26,280</td>
<td></td>
</tr>
<tr>
<td>Operating (loss) income</td>
<td>(15,303)</td>
<td>(13,422)</td>
<td></td>
</tr>
<tr>
<td>Shipments (tonnes)</td>
<td>1,762</td>
<td>2,800</td>
<td></td>
</tr>
</tbody>
</table>

The six month period ended June 30, 2012 has been a difficult period for the Security Paper Products Segment, however, towards the end of the period a significant banknote order was reinstated which the Company expects will contribute to improved operating efficiency for the remainder of the year.

Financial Position

Selected Cash Flow Items

<table>
<thead>
<tr>
<th></th>
<th>Q2 2012</th>
<th>Q1 2012</th>
<th>YTD 2012</th>
<th>Q2 2011</th>
<th>YTD 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (used by) provided before working capital changes</td>
<td>1,087</td>
<td>(4,063)</td>
<td>(2,976)</td>
<td>3,378</td>
<td>2,289</td>
</tr>
<tr>
<td>Non-cash working capital change</td>
<td>4,255</td>
<td>14,834</td>
<td>19,089</td>
<td>(9,678)</td>
<td>(13,859)</td>
</tr>
<tr>
<td>Cash provided (used by) operating activities</td>
<td>5,342</td>
<td>10,771</td>
<td>16,113</td>
<td>(6,300)</td>
<td>(11,570)</td>
</tr>
<tr>
<td>Cash provided from financing activities</td>
<td>34,284</td>
<td>18,736</td>
<td>53,020</td>
<td>958</td>
<td>68,430</td>
</tr>
<tr>
<td>Cash used by investing activities</td>
<td>(4,089)</td>
<td>(45,147)</td>
<td>(49,236)</td>
<td>(31,522)</td>
<td>(60,770)</td>
</tr>
<tr>
<td>Change in cash position</td>
<td>35,537</td>
<td>(15,640)</td>
<td>19,897</td>
<td>(36,864)</td>
<td>(3,910)</td>
</tr>
<tr>
<td>Foreign exchange gain (loss) on cash and cash equivalents</td>
<td>(214)</td>
<td>(497)</td>
<td>(711)</td>
<td>(809)</td>
<td>(894)</td>
</tr>
</tbody>
</table>

Fortress operates in a cyclical industry and its operating cash flows vary accordingly. Fortress' principal operating cash expenditures are for compensation and raw materials. Operating activities provided cash of $16.1 million in the six months ended June 30, 2012 compared to using cash of $11.6 million in the six months ended June 30, 2011.

Working capital is subject to cyclical operating needs, the timing of collection of receivables and the payment of payables and expenses. The significant movement in 2012 is a result of decreased inventory and other receivables partially offset by lower payables attributable primarily to the Fortress Specialty Cellulose completed mill conversion project and the ongoing cogeneration project. In the prior year comparative periods operating activities used cash primarily as a result of increases in accounts receivable and inventory which were somewhat offset by increases in accounts payable.
Financing Activities

During the period ended June 30, 2012, financing activities generated $53.0 million. In June 2012, Fortress completed a $25 million convertible debenture financing with FSTQ as part of the financing initiatives related to the Fortress Global Cellulose mill conversion project. Proceeds received from option exercises during the period were $0.1 million. Cash was generated by drawing on the final principal installments excluding holdbacks on Company's loan agreement with IQ in respect of the Fortress Specialty Cellulose project. In March 2012, the Company entered into a new EUR25 million credit facility with Commerzbank. The new facility was used primarily to repay the balance of an existing loan agreement with GE Capital Bank AG that was used to finance the rebuild of papermachine no.1 at the Landqart mill. A penalty of $2.6 million was paid in connection with the early repayment of the GE indebtedness. Payments on indebtedness (apart from the GE repayment) and debt interest during the period used cash of $1.0 million and $3.0 million, respectively.

In February, 2011 Fortress completed a public offering of common shares by way of short form prospectus for net proceeds of $54.8 million. Also in the six month period ended June 30, 2011, proceeds from debt were $20.5 million, primarily drawdowns on the IQ loan to finance the ongoing conversion project at the Fortress Specialty Cellulose mill. Payments on debt and debt interest used cash of $6.3 million and $1.2 million, respectively during that period.

Investing Activities

Investing activities for the six months ended June 30, 2012 and 2011 used cash of $49.2 million and $60.8 million, respectively. Investment activities relate primarily to the purchase of equipment and other capital expenditures at our mills. Cash used in investing activities for the period ended June 30, 2012 was positively impacted by the $19.4 million the sale of non-core hydropower assets at Landqart. Expenditures excluding the hydropower assets sale are comparable to the previous period and related primarily to expenditures for the conversion (now completed) and cogeneration projects at the Fortress Specialty Cellulose mill.

Liquidity and Capital Resources

As at June 30, 2012, the Company has made aggregate expenditures and accruals of approximately $164.2 million on the conversion of Fortress Specialty Cellulose mill to a dissolving pulp mill and the construction of a new cogeneration facility. As at the date of this MD&A, aggregate expenditures and accruals on the Fortress Specialty Project were approximately $167.7 million. In the latter part of the first quarter of 2012, management reassessed the cogeneration project and identified certain deficiencies in a previous estimate from an engineering firm as well as scope of work adjustments necessary in order to commence delivery of power in the fourth quarter of 2012. As a result of this and other previously reported issues, the current budgeted capital expenditures remaining for the Fortress Specialty Cellulose project as a whole are approximately $47.1 million without any contingencies, which will be spent primarily on the cogeneration project.

Although there can be no assurances, Fortress believes that current cash, cash generated from operations, tax credits, proceeds from the divestiture of non-core assets, proceeds from the 2012 Debenture Offering, together with amounts available under its existing or new credit facilities should be sufficient to meet its debt service, capital expenditure and short term working capital requirements. Fortress' future operating performance and its ability to finance capital expenditures, service its debt and pay other indebtedness of Fortress will be subject to future economic conditions, the financial success of Fortress' business, the successful ramp-up of its dissolving pulp production to full planned capacity and other factors, some of which are not within Fortress' control, including but not limited to changes in market prices for its products, raw materials costs and foreign currency exchange rates. Although the ramp-up of dissolving pulp production to planned capacity at the Fortress Specialty Cellulose mill is anticipated to provide significant cash flow and liquidity, Fortress may determine, in its sole discretion, that market or financial conditions may warrant that it seek additional sources of capital on terms satisfactory to Fortress, including but not limited to additional debt or equity financing, in order to fund capital expenditures, provide additional working capital, enhance liquidity or for other general corporate purposes.

At June 30, 2012, the Company had cash of $42.1 million and debt of $205.3 million. Included in this indebtedness is $98.0 million drawn on the $102.4 million credit facility with IQ in respect of the Fortress Specialty Cellulose project.
The remaining balance has been reported as “Other accounts receivable” since it represents an amount contractually owing to the Company by IQ under the credit facility, which provides that the Company is able to draw down on its loan after it confirms to IQ that certain qualifying capital expenditures are made. The amount that IQ is obligated to make available to the Company upon confirmation that such expenditures have been made meets the definition of an “asset” in accordance with the Conceptual Framework section of IFRS. A corresponding liability is also recorded under “Long term debt” in the balance sheet. There is no right of offset between these two amounts therefore both an asset and a liability have been recorded. Under this credit facility, the Company has, at its discretion, the right to defer a limited number of principal payments. The Company exercised its right and elected to defer twelve months of principal payments without penalty.

The Company has entered into a separate project financing loan with IQ of up to $132.4 million to fund the Fortress Global Cellulose mill conversion project (see “Significant Developments”). The Company has not yet drawn down under this loan.

Subsequent to the quarter end the Company issued unsecured convertible debentures in the total principal amount of $69.0 million that mature on December 31, 2019 (see “Subsequent Events”). Net proceeds received from the 2012 Debenture Offering were approximately $65.7 million. Fortress intends to use approximately $35 million to fund capital expenditures relating to the cogeneration project at its Fortress Specialty Cellulose mill, $15 million to fund capital expenditures relating to its recently acquired Fortress Global Cellulose mill in Lebel-sur-Quévillon, Québec, $1.8 million to reduce outstanding indebtedness and the remainder for working capital and general corporate purposes.

Subsequent to the quarter end, the Company received $14.4 million of investment tax credits. This amount was included in “other accounts receivables” as at June 30, 2012.

**Commitments**

As at June 30, 2012 the Company has:

- committed to purchase $26.6 million in property, plant, and equipment; and
- performance bonds in the amounts of EUR 6.7 million and CHF 0.6 million.

The Company’s objectives when managing capital are to safeguard its assets and maintain a globally competitive cost structure while looking for growth opportunities to provide returns to its shareholders. In addition, the Company works with relevant stakeholders to ensure the safety of its operations and employees, and remain in compliance with applicable environmental regulations and enhance the communities in which it operates.

The Company monitors and assesses on an ongoing basis its financial performance in order to ensure that its net debt levels are prudent, taking into account the anticipated direction of the business cycle. The Company monitors continuously the public and private debt markets and the public equity markets in order to assure that its capital structure is appropriately balanced. The Company can be influenced materially by changes in the relative value of the Canadian dollar, Swiss Franc, U.S. dollar and Euro.

The Company’s capital comprises of net debt and shareholders’ equity:

<table>
<thead>
<tr>
<th></th>
<th>June 30, 2012</th>
<th>December 31, 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and cash equivalents</td>
<td>42,083</td>
<td>22,897</td>
</tr>
<tr>
<td>Less total debt</td>
<td>205,278</td>
<td>152,408</td>
</tr>
<tr>
<td>Net debt</td>
<td>(163,195)</td>
<td>(129,511)</td>
</tr>
<tr>
<td>Shareholders’ equity</td>
<td>240,014</td>
<td>231,639</td>
</tr>
</tbody>
</table>

The Company has certain financial covenants stipulating maximum net debt to capitalization ratios, maximum debt to earnings before interest, taxes, depreciation and amortization ratios, and minimum current ratios. Debt obligations are
owed by various entities within the organization with individual loan agreements specifying the entities within the group of companies that are to be included in the covenant calculations.

The Company ensures it remains in compliance with all of its existing debt covenants in order to facilitate future access to capital. Management reviews past results and forecasts to monitor their compliance. The Company was in compliance with all externally imposed capital requirements for the quarter ended June 30, 2012.

**Outstanding Shares**

The number of common shares outstanding June 30, 2012 and the date of this report was 14,340,193. The number of options outstanding at June 30, 2012 and the date of this report was 548,725. At June 30, 2012 and the date of this report there were 274,084 restricted share units outstanding. At June 30, 2012 and the date of this report there were 147,078 and 148,284 deferred share units outstanding, respectively.

**Related Party Transactions**

Related party transactions consist of remuneration of directors and other key management personnel with whom we have entered in employment agreements. Our Management Information Circular dated June 7, 2012 is available on sedar.com.

**Critical Accounting Estimates**

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in Canada requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Significant estimates are used for, but not limited to, the accounting for doubtful accounts, amortization, asset recoverability, derivative financial instruments, fair valuation of acquired assets, pensions and post-retirement obligations, asset retirement obligations, stock compensation, income taxes and contingencies. Actual results could differ from these estimates.

**Contingencies**

Provisions for liabilities relating to legal actions and claims require judgments using management's best estimates regarding projected outcomes and the range of loss, based on such factors as historical experiences and recommendations of legal counsel. Actual results may vary from estimates and the differences are recorded when known. In respect of a dispute which arose in the fourth quarter of 2011 relating to a faulty input which was provided by a third party supplier of the Landqart mill, the Company expects that any amounts under dispute will be reimbursed to the Company by the supplier. The net impact to the mill is therefore expected to be nil. The treatment of this dispute by the Company reflects the best estimate of management, however there is no assurance that all or any portion of the disputed amount will be reimbursed to the Company. A failure by the Company to be reimbursed for the cost of this input or to have the input replaced or repaired by the supplier could result in a material adverse impact on the financial results of Landqart.

**Provisions**

As part of the acquisition of the Fortress Global Cellulose mill, the Company must contribute $7.5 million to an environmental trust over the next five years with the possibility of an additional $2.5 million in the event that the mill is dismantled in the future. The discount rates used for the valuation of the asset retirement obligation range from 6.8% to 9.8% depending on the timing of the expected payment, which results in an estimated $5.8 million provision recorded in our financial statements.

**New Accounting Pronouncements**

During 2011, the International Accounting Standards Board (“IASB”) issued a number of new and revised accounting standards which are effective for annual periods beginning on or after January 1, 2013, with early adoption permitted. These new and revised accounting standards have not yet been adopted by the Company.

The following new or revised standards are not expected to have a material impact on the amounts recorded in the financial statements of the Company:
• IFRS 10 – *Consolidated Financial Statements*;
• IFRS 11 – *Joint Arrangements*;
• IFRS 12 – *Disclosure of Interests in Other Entities*;
• IFRS 13 – *Fair Value Measurement*; and
• IAS 28 (revised) – *Investments in Associates and Joint Ventures*.

The Company is still in the process of assessing the full impact, if any, of IAS 19 (revised) – *Employee Benefits*.

In 2011, the IASB also amended IFRS 9 – *Financial Instruments*, which is effective for annual periods beginning on or after January 1, 2015, with earlier adoption permitted. The Company is still in the process of assessing the full impact of this standard.

Further details of the new or revised accounting standards and their potential impact on the Company can be found in the consolidated financial statements and notes as at and for the year ended December 31, 2011.

**Risks and Uncertainties**

A comprehensive discussion of risk factors is included in the Company’s 2011 annual information form dated March 30, 2012, available on SEDAR at www.sedar.com. Those as well as the following additional risks may impact the business of the Company:

**Fortress Global Cellulose Mill Project**

The Company's plans to convert the Fortress Global Cellulose mill into a dissolving pulp operation and restart a cogeneration facility is subject to customary risks and uncertainties inherent for large capital projects which could result in the project not completing on schedule or as budgeted. Delays in receiving any operating permits or any required amendments to such permits could result in construction delays, operational deficiencies or funding shortfalls. The Fortress Global Cellulose mill could experience operating difficulties or delays during the period when production of dissolving pulp and, subsequently, "green" energy is being ramped up. The project may not achieve the Company's planned production, quality or cost projections in respect of the dissolving pulp operation, or the expected level of power generation from the cogeneration facility. Cost overruns, equipment breakdowns or failures to perform to design specifications, delays in the generation and sales of surplus energy, could have a material adverse effect on the Fortress Global Cellulose mill's results of operations and financial performance. Although the Company has received assurances and commitments from the Québec Government and Hydro Québec, the Company has not yet entered into a long term power supply agreement or a power purchase (cogeneration) agreement with Hydro Québec in respect of the Fortress Global Cellulose mill and the failure to enter into such agreements on terms satisfactory to Fortress, or at all, will have a material adverse effect on the mill's operations and financial performance.

In addition, pursuant to the terms of the acquisition of the Fortress Global Cellulose mill, Fortress Global is limited to using the acquired assets to produce up to a maximum of 100,000 ADMT of market NBSK pulp at the mill and is restricted from producing paper grade pulp for a period of 10 years. These restrictions may represent a possible reduction in the re-sale value of the mill and a limitation on the ability to operate the mill as a NBSK or paper grade pulp producer.

**Effects of Increased Indebtedness**

The Company may incur additional indebtedness as amounts are drawn down from its project financing as the Fortress Global Cellulose mill project progresses. Increased debt levels may have important consequences for the Company, including, but not limited to the following:
• its ability to obtain additional financing to fund future operations or meet its working capital needs or any such financing may not be available on terms favorable to the Company or at all;
• a certain amount of the Company's operating cash flow will be dedicated to the payment of principal and interest on its indebtedness, thereby diminishing funds that would otherwise be available for its operations and for other purposes;
• a substantial decrease in net operating cash flows or increase in the Company's expenses could make it more difficult for it to meet its debt service requirements, which could force the Company to modify its operations; and
• a leveraged capital structure which may place the Company at a competitive disadvantage by hindering its ability to adjust rapidly to changing market conditions or by making it vulnerable to a downturn in its business or the economy in general, as well as other risks associated with increased leverage.

The Company's ability to meet future debt service and other obligations may depend in significant part on the success of the Fortress Global Cellulose mill project and the Fortress Specialty Cellulose mill and the extent to which the Company can successfully implement its business and growth strategy. There can be no assurance that the Fortress Global Cellulose mill project or the Fortress Specialty Cellulose mill will be successful or that the Company will be able to implement its strategy fully or that the anticipated results of its strategy will be realized. The IQ project financing facility for the Fortress Global Cellulose mill is secured by a charge against all of the assets of Fortress Global. The Company has guaranteed the principal amount of the second tranche of the IQ loan.

Environmental Liabilities

Under the terms of the agreement to acquire the assets of the Fortress Global Cellulose mill, the Company assumed no responsibility for any existing environmental liabilities relating to the lands. However, Fortress Global is required to make contributions pursuant to a trust agreement of an aggregate of $7.5 million over the next five years and an additional contingent amount of $2.5 million in the event of a permanent closure of the Fortress Global Cellulose mill, in respect of environmental remediation costs. The failure by Fortress Global to make such contributions would result in defaults under the security agreements over its assets, which would have a material adverse effect on the continuation of the Fortress Global Cellulose mill project. Although the Company intends to operate the Fortress Global Cellulose mill in accordance with applicable environmental laws, there is no assurance that the Company will not incur additional costs and expenses relating to environmental matters in respect of the assets acquired or in the future as a result of its operations.

In connection with the sale by Landqart of its hydropower assets, Landqart continues to be responsible for a period of 10 years for certain costs relating to historical environmental contamination. Although the Company believes that the Landqart mill has identified and provided for expenditures relating to known environmental matters, including the costs of environmental remediation, it is possible that the Company may incur significant costs in the future for any remediation during such 10 year period relating to the sold hydropower assets.

Forest and Timber Tenures

On April 1, 2010, the Québec Government proclaimed the Sustainable Forest Development Act (the "SFDA") which will officially replace the Forest Act (Québec) on April 1, 2013 and will significantly modify the current Québec Crown wood allocation regime. Pursuant to the SFDA, all previously granted timber supply and forest management agreements (commonly known as "CAAFs") under the Forest Act (Québec) will be cancelled and former CAAF holders will be entitled, under the new regime, to a timber supply guarantee, provided they meet certain conditions as set forth in the SFDA. The guaranteed annual volumes of timber under such guarantee will be determined by the Ministry of Natural Resources and Wildlife (Québec) ("MNRW") and the MNRW will have the discretion to reduce the volume to which a former CAAF holder was entitled under the previous regime. The percentage by which the volume will be reduced may vary among former CAAF holders depending on the species or groups of species concerned, the volumes of timber to which the former CAAF holder would have been entitled to on April 1, 2013 if the CAAF had not been cancelled and the regions from which the timber is sourced. This reduction of volumes of timber allocated to former CAAF holders will be made available to the "Timber Marketing Board", which will be given the responsibility to market the timber to eligible purchasers by way of public auction. Based on comfort letters received from the MNRW, the Company expects to receive a CAAF allocation in respect of the Forest Global Cellulose mill. Accordingly, any CAAF obtained by the Company at the Fortress Global Cellulose mill will be subject to risks and uncertainties relating to the new regime under the SFDA and, once a CAAF is
obtained, there is no assurance that Fortress Global will be able to maintain its wood fibre supply allocation and the availability of, and price for, wood fibre provided for in such CAAF as of April 1, 2013. Although Fortress Global believes it can secure the necessary fibre required at the Fortress Global Cellulose mill, there is no assurance that it will be able to obtain any required fibre supply, by way of public auction or otherwise, in the event that timber volumes granted to it under a CAAF are reduced. An insufficient supply or increased cost or demand for wood fibre or raw materials could materially adversely affect the business, financial condition, results of operations and cash flows of the Fortress Global Cellulose mill.

**Additional Funding Requirements**

The Company may need additional financing in connection with its plan for converting the Fortress Global Cellulose mill and restarting a cogeneration facility thereat, which may not be available in a timely manner or on acceptable terms, if at all. The implementation of the Company's business plan at the Fortress Global Cellulose mill will require a substantial amount of capital and the amounts raised by the Company through the financing initiatives described herein, if completed, may not be sufficient to fund such business plan. The Company will accordingly have further capital requirements if it implements its business plan at the Fortress Global Cellulose mill or takes advantage of further opportunities for acquisitions.

**Disclosure Controls and Internal Controls over Financial Reporting**

During the quarter ending June 30, 2012, there were no changes in the Company’s internal controls over financial reporting that materially affected, or would be reasonably likely to materially affect, such controls.
FORTRESS PAPER LTD.
CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
(Canadian dollars, amounts in thousands, unaudited)

<table>
<thead>
<tr>
<th>Note</th>
<th>June 30, 2012</th>
<th>December 31, 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td><strong>ASSETS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Current</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>42,083</td>
<td>22,897</td>
</tr>
<tr>
<td>Trade accounts receivable</td>
<td>15,992</td>
<td>10,619</td>
</tr>
<tr>
<td>Other accounts receivable</td>
<td>38,463</td>
<td>54,930</td>
</tr>
<tr>
<td>Inventories</td>
<td>43,498</td>
<td>62,151</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>8,518</td>
<td>2,032</td>
</tr>
<tr>
<td>Restricted cash</td>
<td>5,783</td>
<td>553</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>374,778</td>
<td>340,349</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>529,115</td>
<td>493,531</td>
</tr>
<tr>
<td><strong>LIABILITIES AND SHAREHOLDERS' EQUITY</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Current</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable and accrued liabilities</td>
<td>56,619</td>
<td>86,114</td>
</tr>
<tr>
<td>Income taxes payable</td>
<td>2,787</td>
<td>2,224</td>
</tr>
<tr>
<td>Current portion of long-term debt</td>
<td>6</td>
<td>9,130</td>
</tr>
<tr>
<td><strong>Long-term debt</strong></td>
<td>196,148</td>
<td>137,949</td>
</tr>
<tr>
<td><strong>Provisions</strong></td>
<td>7</td>
<td>5,350</td>
</tr>
<tr>
<td><strong>Deferred income taxes</strong></td>
<td>12,559</td>
<td>14,688</td>
</tr>
<tr>
<td><strong>Employee future benefits</strong></td>
<td>6,508</td>
<td>6,458</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>289,101</td>
<td>261,892</td>
</tr>
<tr>
<td><strong>Shareholders' equity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>8</td>
<td>175,859</td>
</tr>
<tr>
<td>Contributed surplus</td>
<td>19,817</td>
<td>13,010</td>
</tr>
<tr>
<td>Accumulated other comprehensive income</td>
<td>1,878</td>
<td>2,688</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>42,460</td>
<td>40,741</td>
</tr>
<tr>
<td><strong>Total shareholders' equity</strong></td>
<td>240,014</td>
<td>231,639</td>
</tr>
<tr>
<td><strong>Total liabilities and shareholders' equity</strong></td>
<td>529,115</td>
<td>493,531</td>
</tr>
</tbody>
</table>

(See accompanying notes)

Approved by the Board of Directors:

“Chadwick Wasilenkoff”
Director

“Richard Whittall”
Director
# FORTRESS PAPER LTD.
## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Canadian dollars, amounts in thousands, unaudited)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$84,023</td>
<td>$89,906</td>
<td>$145,391</td>
<td>$175,394</td>
</tr>
<tr>
<td>Costs and expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of products sold</td>
<td>$(73,059)</td>
<td>$(76,076)</td>
<td>$(125,943)</td>
<td>$(151,336)</td>
</tr>
<tr>
<td>Amortization</td>
<td>$(4,920)</td>
<td>$(3,394)</td>
<td>$(8,917)</td>
<td>$(6,902)</td>
</tr>
<tr>
<td>Selling, general and administration</td>
<td>$(8,621)</td>
<td>$(9,229)</td>
<td>$(18,918)</td>
<td>$(18,508)</td>
</tr>
<tr>
<td>Stock-based compensation</td>
<td>$(498)</td>
<td>$(588)</td>
<td>$(909)</td>
<td>$(1,131)</td>
</tr>
<tr>
<td><strong>Operating (loss) income</strong></td>
<td>$(3,075)</td>
<td>$619</td>
<td>$(9,296)</td>
<td>$(2,483)</td>
</tr>
<tr>
<td>Other income (expense)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Finance expense</td>
<td>$(2,254)</td>
<td>$(974)</td>
<td>$(7,069)</td>
<td>$(2,063)</td>
</tr>
<tr>
<td>Finance income</td>
<td>15</td>
<td>113</td>
<td>27</td>
<td>233</td>
</tr>
<tr>
<td>Gain on sale of property, plant and equipment</td>
<td>5</td>
<td>$19,297</td>
<td>–</td>
<td>$19,297</td>
</tr>
<tr>
<td>Foreign exchange (loss) gain</td>
<td>$(1,811)</td>
<td>$3,889</td>
<td>$(603)</td>
<td>$3,767</td>
</tr>
<tr>
<td><strong>Net income (loss) before income taxes</strong></td>
<td>$12,172</td>
<td>$3,647</td>
<td>$2,356</td>
<td>$(546)</td>
</tr>
<tr>
<td>Income tax recovery (expense)</td>
<td>290</td>
<td>$(740)</td>
<td>$(388)</td>
<td>$(2,276)</td>
</tr>
<tr>
<td><strong>Net income (loss) for the period</strong></td>
<td>$12,462</td>
<td>$2,907</td>
<td>$1,968</td>
<td>$(2,822)</td>
</tr>
<tr>
<td>Income (loss) per share</td>
<td>0.87</td>
<td>0.20</td>
<td>0.14</td>
<td>(0.20)</td>
</tr>
<tr>
<td>Diluted income (loss) per share</td>
<td>0.83</td>
<td>0.19</td>
<td>0.13</td>
<td>(0.20)</td>
</tr>
<tr>
<td>Weighted average number of shares outstanding</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basic</td>
<td>14,322,303</td>
<td>14,232,420</td>
<td>14,314,069</td>
<td>13,826,997</td>
</tr>
<tr>
<td>Diluted</td>
<td>15,117,520</td>
<td>15,144,604</td>
<td>15,185,382</td>
<td>13,826,997</td>
</tr>
</tbody>
</table>

(See accompanying notes)
## FORTRESS PAPER LTD.
### CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Canadian dollars, amounts in thousands, unaudited)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income (loss) for the period</td>
<td>$12,462</td>
<td>$2,907</td>
<td>$1,968</td>
<td>$(2,822)</td>
</tr>
<tr>
<td><strong>Other comprehensive income (loss)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cumulative translation adjustment</td>
<td>$(1,609)</td>
<td>$4,615</td>
<td>$(810)</td>
<td>$5,107</td>
</tr>
<tr>
<td>Actuarial loss recognized on employee future benefits (net of taxes of $251, $224, $50 and $10)</td>
<td>$(1,256)</td>
<td>$(1,113)</td>
<td>$(249)</td>
<td>$(50)</td>
</tr>
<tr>
<td>Asset limit on employee future benefits (net of taxes of $nil, ($13), $nil and ($1))</td>
<td>–</td>
<td>$67</td>
<td>–</td>
<td>$5</td>
</tr>
<tr>
<td><strong>Total other comprehensive (loss) income for the period</strong></td>
<td>$(2,865)</td>
<td>$3,569</td>
<td>$(1,059)</td>
<td>$5,062</td>
</tr>
<tr>
<td><strong>Total comprehensive income for the period</strong></td>
<td>$9,597</td>
<td>$6,476</td>
<td>$909</td>
<td>$2,240</td>
</tr>
</tbody>
</table>

*(See accompanying notes)*
### FORTRESS PAPER LTD.
### CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

*(Canadian dollars, amounts in thousands, unaudited)*

<table>
<thead>
<tr>
<th>Share capital</th>
<th>Contributed surplus</th>
<th>Accumulated other comprehensive income (loss)</th>
<th>Retained earnings</th>
<th>Total equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
</tbody>
</table>

#### Balance – December 31, 2011

| Net income for the period | – | – | – | 1,968 | 1,968 |
| Other comprehensive income (net of tax) | – | – | (1,059) | – | (1,059) |
| Comprehensive income (loss) for the period | – | – | (1,059) | 1,968 | 909 |
| Employee future benefit adjustments transferred to retained earnings | – | – | 249 | (249) | – |
| Employee share options *(note 9):* | | | | | |
| Stock based compensation | – | 909 | – | – | 909 |
| Restricted share units vested | 461 | (461) | – | – | – |
| Options exercised | 198 | (54) | – | – | 144 |
| Issuance of convertible note *(note 6)* | – | 1,793 | – | – | 1,793 |
| Warrants *(note 8)* | – | 4,620 | – | – | 4,620 |

**Balance – June 30, 2012**

| $ | 175,859 | 19,817 | 1,878 | 42,460 | 240,014 |

#### Balance – December 31, 2010

| Net loss for the period | – | – | – | (2,822) | (2,822) |
| Other comprehensive income (net of tax) | – | – | 5,062 | – | 5,062 |
| Comprehensive income (loss) for the period | – | – | 5,062 | (2,822) | 2,240 |
| Employee future benefit adjustments transferred to retained earnings | – | – | 45 | (45) | – |
| Employee share options *(note 9):* | | | | | |
| Stock based compensation | – | 1,131 | – | – | 1,131 |
| Restricted share units vested | 632 | (632) | – | – | – |
| Options exercised | 881 | (242) | – | – | 639 |
| Redemption of convertible note *(note 6)* | 7,363 | (948) | – | – | 6,415 |
| Private placement *(note 8)* | 54,782 | – | – | – | 54,782 |

**Balance – June 30, 2011**

| $ | 174,806 | 9,845 | 7,016 | 64,326 | 255,993 |

*(See accompanying notes)*
FORTRESS PAPER LTD.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the six months ended
(Canadian dollars, amounts in thousands, unaudited)

<table>
<thead>
<tr>
<th>Note</th>
<th>June 30, 2012</th>
<th>June 30, 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$</td>
<td>$</td>
</tr>
</tbody>
</table>

**Cash flows from (used by) operating activities**

Net income (loss) 1,968 (2,822)

Adjustments:

- Gain on sale of property, plant and equipment 5 (19,297) –
- Amortization 8,917 6,902
- Income tax expense 388 2,276
- Income taxes paid (3,658) (4,526)
- Foreign exchange loss (gain) 755 (2,502)
- Finance expense 7,042 1,830
- Stock based compensation 909 1,131

(2,976) 2,289

Change in non-cash working capital items

- Accounts receivable 6,101 (12,639)
- Inventories 18,148 (4,791)
- Prepaid expenses (329) (498)
- Accounts payable and accrued liabilities and other (4,831) 4,069

16,113 (11,570)

**Cash flows from (used by) financing activities**

- Options exercised 8 144 639
- Repayment of long-term debt (27,157) (6,246)
- Proceeds from long-term debt 85,219 20,544
- Net proceeds from issuance of common shares 8 – 54,782
- Payment on capital leases – (121)
- Long-term debt prepayment penalty 6 (2,615) –
- Payment of long-term debt interest (2,571) (1,168)

53,020 68,430

**Cash flows from (used by) investing activities**

- Additions to property, plant and equipment (55,796) (58,890)
- Proceeds from sale of property, plant and equipment 5 19,414 –
- Startup costs capitalized (8,585) –
- Restricted cash (5,269) (1,130)
- Proceeds from Green Transformation Program 11 1,000 –
- Acquisition of Fortress Optical Features – (750)

(49,236) (60,770)

**Increase (decrease) in cash position**

- Foreign exchange loss on cash and cash equivalents (711) (894)
- Cash and cash equivalents, beginning of year 22,897 42,559

**Cash and cash equivalents, end of period**

42,083 37,755

**Supplementary cash flow information**

(See accompanying notes)
1. NATURE OF OPERATIONS

Fortress Paper Ltd. (the “Company” or “Fortress”) was incorporated on May 30, 2006 under the laws of the Province of British Columbia. The address of the Company’s registered office is 157 Chadwick Court – 2nd floor, North Vancouver, British Columbia, Canada V7M 3K2. From the date of incorporation to July 31, 2006, the Company was inactive. The Company’s fiscal year-end is December 31. Fortress Paper operates internationally in three distinct business segments: dissolving pulp, specialty papers and security paper products. The Company operates its dissolving pulp business at the Fortress Specialty Cellulose Mill located in Canada, which is also in the process of expanding into the renewable energy generation sector with the construction of a cogeneration facility. Fortress Specialty Cellulose was converted into a dissolving pulp mill with ramp up production starting in December of 2011. Commercial production at Fortress Specialty Cellulose for accounting purposes, with the equipment operating as intended by management, began on March 18, 2012. The Company is also seeking to expand its dissolving pulp capacity with the recent acquisition of the Fortress Global Cellulose Mill located at Lebel-sur-Quévillon, Québec, which the Company intends to convert into a dissolving pulp mill and re-start the cogeneration facility. The Company operates its specialty papers business at the Dresden Mill located in Germany, where it is a leading international producer of specialty non-woven wallpaper base products. The Company operates its security paper products business at the Landqart Mill located in Switzerland, where it produces banknote, passport, visa and other brand protection and security papers, and at its Fortress Optical Facility located in Canada, where it manufacturers optically variable thin film material.

2. BASIS OF PRESENTATION

These condensed interim consolidated financial statements have been prepared in accordance with International Accounting Standard ("IAS") 34 Interim Financial Reporting. The Company has consistently applied the same accounting policies throughout all periods presented, as if these policies had always been in effect. The policies applied in these condensed interim consolidated financial statements are based on International Financial Reporting Standards ("IFRS") issued and outstanding as of August 7, 2012, the date the Board of Directors approved the statements.

These unaudited interim financial statements do not include all of the disclosures required by IFRS for annual financial statements and, accordingly, should be read in conjunction with the consolidated financial statements and notes as at and for the year ended December 31, 2011 (available on SEDAR at www.sedar.com). These unaudited interim financial statements follow the same accounting policies and methods of their application as December 31, 2011 consolidated financial statements.

3. NEW ACCOUNTING PRONOUNCEMENTS

During 2011, the International Accounting Standards Board (“IASB”) issued a number of new and revised accounting standards which are effective for annual periods beginning on or after January 1, 2013, with early adoption permitted. These new and revised accounting standards have not yet been adopted by the Company.

The following new or revised standards are not expected to have a material impact on the amounts recorded in the financial statements of the Company:

- IFRS 10 – Consolidated Financial Statements;
- IFRS 11 – Joint Arrangements;
- IFRS 12 – Disclosure of Interests in Other Entities;
The Company is still in the process of assessing the full impact, if any, of IAS 19 (revised) – *Employee Benefits*.

In 2011, the IASB also amended IFRS 9 – *Financial Instruments*, which is effective for annual periods beginning on or after January 1, 2015, with earlier adoption permitted. The Company is still in the process of assessing the full impact of this standard.

Further details of the new or revised accounting standards and their potential impact on the Company can be found in the consolidated financial statements and notes as at and for the year ended December 31, 2011.

4. **OTHER ACCOUNTS RECEIVABLE**

<table>
<thead>
<tr>
<th>Note</th>
<th>June 30, 2012</th>
<th>December 31, 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>6</td>
<td>4,052</td>
<td>8,092</td>
</tr>
<tr>
<td>11</td>
<td>15,938</td>
<td>16,310</td>
</tr>
<tr>
<td></td>
<td>5,053</td>
<td>10,990</td>
</tr>
<tr>
<td></td>
<td>4,389</td>
<td>7,388</td>
</tr>
<tr>
<td></td>
<td>6,171</td>
<td>6,229</td>
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<tr>
<td>11</td>
<td>266</td>
<td>2,713</td>
</tr>
<tr>
<td></td>
<td>2,594</td>
<td>3,208</td>
</tr>
<tr>
<td></td>
<td>38,463</td>
<td>54,930</td>
</tr>
</tbody>
</table>

*Receivable from supplier*

As at June 30, 2012 and December 31, 2011, a customer dispute existed for product supplied by the Company. The complaint was the result of a faulty input which was provided by a third party supplier of the Company. Any amounts under dispute will need to be reimbursed to the Company by the supplier. Differences between June 30, 2012 and December 31, 2011 are related to foreign exchange differences. As a result, the following amounts were recorded:

<table>
<thead>
<tr>
<th>Note</th>
<th>June 30, 2012</th>
<th>December 31, 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td></td>
<td>(979)</td>
<td>(988)</td>
</tr>
<tr>
<td></td>
<td>4,273</td>
<td>4,313</td>
</tr>
<tr>
<td></td>
<td>2,877</td>
<td>2,904</td>
</tr>
<tr>
<td></td>
<td>6,171</td>
<td>6,229</td>
</tr>
<tr>
<td></td>
<td>6,171</td>
<td>6,229</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
5. PROPERTY, PLANT AND EQUIPMENT

On June 20, 2012, the Company purchased the assets of a shutdown pulp mill in Lebel-sur-Quevillon, Quebec through a wholly owned subsidiary, Fortress Global Cellulose. The Company will be converting the mill into a dissolving pulp mill. The purchase price of $7,205 was recorded to property, plant and equipment and was made up of the following:

<table>
<thead>
<tr>
<th>Note</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price</td>
<td>–</td>
</tr>
<tr>
<td>Transaction costs</td>
<td>1,394</td>
</tr>
<tr>
<td>Asset retirement obligation assumed</td>
<td>7 5,811</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>7,205</td>
</tr>
</tbody>
</table>

During the three months ended June 30, 2012, the Company sold its hydropower assets and associated real estate at the Landqart mill for CHF 18 million. The carrying amount of the assets sold was CHF 316. The resulting gain on the sale was recognized during the three months ended June 30, 2012.

6. LONG-TERM DEBT

<table>
<thead>
<tr>
<th>June 30, 2012</th>
<th>December 31, 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Credit agreement with bank maturing 2014; interest at 2.65%; secured by current assets (EUR 192; 2011: EUR 289)</td>
<td>248</td>
</tr>
<tr>
<td>Credit agreement with lender maturing 2018; interest at 6.2% and 7.1%; secured by property, plant and equipment (EUR nil; 2011: EUR 19,675) (a)</td>
<td>–</td>
</tr>
<tr>
<td>Credit agreement with lender maturing 2018; interest at 3.81% secured by property, plant and equipment and inventory (EUR 24,764; 2011: EUR nil) (b)</td>
<td>31,971</td>
</tr>
<tr>
<td>Credit agreement with bank maturing 2012; interest at 4.8%; unsecured (CHF 785; 2011: CHF 1,570)</td>
<td>843</td>
</tr>
<tr>
<td>Credit agreement with bank maturing 2011, 2013 and 2018; interest up to 3.1% and 4.9%; secured by property, plant and equipment (CHF 6,300; 2011: CHF 5,400) (c)</td>
<td>6,769</td>
</tr>
<tr>
<td>Credit agreement with lender maturing 2016; unsecured (CHF 4,350; 2011: CHF 4,584) (d)</td>
<td>4,675</td>
</tr>
<tr>
<td>Credit agreement with lender maturing 2016; interest at 6.5%; unsecured (e)</td>
<td>34,151</td>
</tr>
<tr>
<td>Credit agreement with lender maturing 2020; interest up to 5.5%; secured by assets (f)</td>
<td>104,293</td>
</tr>
<tr>
<td>Credit agreement with lender maturing 2017; interest at 7%; unsecured (g)</td>
<td>22,328</td>
</tr>
<tr>
<td>Credit agreement with lender maturing 2023; interest up to 5.5%; secured by assets (h)</td>
<td>–</td>
</tr>
<tr>
<td></td>
<td>205,278</td>
</tr>
<tr>
<td>Less: Current portion</td>
<td>(9,130)</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>196,148</td>
</tr>
</tbody>
</table>
FORTRESS PAPER LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
For the three and six month periods ended June 30, 2012 and 2011
(Canadian dollars, amounts in thousands except share and per share data, unaudited)

<table>
<thead>
<tr>
<th></th>
<th>June 30, 2012</th>
<th>December 31, 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal value of debt</td>
<td>215,987</td>
<td>160,819</td>
</tr>
<tr>
<td>Unamortized borrowing costs and amounts allocated to equity</td>
<td>(10,709)</td>
<td>(8,411)</td>
</tr>
<tr>
<td>Net amount recorded in liabilities</td>
<td>205,278</td>
<td>152,408</td>
</tr>
</tbody>
</table>

Borrowings under the above agreements require maintenance of certain financial and non-financial covenants. The Company has been in compliance with all covenants for the six months ended June 30, 2012.

(a) At March 30, 2012, the remaining EUR 19,296 of the facility was repaid in full, utilizing proceeds from (b) below. A prepayment penalty of EUR 1,992 has been recorded in finance expenses. Up to the date of repayment, the facility had an interest rate of 7.1%. Interest was calculated at a 7.6% effective rate.

(b) The credit agreement is a facility for up to EUR 25 million, of which EUR 25 million has been drawn as at June 30, 2012. The facility bears interest at a rate of 3.8%. Beginning in September 2012, the loan is repayable in equal quarterly installments over 5 years. Interest has been calculated at a 4.1% effective rate.

(c) $3,385 is being held in restricted cash at June 30, 2012 which is to be used to pay down this debt during 2012.

(d) The credit agreement is a facility for CHF 5,310 that bears no interest and is repayable based on the timing of production for the lender. Interest has been calculated at a 5% effective rate.

(e) The credit agreement is an unsecured convertible note of the Company in the principal amount of $40,250 that matures in December 2016. The convertible note bears interest at an annual rate equal to 6.5%, calculated semi-annually.

The holder of the convertible note may, at its option, convert the convertible note into common shares at any time prior to maturity. The conversion price shall be equal to $37.50 per share.

The Company may redeem the debentures in whole or in part on and after December 31, 2014 and prior to the maturity date, at its option, and repay in advance the debenture at a price equal to the principal amount plus accrued and unpaid interest, provided that the volume weighted average average trading price of common shares on the Toronto Stock Exchange during 20 consecutive trading days is not less than $46.88 per share.

After considering borrowing costs of $2,178, the Company initially recorded a liability portion of $33,607 and an equity portion of $2,804 in contributed surplus (net of ($1,661) tax). The liability portion was valued using a 9.5% initial interest rate. Interest is calculated at a 10.85% effective rate.

(f) The credit agreement is a facility for up to $102.4 million, granted to Fortress Specialty Cellulose to support the conversion to dissolving pulp and co-generation capital expenditure programs. At June 30, 2012, $102,400 (December 31, 2011, $79,502) has been drawn on this facility. Of this amount $4,052 is pending receipt from the lender and has been included in other accounts receivable (December 31, 2011: $8,092). A The facility bears interest at a rate of 5% for the first five years of the loan and at a rate of up to 5.5% for the second five years of the
loan. Commencing after two years, the facility is repayable in equal quarterly installments up to June 30, 2020. Interest for the first two years of the credit agreement is added to the principal of the loan. The total interest capitalized and added to the principal up to June 30, 2012 is $2,236.

Interest has been calculated at a 5.6% effective rate.

(g) The credit agreement is an unsecured convertible note of the Company in the principal amount of $25,000 that matures in June 2017. The convertible note bears interest at an annual rate equal to 7%, calculated semi-annually.

Commencing June 20, 2012, the holder of the convertible note may, at its option, convert the convertible note into common shares at any time until the close of business on the last business day prior to maturity. The conversion price shall be equal to $32.28 per share.

The Company may redeem the convertible note on or after June 20, 2014, at its option and repay in advance this option in whole or in part at par plus accrued and unpaid interest if the volume weighted average trading price of common shares on the TSX during 20 consecutive trading days, is not less than $40.35 per share.

After considering borrowing costs of $211, the Company initially recorded a liability portion of $22,328 and an equity portion of $1,793 in contributed surplus (net of ($668) tax). The liability portion was valued using a 9.5% initial interest rate. Interest is calculated at a 9.7% effective rate.

(h) The credit agreement is a facility for up to $132.4 million, granted to Fortress Global Cellulose to support the conversion to dissolving pulp expenditure program. The loan is repayable ten years after the first draw on the facility. At June 30, 2012, $nil has been drawn on this facility. The facility bears interest at a rate of 5% for the first five years of the loan and at a rate of up to 5.5% for the second five years of the loan. Commencing two years after the first draw on the loan, the facility is repayable in equal quarterly installments. Interest for the first two years of the credit agreement is added to the principal of the loan.

Borrowing costs of $7,006 have been deferred and recorded as a prepaid expense until the loan is drawn upon.

Included in the borrowing costs of the loan are 715,000 warrants which have been provided to the lender. The warrants have an exercise price of $21.52 and are exercisable from December 31, 2014 to December 31, 2017, when they expire (note 8).

Interest will be calculated at a 6.3% effective rate.
7. PROVISIONS

On June 20, 2012, the Company purchased the assets of a mill in Lebel-sur-Quevillon, Quebec. As part of the purchase, the Company entered into an environmental Trust Agreement (the “Environmental Trust”) to be used for environmental remediation for potential problems that existed at the date of purchase. The Company must fund $7.5 million over the next 5 years in the intervals set out below. The Company must also fund another $2.5 million in the event that the mill is dismantled in the future. The liability for the Company is for existing environmental liabilities at the date of purchase has been limited at the amounts set out above. Any further environmental remediation costs are to be paid by the previous owners of the mill and the provincial government. The discount rates used for the valuation of the asset retirement obligation range from 6.8% to 9.8% depending on the timing of the expected payment.

<table>
<thead>
<tr>
<th>June 30, 2012</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Potential Environmental Trust payments</td>
<td>10,000</td>
</tr>
<tr>
<td>Discount</td>
<td>(4,189)</td>
</tr>
<tr>
<td>Net amount recorded as provision</td>
<td>5,811</td>
</tr>
<tr>
<td>Less: current portion</td>
<td>(461)</td>
</tr>
<tr>
<td>Provision, long-term</td>
<td>5,350</td>
</tr>
</tbody>
</table>

The timing of potential Environmental Trust payments are as follows:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>500</td>
</tr>
<tr>
<td>2014</td>
<td>500</td>
</tr>
<tr>
<td>2015</td>
<td>1,500</td>
</tr>
<tr>
<td>2016</td>
<td>1,500</td>
</tr>
<tr>
<td>2017</td>
<td>3,500</td>
</tr>
<tr>
<td>Thereafter</td>
<td>2,500</td>
</tr>
<tr>
<td>Total potential Environmental Trust payments</td>
<td>10,000</td>
</tr>
</tbody>
</table>

8. SHARE CAPITAL

Authorized

Unlimited number of common shares without par value
Unlimited number of preferred shares with par value $1,000
Issued and fully paid — common shares

<table>
<thead>
<tr>
<th>Note</th>
<th>Number of Shares</th>
<th>Share Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance, December 31, 2010</td>
<td>12,683,588</td>
<td>111,148</td>
</tr>
<tr>
<td>Private placement</td>
<td>1,112,050</td>
<td>54,782</td>
</tr>
<tr>
<td>Restricted Share Units vested</td>
<td>9</td>
<td>69,506</td>
</tr>
<tr>
<td>Options exercised</td>
<td>9</td>
<td>88,450</td>
</tr>
<tr>
<td>Shares issued on redemption of Convertible Note</td>
<td>350,000</td>
<td>7,283</td>
</tr>
<tr>
<td><strong>Balance, December 31, 2011</strong></td>
<td><strong>14,303,594</strong></td>
<td><strong>175,200</strong></td>
</tr>
<tr>
<td>Restricted Share Units vested</td>
<td>9</td>
<td>18,599</td>
</tr>
<tr>
<td>Options exercised</td>
<td>9</td>
<td>18,000</td>
</tr>
<tr>
<td><strong>Balance, June 30, 2012</strong></td>
<td><strong>14,340,193</strong></td>
<td><strong>175,859</strong></td>
</tr>
</tbody>
</table>

Warrants

On June 20, 2012, the Company issued 715,000 warrants to a lender. The warrants have an exercise price of $21.52 and are exercisable from December 31, 2014 to December 31, 2017, when they expire. The warrants were valued at $8.62 per warrant at the grant date using the Black Scholes pricing model. The Black Scholes pricing model requires the input of highly subjective assumptions including the expected volatility. Changes in the assumptions can materially affect the fair value estimate, and, therefore, the existing models do not necessarily provide a reliable measure of the fair value of the Company’s warrants. Assumptions used in the pricing model are as follows:

<table>
<thead>
<tr>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk-free interest rate</td>
</tr>
<tr>
<td>Expected life of warrants</td>
</tr>
<tr>
<td>Annualized volatility</td>
</tr>
<tr>
<td>Dividend rate</td>
</tr>
</tbody>
</table>

All 715,000 warrants were outstanding as at June 30, 2012.

9. STOCK-BASED COMPENSATION

During 2006, the Company adopted a stock incentive plan. The exercise price of options granted under the stock option plan shall be as determined by the Board of Directors when such options are granted, subject to any limitations imposed by any relevant stock exchange or regulatory authority.
At the Company’s annual general meeting held April 30, 2009, shareholders approved a long-term incentive plan which provides for the grant of restricted share units, performance share units and deferred share units to key employees and directors of the Company. The aggregate number of shares issuable under the long-term incentive plan in respect of awards, together with shares reserved for issuance under all of the Company's other security-based compensation arrangements, shall not exceed ten percent of the Company's issued and outstanding shares.

**Stock Options**

The weighted average fair value of the options granted in 2009 was $2.98 an option at the grant date using the Black Scholes option pricing model. No options were granted during the six months ended June 30, 2012 or during the year ended December 31, 2011. Option pricing models require the input of highly subjective assumptions including the expected volatility. Changes in the assumptions can materially affect the fair value estimate, and, therefore, the existing models do not necessarily provide a reliable measure of the fair value of the Company’s stock options. Assumptions used in the pricing model are as follows:

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk-free interest rate</td>
<td>1.78%</td>
</tr>
<tr>
<td>Expected life of options</td>
<td>5 years</td>
</tr>
<tr>
<td>Annualized volatility</td>
<td>53%</td>
</tr>
<tr>
<td>Dividend rate</td>
<td>Nil</td>
</tr>
</tbody>
</table>

Stock option transactions and the number of stock options outstanding are summarized as follows:

<table>
<thead>
<tr>
<th></th>
<th>Number of options</th>
<th>Exercise Price $</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance, December 31, 2010</strong></td>
<td>655,175</td>
<td>8.00</td>
</tr>
<tr>
<td>Exercised</td>
<td>(88,450)</td>
<td>8.00</td>
</tr>
<tr>
<td><strong>Balance, December 31, 2011</strong></td>
<td>566,725</td>
<td>8.00</td>
</tr>
<tr>
<td>Exercised</td>
<td>(18,000)</td>
<td>8.00</td>
</tr>
<tr>
<td><strong>Balance, June 30, 2012</strong></td>
<td>548,725</td>
<td>8.00</td>
</tr>
</tbody>
</table>

As at June 30, 2012, 548,725 stock options were exercisable (December 31, 2011: 566,725). The stock options issued have various vesting dates that range from one to three years from the IPO or grant dates.

**Deferred Share Unit Awards**

A Deferred Share Unit ("DSU") is a right granted to a non-employee director to receive one common share of the Company, from treasury, on a deferred basis. The value of the DSUs, when redeemed, is equal to the market value of the shares on the redemption date, including the value of dividends paid on the Company's common shares, if any, as if they had been reinvested in additional DSUs on each payment date. The DSUs may only be redeemed upon a director's retirement from the Company. The Company recognizes the expense at the time of grant.
DSU transactions and the number of DSUs outstanding are summarized as follows:

<table>
<thead>
<tr>
<th></th>
<th>Number of DSUs</th>
<th>Expense recognized</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, December 31, 2010</td>
<td>139,023</td>
<td>5,470</td>
</tr>
<tr>
<td>Granted</td>
<td>3,850</td>
<td>172</td>
</tr>
<tr>
<td>Balance, December 31, 2011</td>
<td>142,873</td>
<td>5,642</td>
</tr>
<tr>
<td>Granted</td>
<td>4,205</td>
<td>125</td>
</tr>
<tr>
<td>Balance, June 30, 2012</td>
<td>147,078</td>
<td>5,767</td>
</tr>
</tbody>
</table>

Restricted Share Unit Awards

A Restricted Share Unit ("RSU") is a right granted to a key employee to receive one common share of the Company, from treasury, on a time vested basis. The fair value of restricted share awards is determined based upon the number of shares granted and the quoted price of the Company’s stock on the date of grant. Restricted shares generally vest over three to five years.

RSU transactions and the number of RSUs outstanding are summarized as follows:

<table>
<thead>
<tr>
<th></th>
<th>Number of RSUs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, December 31, 2010</td>
<td>315,042</td>
</tr>
<tr>
<td>Granted</td>
<td>17,128</td>
</tr>
<tr>
<td>Vested</td>
<td>(69,506)</td>
</tr>
<tr>
<td>Balance, December 31, 2011</td>
<td>262,664</td>
</tr>
<tr>
<td>Granted</td>
<td>36,869</td>
</tr>
<tr>
<td>Vested</td>
<td>(18,599)</td>
</tr>
<tr>
<td>Forfeited</td>
<td>(6,850)</td>
</tr>
<tr>
<td>Balance, June 30, 2012</td>
<td>274,084</td>
</tr>
</tbody>
</table>

10. ACCUMULATED OTHER COMPREHENSIVE INCOME

Accumulated other comprehensive income is comprised of cumulative translation adjustments for all periods presented.

11. GOVERNMENT ASSISTANCE

Pulp and paper green transformation fund

On June 17, 2009, the Canadian federal government announced the Pulp and Paper Green Transformation Program ("the Program"). The Program is designed as a reimbursement of funds to be spent on qualifying energy
and environmental capital projects, credits may be used until the Program end date of March 31, 2012. The Company has been allocated $9.9 million from the Program on June 28, 2011. The Company has received Program approval to apply the funding to the installation of lime kiln and recovery boiler upgrades at the Fortress Specialty Cellulose mill. These projects are expected to provide economic and environmental benefits to the Company’s operations. As at December 31, 2011 the Company had received $8.9 million under the Program. The remaining $1.0 million was received during the three months ended June 30, 2012.

Training grants

During the three and six months ended June 30, 2012, the Fortress Specialty Cellulose mill recorded $382 and $655, respectively, in training grants from the Quebec provincial government as a reduction of costs. During 2011, the Fortress Specialty Cellulose mill recorded $1,279 in training grants as a reduction of costs. Of this amount, $266 (December 31, 2011: $746) has been recorded as other receivables. There are no repayment obligations as of June 30, 2012.

Investment tax credits

The Company has filed for investment tax credits from the Canada and Quebec governments totalling $15,938 (December 31, 2011: $16,310) relating to qualifying plant and equipment purchases made during the year ended December 31, 2011. This entire amount was outstanding as at June 30, 2012.

12. COMMITMENTS

As at June 30, 2012, the Company has committed to purchase $28.9 million in property, plant, and equipment.

As at June 30, 2012, the Company has performance bonds in the amounts of EUR 6,682, CHF 587 and USD 4.

13. SEGMENTED INFORMATION

The segmentation of the Company's manufacturing operations is based on a number of factors, including production, production processes, and economic characteristics. Fortress’ business segments were re-classified in 2012 given changes in the nature of products being produced. For the purposes of the three and six months ended June 30, 2011, the Company’s dissolving pulp segment was producing specialty pulp. The Landqart mill and Fortress Optical Features produce security papers and products. The Dresden mill produces non-woven wallpaper base products. Fortress Specialty Cellulose produces dissolving pulp products. For the three and six months ended June 30, 2012, dissolving pulp segment operating results up to March 18, 2012 were capitalized to property, plant and equipment during the startup period for dissolving pulp.
### FORTRESS PAPER LTD.
#### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
For the three and six month periods ended June 30, 2012 and 2011
(Canadian dollars, amounts in thousands except share and per share data, unaudited)

<table>
<thead>
<tr>
<th>Three months ended June 30, 2012</th>
<th>Wallpaper</th>
<th>Security</th>
<th>Dissolving pulp</th>
<th>Corporate</th>
<th>Fortress Paper Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>40,814</td>
<td>8,112</td>
<td>35,097</td>
<td>–</td>
<td>84,023</td>
</tr>
<tr>
<td>Operating income (loss)</td>
<td>9,626</td>
<td>(8,121)</td>
<td>(2,816)</td>
<td>(1,764)</td>
<td>(3,075)</td>
</tr>
<tr>
<td>Amortization&lt;sup&gt;1&lt;/sup&gt;</td>
<td>(798)</td>
<td>(1,970)</td>
<td>(2,172)</td>
<td>–</td>
<td>(4,920)</td>
</tr>
<tr>
<td>Stock-based compensation&lt;sup&gt;1&lt;/sup&gt;</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>(498)</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>33</td>
<td>226</td>
<td>21,724</td>
<td>–</td>
<td>21,983</td>
</tr>
<tr>
<td>Total assets</td>
<td>63,086</td>
<td>137,463</td>
<td>296,373</td>
<td>32,193</td>
<td>529,115</td>
</tr>
</tbody>
</table>

**Sales by geographic area**

<table>
<thead>
<tr>
<th>%</th>
<th>Europe</th>
<th>Asia</th>
<th>Other</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>53.7</td>
<td>41.8</td>
<td>4.5</td>
<td>100.0</td>
</tr>
</tbody>
</table>

<sup>1</sup>Stock-based compensation and amortization are included in operating earnings (loss).

<table>
<thead>
<tr>
<th>Three months ended June 30, 2011</th>
<th>Wallpaper</th>
<th>Security</th>
<th>Dissolving pulp</th>
<th>Corporate</th>
<th>Fortress Paper Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>36,566</td>
<td>13,379</td>
<td>39,961</td>
<td>–</td>
<td>89,906</td>
</tr>
<tr>
<td>Operating income (loss)</td>
<td>6,804</td>
<td>(6,779)</td>
<td>3,316</td>
<td>(2,722)</td>
<td>619</td>
</tr>
<tr>
<td>Amortization&lt;sup&gt;1&lt;/sup&gt;</td>
<td>(702)</td>
<td>(1,852)</td>
<td>(840)</td>
<td>–</td>
<td>(3,394)</td>
</tr>
<tr>
<td>Stock-based compensation&lt;sup&gt;1&lt;/sup&gt;</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>(588)</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>3,144</td>
<td>3,953</td>
<td>30,778</td>
<td>–</td>
<td>37,875</td>
</tr>
<tr>
<td>Total assets</td>
<td>65,663</td>
<td>150,979</td>
<td>152,986</td>
<td>17,731</td>
<td>387,359</td>
</tr>
</tbody>
</table>

**Sales by geographic area**

<table>
<thead>
<tr>
<th>%</th>
<th>Europe</th>
<th>Asia</th>
<th>North America</th>
<th>Other</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>50.0</td>
<td>44.4</td>
<td>–</td>
<td>5.6</td>
<td>100.0</td>
</tr>
</tbody>
</table>

<sup>1</sup>Stock-based compensation and amortization are included in operating earnings (loss).
FORTRESS PAPER LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
For the three and six month periods ended June 30, 2012 and 2011
(Canadian dollars, amounts in thousands except share and per share data, unaudited)

<table>
<thead>
<tr>
<th>Six months ended June 30, 2012</th>
<th>Wallpaper</th>
<th>Security</th>
<th>Dissolving pulp</th>
<th>Corporate</th>
<th>Fortress Paper Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>78,472</td>
<td>21,387</td>
<td>45,532</td>
<td>–</td>
<td>145,391</td>
</tr>
<tr>
<td>Operating income (loss)</td>
<td>18,189</td>
<td>(15,303)</td>
<td>(7,513)</td>
<td>(4,669)</td>
<td>(9,296)</td>
</tr>
<tr>
<td>Amortization¹</td>
<td>(1,667)</td>
<td>(3,910)</td>
<td>(3,340)</td>
<td>–</td>
<td>(8,917)</td>
</tr>
<tr>
<td>Stock-based compensation¹</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>(909)</td>
<td>(909)</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>1,258</td>
<td>824</td>
<td>42,202</td>
<td>–</td>
<td>44,284</td>
</tr>
<tr>
<td>Total assets</td>
<td>63,086</td>
<td>137,463</td>
<td>296,373</td>
<td>32,193</td>
<td>529,115</td>
</tr>
</tbody>
</table>

Sales by geographic area

<table>
<thead>
<tr>
<th></th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Europe</td>
<td>60.0</td>
</tr>
<tr>
<td>Asia</td>
<td>31.3</td>
</tr>
<tr>
<td>Other</td>
<td>8.7</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
</tr>
</tbody>
</table>

¹Stock-based compensation and amortization are included in operating earnings (loss).

<table>
<thead>
<tr>
<th>Six months ended June 30, 2011</th>
<th>Wallpaper</th>
<th>Security</th>
<th>Dissolving pulp</th>
<th>Corporate</th>
<th>Fortress Paper Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>73,567</td>
<td>26,280</td>
<td>75,547</td>
<td>–</td>
<td>175,394</td>
</tr>
<tr>
<td>Operating income (loss)</td>
<td>13,810</td>
<td>(13,422)</td>
<td>2,374</td>
<td>(5,245)</td>
<td>(2,483)</td>
</tr>
<tr>
<td>Amortization¹</td>
<td>(1,351)</td>
<td>(3,801)</td>
<td>(1,750)</td>
<td>–</td>
<td>(6,902)</td>
</tr>
<tr>
<td>Stock-based compensation¹</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>(1,131)</td>
<td>(1,131)</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>5,134</td>
<td>16,912</td>
<td>44,076</td>
<td>–</td>
<td>66,122</td>
</tr>
<tr>
<td>Total assets</td>
<td>65,663</td>
<td>150,979</td>
<td>152,986</td>
<td>17,731</td>
<td>387,359</td>
</tr>
</tbody>
</table>

Sales by geographic area

<table>
<thead>
<tr>
<th></th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Europe</td>
<td>53.3</td>
</tr>
<tr>
<td>Asia</td>
<td>36.0</td>
</tr>
<tr>
<td>North America</td>
<td>1.8</td>
</tr>
<tr>
<td>Other</td>
<td>8.7</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
</tr>
</tbody>
</table>

¹Stock-based compensation and amortization are included in operating earnings (loss).
14. SUPPLEMENTARY CASH FLOW INFORMATION

Non cash item

During the six months ended June 30, 2011, 350,000 common shares of the Company were issued for the redemption of the Convertible Note (note 8).

Non cash property, plant and equipment purchases included in accounts payable decreased by $26,123 for the six months ended June 30, 2012 and increased by $5,450 for the six months ended June 30, 2011.

15. SUBSEQUENT EVENT

On July 10, 2012, the Company issued an unsecured convertible notes in the total principal amount of $69,000 that mature on December 31, 2019. The convertible notes bear interest at an annual rate equal to 7%, calculated semi-annually.

The holder of a convertible note may, at its option, convert the convertible note into common shares at any time prior to maturity. The conversion price shall be equal to $31.00 per share.

The Company may redeem the debentures in whole or in part on and after July 1, 2015 and prior to the July 1, 2017, at its option, and repay in advance the debenture at a price equal to the principal amount plus accrued and unpaid interest, provided that the volume weighted average trading price of common shares on the Toronto Stock Exchange during 20 consecutive trading days is not less than $37.50 per share. On or after July 1, 2017 and prior to the maturity date, the debentures may be redeemed in whole or in part at the option of the Company at a price equal to the principal amount plus accrued and unpaid interest.