Printing and Writing Papers Report

Coated Free Sheet Under Pressure as Grade, Market Competition Increases

— BY HAROLD M. CODY, CONTRIBUTING EDITOR

One of the paper industry's historically fastest growing sectors is undergoing wrenching change due to intense market competition from other grades and shifts in global trade largely caused by changes in regional supply and demand. Coated free sheet papers are at the top of the graphic paper value chain in terms of selling prices and traditionally in profits. Growth in a variety of uses led to strong demand growth in the last two decades.

At one time, barriers to entry such as proprietary process and equipment technology made the coated paper market hard to penetrate for new producers. However, these barriers have fallen as off-the-shelf technology has become readily available. One result has been rapid capacity growth in non-traditional producing areas such as Asia as demand in these regions has surged in response to the area's growing economies. European mills have also invested large sums of capital to expand capacity based on an export strategy. In turn, U.S. imports have surged to record levels.

Shift in U.S. Source of Supply

These competitive forces led to the removal of nearly 900,000 tons of U.S. coated free sheet capacity in 2001 and 2002. Thus, despite the addition of more than 200,000 tons of capacity as a result of Stora's conversion of capacity from coated groundwood to free sheet, coated free sheet capacity was down about 500,000 tons at the end of 2003 versus just two years ago.

These withdrawals are a direct result of global competition in the form of low cost imports and low cost North American producers. Following three years of decline, and barring any further major withdrawals, U.S. coated free sheet capacity should post some modest gains beginning in 2004, although there is capacity that remains at risk, particularly if mills fail to innovate and to continually drive down costs.

As world capacity has grown, U.S. coated free sheet imports have surged in recent years, in particular fueled by the rising capacity in Asia. The market share held by coated free sheet imports has risen in the last decade from a relatively low level to nearly one quarter of supply. In the coated sheet market, the share may be nearly one-third. The biggest change was a surge of imports from Asia beginning in early 2002 and continuing in 2003, where for most of the year they exceeded imports from Europe.

Korea is by far the largest Asian exporter of coated wood free grades to the U.S. Imports reached just over 300,000 tons in 2002, making them the largest supplier and exceeding the 230,000 tons of coated free sheet imports from Canada. Korean mills have expanded capacity considerably, but one added reason for this surge in Korean shipments to the U.S. is growing capacity in China that has displaced some Korean tonnage previously exported to China.

U.S. imports from China have also risen from very low levels just two years ago to nearly 40,000 tons in 2002 and are estimated at about 55,000 to 60,000 tons in 2003. However, the long-term outlook for imports from China or Korea remains unclear since growth in domestic Chinese demand could easily consume the current level of capacity.

New high brightness coated groundwood grades have also been developed in Europe and an increase in imports of these grades has also been a factor. These imports illustrate the increasingly global nature of the coated paper market and the impact that technology has on traditional products.

Shifts by some users from coated free sheet to lower priced groundwood grades, including the use of these new high brightness papers, have led to a slip in coated free sheet demand. Through October 2003, U.S. coated groundwood

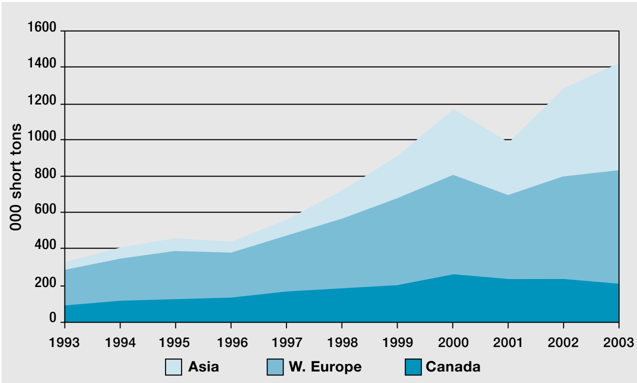

Figure 1: U.S. Coated Free Sheet Imports by Region (estimated 2003 data based on annualized rate through September)

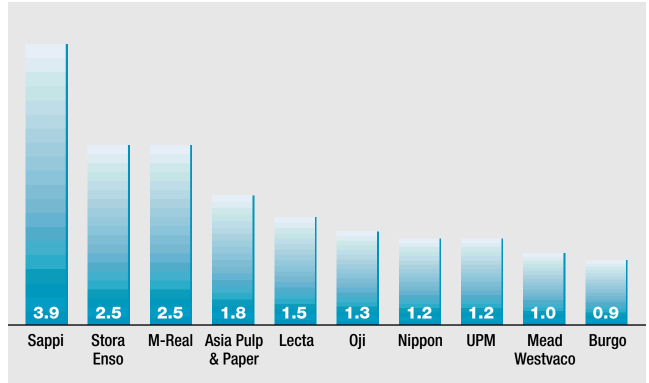

Table 1: Coated Free Sheet Capacity by Company (million metric tpy)

demand is up nearly 10%, while coated free sheet is off about 3% vs. last year. Demand is expected to rise in 2004 as overall demand for printing and writing papers improves in line with economic growth, but coated free sheet apparent consumption is still likely to remain at or below the 2002 level until further growth in demand in 2005.

Low Cost Mills To Continue Capacity Shift

Several major new projects have been announced that could continue to rapidly increase coated free sheet capacity in China. Projects by Oji Paper of Japan and Stora Enso would add major new capacity (250,000 mtpy and 450,000 mtpy coated paper production lines, respectively) by about 2006. However, the projects are currently under study and it's unclear if they both will move forward. The larger of the two proposed lines and an existing line in China are far larger than any production unit in North America, and larger than only a couple of coated free sheet production lines in Europe.

While coated free sheet selling prices vary, they have typically run in the $800-$900/ton range as recently as the 2000 to 2001 period for the higher volume No. 3 grades and much higher for heavy weight sheets. Prices have recently dropped down under $800/ton and it appears that, in order to compete over the long term in North America and around the world, mills will face the need to compete at even lower prices.

According to some estimates, in the not-too-distant future, it will be necessary to compete at the $600/ton price range on commodity coated free sheet grades due to competition from large new lost cost machines. This is quite a challenge for many North American mills, particularly non-integrated facilities, but also even for large, relatively low cost producers.

All of these factors mean that little and possibly no price gains will be likely in the near future, although the changing value of the Euro vs. the dollar may force European mills to raise coated free sheet prices modestly, particularly on web grades. Currency shifts have little impact on imports from Asia or South America, but the weak dollar has pinched European profits.

However, the U.S. is a key export market for many countries in Europe, with more than 500,000 tons of coated free sheet flowing to the U.S. annually. The flow of paper has continued despite the loss of profit margin caused by the weak dollar since the only option is to shut down capacity.

However, major price gains appear unlikely since cheap imports from Asia will continue to be readily available. In addition, despite a reduction in U.S. capacity, the surge of imports and weak demand has meant U.S. operating rates have been very low for most of 2003 and don't look to pick up much in 2004.

Another factor making it difficult to not only raise coated free sheet prices but to even be able to stop them from a long-term decline is that, despite a spate of mergers and closures in recent years, capacity remains fragmented on a global basis. As shown in Table 1, 10 companies have a coated free sheet capacity at or above the one million ton mark. It appears that the market may remain too fragmented for producers to exert any level of supply control.

In summary, the market will remain competitive, but if the U.S. economy continues to expand, coated free sheet demand will also post modest gains. By the end of 2004, prices may post modest gains on some grades, but mills will need to continue to look at lower costs as the only means of significant margin improvements