

Coated Paper Markets Post Strong Rebound

Growth in demand expected to continue following largest gain since 1997.

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IN EARLY 2004, the outlook for coated papers was promising but hardly anyone expected the surge that led to the strongest gain in U.S. coated paper markets since 1997. Based on initial year-end data (which even if revised—as they usually are—likely would not

change the fact that it was a great year), demand surged for the third straight year, rising at a robust rate of nearly 7% for both coated groundwood and free sheet (see Figure 1).

This growth is even more impressive given that the big 13% demand surge in 1997 followed on the heels of a 10% drop in 1996. Overall consumption set a new record at 11.5 million tons, and the 800,000-ton increase in demand is one of the largest on record.

A strong U.S. economy provided the underlying boost to demand, as print advertising and marketing expenditures posted solid gains in many of coated paper's major end-uses. In the key magazine and periodical market, ad pages grew 3.5 - 4% in 2004, while direct mail posted solid gains as well, with the large and important catalogs market posting a very strong rebound. End-use market growth in 2004 expanded on the more modest gains posted in the 2002-03 period and resulted in an expansion of coated groundwood demand of almost one million tons in the past two years.

U.S. mills shared fully in the gains, with coated free sheet output rising 7.3%, the first increase in three years, while coated groundwood output rose 5.5%. Groundwood mills operated at nearly full capacity, resulting in tight markets. The strike-related downtime at UPM's large coated groundwood mill in Canada is one contributor to this tightness and is also a factor behind continued growth in coated groundwood imports from Europe, despite the weak dollar. If the

strike lasts until the seasonally strong third quarter 2005 period, its effect on paper availability could be pronounced.

As shown in Figure 2, while imports continued to gain market share in 2004, they posted the smallest increase since 2001, when imports lost share as demand plummeted in the 2001 downturn. Both freesheet and groundwood imports rose over 2003 levels to an estimated total of 3.2

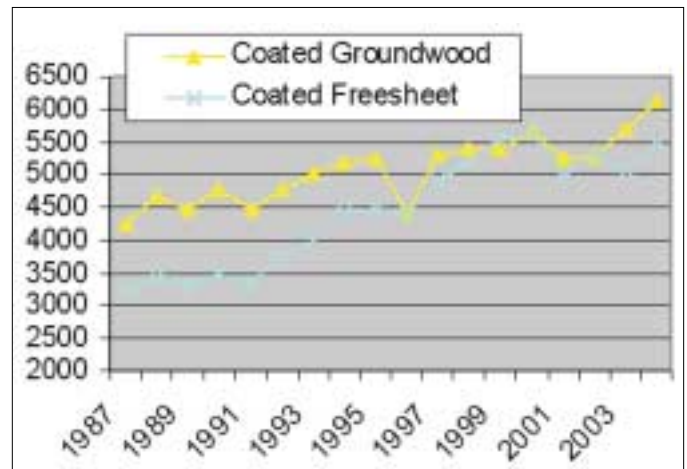


Figure 1. U.S. Coated Paper Demand (000 tons).

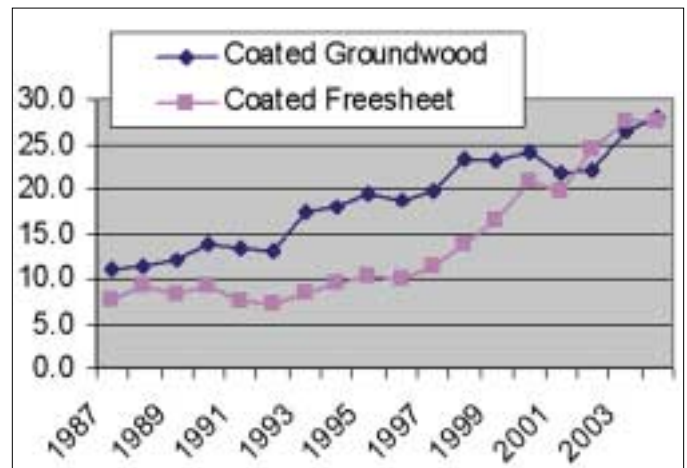


Figure 2. Coated Paper Imports—Share of U.S. Demand (%).

million tons. At 28% of consumption, this is imported paper's largest share on record.

Pricing Impacts. From a customer or buyer perspective, the news isn't good, as prices have and will continue to rise in line with booming demand. Since mid-2004, prices on large volume coated grades are up by about \$100/ton. Given a tight supply situation, particularly in mechanical grades, prices are likely to rise further.

An executive at one of the world's largest producers in Europe recently summarized the producer's view by stating that "now is the time to adjust prices." Some major producers, such as IP and MeadWestvaco, announced price hikes on coated papers targeted for March 1, and thus most producers were targeting increases for sometime in first quarter 2005.

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If markets continue strong into the spring, pricing could reach levels not seen since 2000, and will likely post double-digit year-over-year gains in 2005. One big question is how this sudden price surge impacts demand going forward. Historically, large and sudden price swings temper demand growth in segments particularly sensitive to substrate costs, notably catalogs and magazines, which trim usage to counter rising costs.

While this robust expansion will likely slow in 2005, the outlook is excellent for coated paper mills around the world, and there should be strong gains in profitability as prices surge. While growth is expected to be restrained by rising prices, demand is likely to remain solid and markets tight.

As the full impact of higher prices and slowing end-use demand come to bear, overall demand growth could slow noticeably next year. Also, capacity could begin to expand next year as several projects possibly move ahead, particularly for coated groundwood. However, producers may be reticent to expand if they view this as a short-term surge, and thus major expansions seem unlikely before 2006 as producers look to see how long the current expansion can last. ■