

Hard Work by Producers Balances Uncoated Freesheet Markets – At Least for Now



By Harold Cody

Uncoated freesheet demand has been falling due to long term structural changes in underlying demand, but the closure of 2 million tons of capacity since 2007 has balanced supply and demand, and attempts to implement higher prices have followed. This has improved the outlook for 2008. But whether producers can stay ahead of the curve via capacity curtailments if the economy stumbles further and demand drops again is an ongoing question.

Uncoated freesheet markets showed surprising strength starting in late 2007 and continuing into early 2008, allowing producers to entertain hope that markets for the remainder of the year might be an improvement despite a generally gloomy economic outlook.

With the balance of supply and demand shifting, producers moved quickly to take the initiative by announcing two price increases in early 2008 on major uncoated freesheet grades—the first uptick in pricing in some time.

The biggest question going forward of course is the state of the U.S. economy and whether the current weakness turns into a major downturn that undermines demand faster than producers can shift supply, i.e. implement further capacity reductions, to offset it. If this occurred, it would knock out the underpinnings of the current market that appears to support a rise in prices.

The recent gains are a bit surprising against a background that includes market fundamentals that are trending in a negative direction and given the current state of the economy. From a grade standpoint, things aren't all that good. For example, demand continued a long-term decline last year as North American uncoated freesheet demand fell 5.5% in 2007 vs. the 2006 level to 13 million tons according to data from the Pulp & Paper Products Council. Total North American printing and writing paper demand fell to 32.5 million tons, a drop of about 3%. The drop in demand

wasn't surprising, as uncoated freesheet demand has been falling since the late 1990s due to underlying structural demand changes. U.S. per capita demand for uncoated freesheet papers has been on the decline due to a wide range of factors including product substitution and technology related changes. Year-to-year demand has fluctuated up and down and masked this trend somewhat due to short term factors such as the negative impact of rising postal rates or,

conversely, the positive impact on demand of things like the Olympics or an election-year, but the overall direction of demand is down.

And while pundits argue back and forth about how bad the economy really is right now

(whether it is really bad as it seems if measured by perceptions of the mess called the housing market, or not all that bad if you look at the broader economy), it certainly isn't robust enough to lead anyone to think an economic boom will revive paper demand.

Producers took the hard medicine required and reduced North American capacity significantly (about 2 million tons) over the 2007 to 2008 period.

Disciplined Capacity Management

However, while demand has been slowly falling, not all the news about uncoated fine paper markets has been bad. Similar to what has occurred in grades such as linerboard or newsprint, uncoated freesheet producers have stepped up to the plate and faced the fact that dramatic change was required to match the reality of the U.S. uncoated freesheet market. Producers took the hard medicine required and

North American Printing/Writing Paper Statistics

December 2007 (000 metric tonnes)

	DECEMBER 2007	% CHG. YEAR AGO	YEAR-TO-DATE 2007	% CHG. YEAR AGO
UNCOATED FREESHEET				
Shipments	905	-5.1	11,665	-4.4
Operating rate	86	86 (1)	92	92 (1)
Imports	45	5.3	543	-1.0
Demand	915	-5.6	11,757	-5.5
TOTAL PRINTING & WRITING				
Shipments	2,216	0.4	27,379	-0.8
Operating rate	91	87 (1)	93	92 (1)
Imports	253	-0.2	3,298	-11.3
Demand	2,378	0.0	29,457	-3.0

reduced North American capacity significantly over the 2007 to 2008 period. Capacity has declined 2.2% per year on average, falling from just under 16 million short tons to an estimated 13.1 million tons. In 2007-2008 alone, about 2 million tons of capacity has been closed in North America. As a result, operating rates have been slowly climbing and this is why prices have begun tentatively to move up. For example, operating rates fell as low as 91% in 2005 before rebounding to the 93-94% level in 2007. If present trends hold, operating rates should rise slightly in 2008 and could hit 95%-96%.

Contributing considerably to the push to reduce capacity has been the ongoing and intense pressures exerted by rising costs. Non-integrated mills have really been suffering due to very high market pulp prices, exacerbated by high energy costs, which are an even more critical problem for non-integrated mills that don't have the advantages of integrated mills that burn by-products to generate power. Fraser Paper's announcement in early 2008 that it would indefinitely idle about 110,000 tpy of commodity uncoated freesheet capacity at its Gorham New Hampshire mill is just the most recent example among many closures announced over the 2007-2008 period.

Canadian mills have been under extreme pressure due to the added cost burden of unfavorable exchange rates, and capacity closures in Canada have been widespread. The Canadian dollar hit parity with the U.S. dollar for the first time in essentially a generation last fall, as it grew in value by

16% just in 2007. A total of 1.5 to 2.0 million metric tons of paper and board capacity was closed in Canada in 2007. It appears that pulp prices and energy costs will remain high in 2008, and thus additional closures may occur this year, which will help sustain operating rates if demand falters.

Another key factor that has led to the closures was a wave of industry consolidation and the subsequent rise in the level of capacity concentration, which is the highest ever in many industry grade segments.

Good Balance Helps Pricing

Imports from offshore, which in the uncoated freesheet market are much more minor than in areas such as coated paper grades, nevertheless have also remained at a very low level, further working to reduce supply to match demand. Imports have dropped while at the same time exports have posted a modest gain, resulting in a very low level of net imports. Thus, as domestic capacity has fallen, it has translated directly into balancing supply with demand.

As noted, the improvement in supply/demand has allowed uncoated freesheet producers to attempt to boost prices. Several major mills announced a \$60/ton price increase in early February 2008 on offset roll grades, the second increase since late 2007. Producers had announced a \$60/ton increase on cut-size grades that was to take effect in early February. It was too early at the time of this writing to ascertain if they were successfully being implemented.

However, it appears that for now uncoated freesheet mills have the wind to their backs due to several factors and these initial increases stand a good chance of succeeding. First, with an election year coming up, demand is likely to receive a boost, which will lead to a modest improvement in demand, or at worst it will limit slippage to only a slight decline. Historically big events such as elections, the Olympics, etc., give a short term boost to demand. This will combine with the strong push on costs driven by high fiber and energy costs, and which are expected to stay high, and which in turn will likely lead to further capacity withdrawals at non-integrated mills. These factors will help sustain operating rates in a range favoring a strong market.

The bottom line of all this is that 2008 might not turn out too bad for uncoated freesheet producers. ■

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