

# How will the Paper Industry Weather the Economic Storm?

It's a whole new world—one that calls for major structural changes that will result in a very different pulp and paper industry.

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The economic world has suddenly changed. The stable and benign global economy of the past several years is now gone. The strong growth, low inflation, favorable interest rates, easy liquidity and positive consumer sentiment, is a thing of the past. The current credit crisis has shaken the financial markets, undermined the confidence of consumers and investors, and caused enormous financial damage everywhere. Not surprising, PricewaterhouseCoopers (PwC) has downgraded their forecast for Real Global GDP growth to 1.0% for 2009, with downward pressure coming from the forecasts of negative growth in all major developed countries in 2009.

History teaches us that deep economic recessions bring about major structural changes. The present crisis presents a great opportunity for the North American paper industry to redefine its way forward. One thing for certain is that the industry will survive. But this surviving industry will emerge as a very different industry.

How will the North American paper industry weather the economic storm? What will it look like afterwards? What will the characteristics of the winners be and what will the winning strategies look like?

## DRIVERS OF THE DOWNTURN

The banking sector has incurred unprecedented losses since the credit crisis began in 2007. A number of large players in the financial services industry have gone bankrupt, been taken over, or been forced to seek government bailouts. Scarcely any industry has been untouched as the credit crisis has undermined companies' financing capabilities and overall business performance. The banks have cut back on their existing lines of credit and tightened the terms on which they issue new loans in an attempt to reduce their liquidity risks. These changes have brought lending to a sudden halt and have sent the cost of borrowing soaring despite nominal lending rates approaching zero.

There is an old saying in the corporate finance world: "The best time to borrow money is when you do not need it." However, given the current market conditions, many companies are finding that it is already too late to obtain any significant external funding. If they are to survive, they will have to take stock of their liquidity sources and assess alternative ways to satisfy their liquidity needs.

Conversely, for those companies fortunate enough to have ready access to cash and strong balance sheets, the

economic crisis could be seen as an opportunity. For example, they could take the opportunity to acquire vulnerable competitors or hire highly qualified employees from organizations that can no longer afford to retain them.

### IMPACT OF THE DOWNTURN ON THE SECTORS

The paper industry is no different than other sectors. The impact varies according to a company's position in the value chain. Wood products producers have been suffering severely since residential building activity peaked in 2006. Printing papers producers have suffered, and will likely continue suffering due to advertising spending contractions and accelerated substitutions, with low cost digital alternatives. Industrial packagers have been hit by the downturn in production.

Packaging for fast moving consumer goods and tissue have suffered, but can be expected to remain more resilient the closer they are to meeting essential needs (i.e., for food, beverages and basic health and hygiene). In fact, the only recession-proof business in the industry might be the production of low cost private label bathroom tissue products, since market demand is likely to shift to lower cost brands during the recession.

With weak demand and plenty of supply, there is no incentive for buyers to carry inventory in excess of immediate requirements. There is a risk of deflation from buyers choosing to delay purchases in anticipation of price decreases caused by the abundance of product in the marketplace. Temporary restocking purchases may create a false rise and the perception that demand has recovered. However, a real recovery and renewed level of purchasing cannot be expected until a time of greater market certainty.

In the past, developing markets have served as an important outlet for surplus production. Not this time. Producers have limited opportunity to divert excess inventory to export markets due to the slowdown in the global economy, the strengthened dollar, and the new capacity in emerging markets. In fact, emerging market producers are looking to divert their excess inventory to the US.

Well before the financial system came close to collapse, the demand for paper products had already fallen significantly. Before credit had ceased and confidence had evaporated, the market had already begun to shun paper products due to environmental concerns and lower cost alternatives.

### Printing and Writing Paper

The number of paper types and grades offered has made paper a complicated commodity product in North America. The paper sector is losing market share to electronic applications because of the timeliness and convenience offered by technology. Business communications, document storage, retail transactions, and online banking are just a few examples. Winning companies will recognize the need to simplify their product offerings (and the associated overhead structures) and run fewer products through equipment at maximum capacity.

For paper producers, the past cycle never really peaked. Only pulp producers benefited financially. Traditionally, the

paper prices were linked to pulp prices. However, over the last five years or more, the prices uncoupled. With excess papermaking capacity and demand making paper a commodity, the paper industries conversion margin has been squeezed. The paper industry now needs to exercise discipline in shutting down capacity

permanently. The challenge will be for companies to recognize when the industry has hit rock bottom and the time for shutting down is right.

### Newsprint

The newsprint sector already in decline has been severely impacted by the changing market conditions. Increasing numbers of news readers are moving to online and electronic media options. The struggles of daily publishers were brought to the forefront when Tribune Co. announced it was filing for bankruptcy protection. Major daily publishers are operating with higher costs, falling circulation, and loss of revenue, as advertiser spending shifts to the Internet. For the third quarter of 2008 alone, newspaper advertising revenue dropped by \$2 billion. At the time of writing, it seemed that a queue was forming of newspaper publishers heading for Chapter 11.

For book publishers, the substitution of electronic media for research publications and textbooks seems to be gaining momentum. The leisure reading industry is now wondering whether electronic reading devices such as Amazon's Kindle will catch on once consumers have money again for technology gadgets. With all of these switches to digital, the paper industry should aim to raise awareness that they come at an environmental cost. A switch from paper to digital may not necessarily reduce the environmental impact.

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### Paperboard and Packaging

With the drop in gross domestic product, the overall demand for packaging of industrial products and consumer goods and exports has declined. Improvements are not expected until there are signs of resurgence in consumer confidence and spending. Packaging for consumer essentials has proven more resilient. Packaging of consumer products continues to see structural changes driven by sustainability and money saving: for example, reducing layers and lightweighting. Plastic has replaced paper in many wrapping applications due to its strength, portability and ease of use properties. Looking ahead, paper should retain its market share as it has a favorable environmental acceptance.

**Tissue** is a consumer staple. While the sector does not necessarily enjoy the same returns as other sectors in a healthy economy, there are fewer fluctuations in demand compared to other industry sectors. Tissue is likely to experience a smaller decrease in demand than other paper products. However, lower consumer confidence will result in a shift in demand from brand names to generic choices. The margins of paper producers could be adversely affected.

### INDUSTRY RESPONSE TO THE DOWNTURN

All businesses started by cutting or deferring capital spending and unessential maintenance, reducing working capital and focusing in the short term on cash generation or conservation. In many sections of the paper industry, production levels have nose-dived as demand has crashed and inventory is driven out of supply chains. Companies with high debt levels and/or weak cash generation are the most vulnerable to failure, as are those companies that were already under severe margin pressure coming into the downturn.

Falling raw material, energy, chemical and other input prices have helped many producers in their cost cutting. Although spot prices for most inputs have fallen, the benefits will have been delayed where higher contracted prices are still in force. US producers have benefited from imported inputs as the dollar has strengthened.

The industry has already been through the early stages of supply-side adjustment, as downtime has been increased. It is now moving into deeper cost and permanent capacity adjustments, focused on companies' highest cost capacity. For some businesses, these steps have been essential to ensuring survival. According to the PPI Pulp & Paper Week, producers permanently or indefinitely shut nearly 5.7 million tons (5% of capacity) of North American paper and board capacity in 2008. This is a good start, but additional capacity reductions are needed through 2009.

Having dealt with the easier targets for cost saving and cash generation, many companies are now moving on with renewed vigor to start or strengthen existing business simplification and operational efficiency programs.

Although some companies are undertaking mill reconfigurations, streamlining manufacturing processes, and a range of other measures to improve asset utilization, investment cash is strictly limited. Therefore, spend on small, low cost capital projects with quick paybacks, such as waste material and energy recovery systems, co-generation plants, and equipment conversion, are generating benefits.

Conversion of waste material to biodiesel and ethanol, and installation of equipment such as recovery boilers also have the potential to provide additional revenue or offset costs. For example, Kruger Product Inc. in Canada has recently added a new converting line and is investing in a new biomass gasification system developed by Nexterra Energy Corp.

There has been some progress made in product development. Savings have been produced by increases in the percentage of recycled material content used in printing paper and projects to improve efficiency and reduce water, and energy and chemical consumption.

Moving on, simpler, leaner and increasingly flexible business models are emerging that are better positioned to respond to changing market conditions. For example, by selling the paper and packaging business at a profitable point in the cycle, Boise Cascade LLP was able to further reduce debt and create a leaner company with a more competitive position in the wood products and building materials market. That said, few companies will currently find a profitable point in this cycle, so the advantages of more flexible business models may be limited for the time being.

### DEAL ACTIVITY

Despite tough conditions, we expect some deal activity will continue. Such deals will include the acquisition of distressed businesses by stronger players and more strategic deals at low values where consolidation is needed. Indeed, consolidation is a strong response to weak demand and market uncertainty, enabling better supply-side discipline to be maintained, leadership in setting prices, and the proactive management of inventory fluctuations in the market. However, determining the timing and pricing of assets is critical as, the price of many assets remains inflated. Integrating into a leaner business model may help smaller players in commodity sectors bolster their existing positions.

According to a recent PwC report, the North American forest products industry led the world in 2007 with 62% of

global merger and acquisition activity. The expected continuation of this trend, although on much reduced volume, will be confirmed when we publish our 2008 deal analysis in mid-2009. Increased private equity participation on the supply-side has been a driving force for change, and a departure from the traditional forest company approach to the business. Much of the consolidation and restructuring activity in the industry in recent years has been fuelled by private equity. The private equity market operates with greater financial discipline, a focus on strategy, a sense of urgency, and a willingness to make difficult decisions under the influence of private equity practices. Private equity capital is a likely source of capital for distressed companies that are unable to obtain traditional financing.

The highly distressed businesses currently on the market may be potential acquisition opportunities for industry competitors with strong balance sheets. In these deals, timing is everything. As prices drop, distressed assets appear to be

good bargains, but are they? Equity and asset valuations are based on historical performance, old and out-dated forecasts and analysis. Even where realistic asset valuations can be

achieved, management will still face challenges of turning businesses around while integrating into a new and leaner business model. Difficult credit markets also limit the amount of new investment available for acquisitions. One bright spot is that the industry is at the forefront of the drive to become

more sustainable. As demand for products with a high recycled fiber content produced in a carbon neutral process increases, the economics and sustainability of a waste-based platform for energy and paper production may increasingly look more attractive. Industry achievements in sustainability need to be more widely publicized, particularly in light of the growing group of green-conscious consumers. The economic downturn seems unlikely to decrease interest in green products and packaging, provided prices remain affordable to consumers.

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### SURVIVAL STRATEGIES

There are a variety of different approaches companies could use to make it through this economic downturn. The industry winners will be those who conduct scenario planning and who are flexible and adaptable to changing market conditions. Balance sheet strength is key, as well as the ability to anticipate and react quickly to supply and demand fluctuations.

A focus on core products and evaluation of business assets, a long term approach to the business, and creation of significant critical mass from which to deliver synergy savings, will position companies well to benefit whenever markets improve.

Winning companies will be those with robust survival strategies, which means striking a balance between the long term and short term imperatives. Aiming solely to survive the downturn is unlikely to be enough. A robust survival strategy will include tight cash and cost management, active engagement with supply chains and customers to keep focused on what really matters, and retaining and motivating your best people. Surviving and coming out ahead will require agility and flexibility. We know this is a severe downturn, but we do not know how deep or how long it will last, making business planning very difficult. As a result, companies would be wise to develop a range of financial and operational scenario models. The scenarios must be well designed and focused. It is recommended to develop three or four feasible futures that will allow you to explore the strategic options, and adapt quickly.

Fundamental to a winning strategy is grasping opportunity. Crises historically have been fertile times for innovation. In North America, the demand for paper products is in decline, but for an industry based on a renewable resource, the downturn does present an opportunity to strengthen its green credentials. Strength can be found for example, by focusing on biomass-based energy and later on a range of other value-added fiber-based products, improved resource efficiency through increased recovery, and reuse of fiber products. While finding new sizeable applications for paper might be tough, innovation could come through the proactive defense of paper usage from continued erosion, in those areas where the benefits of paper can be demonstrated to be superior.

Pursuing these opportunities also requires innovation to help minimize the risks. Innovation may mean pursuing greater collaboration within the industry on common agendas, or it may mean working with partners outside the industry, for example, in relation to the energy opportunities. In short,

as the risks become too great for any single business, it may become essential to develop more collaborative business models to exploit opportunities in order to get funding.

### CONCLUSION

This economic crisis will be a real test for the industry. Many of the largest players entered the recession with high levels of debt. At the time of writing, one of the largest, Smurfit-Stone Container, had sought bankruptcy protection. There is no shelter from the downturn – it's global, it's deep and every sector is affected. When the downturn ends, and most economists predict that will not occur until 2010 at the earliest, the industry will have restructured, capacity will have been reduced, many companies will have ceased operating, and there will be a loss of many jobs.

There are risks to manage and challenges to surmount. But crises can also provide a chance to deal with structural issues that were previously too difficult to confront. They can, for example, unite stakeholders in confronting the problems necessary to enhance competitiveness, including undertaking large restructurings. As credit continues to tighten across many industries, we expect to see well-capitalized companies take advantage of rare opportunities to address their strategic objectives by acquiring or merging with other organizations.

Managers have learned that the past provides no guidance for what is to come. It is not reasonable to assume that patterns of demand for paper before the downturn will simply return once the economic storm is over. Instead, a step reduction in overall demand for paper can be expected, as people simply learn to use less. Changes in buying behaviors during the downturn, such as paper qualities, can also be expected to create new norms.

The challenge for the industry is to recognize these trends and to adjust its supply in as orderly a way as possible. The signs are mixed. The industry had shown that it was getting better at managing supply more in line with demand. Private equity's strong influence in the sector, along with disciplined capacity management could be the beneficial umbrella needed to weather this economic storm. However, the stress of recession will put discipline to the test. ■

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