



Tough Markets Linger for Coated Free Sheet

Rising paper prices and higher postal costs continue to dampen demand growth in North America, but global outlook is much better.

By Harold M. Cody

During the past year and a half, coated free sheet markets have seemingly gone from boom to bust in short order. U.S. markets for this premier printing paper grade rebounded strongly in 2004, with demand jumping 7% as a recovery in advertising and overall economic activity following the 2001-2003 downturn boosted use. It appeared to set the stage for a modest upswing that would carry into 2005 and beyond.

However, the coated free sheet rebound in North America was derailed in 2005 as preliminary data indicate consumption finished the year down slightly vs. 2004. Demand was very weak in early 2005, but after bottoming out in April and May, it gradually trended up for the remainder of the year.

Despite this challenge to U.S. and Canadian mills, on a global basis coated free sheet papers continue to be one of the industry's fastest growing sectors. Global demand rose 5.7% annually during the 1988-2003 period, faster than any other printing paper, and while global growth is projected to slow to 4% to 5% annually, it will continue to outpace other grades.

The problems facing North American mills are caused by a combination of factors including: (1) region specific demand shifts, (2) trade flows, global capacity and globalization trends, (3) rising input costs, and (4) inter-grade competition.

First and foremost, the lack of demand growth last year reminds us yet again that U.S. graphic paper continues to undergo a transformation driven primarily by the increasing impact of internet based advertising and sales on traditional print media as well as competition from other grades. In 2006, demand will be negatively impacted by higher postal rates and, it appears, higher paper prices.

These factors will have a direct impact on demand by reducing consumption and use of catalogs and direct mail, which combined account for about 20% of North American consumption. Magazines account for about 10% of use, while other miscellaneous commercial printing uses consume the bulk of the remainder, or 35% to 40% of total coated free sheet consumption.

Trade Pressures Ease But Won't Go Away

During 2002-2004, imports surged to record levels, accounting for 27% of U.S. coated free sheet demand in 2004 at a volume of 1.5 million tons. This changed the playing field by making coated fine paper probably the most global of all North American paper markets, and resulting in a collapse in prices. Prices bottomed out at record low levels in 2002 before gradually recovering some in 2004.

During 2005, U.S. imports actually leveled off as global capacity began to more closely match demand following the unprecedented level of excess capacity in the early to mid-2000s. Imports fell about 10% from the record 1.5 million tons imported during 2004. U.S. imports of coated free sheet from Asia, which had been trending up for most of the past two years, trended down for much of 2005, as did European imports. The biggest shift was in imports from Korea, which dropped from a peak of nearly 50,000 tons/month in early 2005, to 25,000 tons/month in the fall. Imports from China also slipped a bit from a level of just over 15,000 tons/month, but remained near that level.

The key question is whether imports will surge again, or if local demand in Asia can continue to expand at a rapid enough pace to consume growing Chinese production. While not as obvious, imports from China and other areas of Asia of printed matter such as books have also increased, reducing domestic paper demand even further. This is a trend to watch in the future.

Controlling Supply in 2006

So where does this mixed bag of good and bad news leave us for 2006? It means mills will likely endure another tough year. On the negative side, rising paper prices and higher postal costs will, as they always do, put a dampener on demand growth that would already be expected to be tepid. With demand for paper expected to be at best flat, control of supply will be a key to profits and pricing.

In addition to weak demand, a severe profits pinch driven by a spike in both mill energy and chemical costs during 2005 also propelled producers to make difficult decisions on

capacity withdrawals. Subsequently, about 10% of North American capacity was shutdown permanently last year and there were limited closures in Europe as well. About 625,000 tons of North American coated free sheet capacity was pulled from the market, including the shutdown of a paper machine in Muskegon, Mich., a mill in Pasadena, Texas, and closures in Canada as well.

At the beginning of 2005, U.S. capacity was about 4.9 million tons, but this was lowered at an adjusted capacity of about 4.6 million tons following the closures. With shipments at about 4.6 million tons, this resulted in operating rates rising to nearly 100% by year-end.

Combining this with a slowing of capacity growth in Asia means that global supply and demand are more in balance than they have been in some time. Due to this, prices are likely to gain further in 2006, following modest hikes implemented during the second half of 2005. In fact, several major North American producers announced \$50/ton price hikes in February in an attempt to recover margin lost to higher costs.

Overall, the coated free sheet market isn't a bad one to be in, unless you're in North America, which remains a very tough market and where a considerable amount of high cost capacity remains and is at risk. Certainly worth watching, China has now transitioned from a net importer to a net

NORTH AMERICAN PRINTING & WRITING PAPER STATISTICS					
(000 metric tons)					
	11/05	% Change Year Ago	Year-to-Date 2005	% Change Year Ago	
Coated Free Sheet					
Shipments	353	0.2	4,160	-0.6	
Operating rate	83	87 ¹	88	92 ¹	
Imports	98	-21.7	1,163	-9.1	
Demand	436	-3.8	5,086	-2.3	
Total P&W					
Shipments	2,295	-0.6	25,666	-1.9	
Operating rate	90	91 ¹	90	93 ¹	
Imports	257	-17.1	2,907	-4.5	
Demand	2,480	-2.5	27,647	-2.1	
MILL INVENTORIES					
	11/05	10/05	11/04	Change From Month Ago Year Ago	
Coated Free Sheet	629	604	614	25	14
Coated Mechanical	187	196	163	-9	24
Total P&W	2,283	2,310	2,256	-27	27

1. Actual figure, not a percentage change.

r = revised.

Source: Pulp and Paper Products Council, American Forest & Paper Assn.

exporter of printing papers, which could lead to further "outsourcing" of North American coated paper supply.

It's just not clear how big of a factor this will be in 2006. ■

Harold Cody is a contributing editor at PaperAge. He can be reached at: info@paperage.com