



By Harold Cody

# Freesheet Mills Struggle To Offset Collapse in Demand

Uncoated freesheet mills are scrambling to cut output as shipments in January dropped for the thirteenth straight month. Major declines in costs for fiber and energy helped boost margins prior to the evaporation in demand that began in October 2008 but prices are now under downward pressure. Demand will at best be weak throughout 2009, so the question is: can mills stay ahead by aggressively cutting output to avoid a complete price collapse?

**While the news isn't good to say the least,** let's keep in mind that U.S. uncoated freesheet markets, at least so far, aren't nearly as bad off as the situation facing the U.S. auto industry. That comparison struck me here in the cold Midwest, where a lot of cars are made, as I try to make some sense of chaotic market for ...every commodity you can name.

For car makers, the news is really terrible, as the collapse in consumer demand has meant taxpayers paying to keep them afloat. Auto demand has undergone a shocking drop, from a level of 16.6 million vehicles sold in the U.S. in 2006 to just 13.2 million last year. Some analysts project that it may fall as low as ten million cars this year. Time magazine estimated the revenue on one million cars at about \$25 billion, meaning Ford, GM, etc., have lost \$75 billion in revenue and could lose the same again!

With that perspective in mind, at least we see that things could be worse. And make no mistake about it, things are pretty bad. Pulp and paper markets, across all grades and geography, are facing the worst downturn since the oil embargo induced recession in the mid-1970s and the current situation is comparable to that historically bad downturn.

Uncoated freesheet producers and all printing and writing grades are facing a widespread and severe downturn in global demand. The question is how much worse it will get before we hit bottom and whether or not mills can avert a total pricing collapse. The biggest hope is that sometime in

2009, all of the steps being taken to strengthen the economy will gain traction and the economy, and in turn paper demand, hits bottom and begins a slow recovery.

## Thirteen and Counting

As noted in my last column (containerboard), things didn't really go bad for most pulp and paper grades until the fourth quarter of last year, when economic problems combined with the freeze in credit put the brakes on the economy. In fact, for a good portion of 2008, uncoated freesheet markets weren't all bad. Margins had reached the highest level in a

long time following two successful price increases, which raised prices to record levels, while some key input costs dropped with the collapse in oil prices, plummeting recycled fiber costs and easing in pulp prices.

However, as the true depth of our economic problems became clear, demand contracted rapidly across a wide range of the U.S. economy. Businesses of all types sharply curtailed purchases in late 2008 to trim inventories in the face of an unusually

weak and uncertain outlook for a wide array of products. Consumers of paper were no different, as they faced extremely weak demand for paper used in advertising, packaging and printing. In many industries orders didn't shrink; they all but ceased.

By October, uncoated freesheet shipments were in a freefall, dropping 10.7%, 17% and 13%, respectively, for the last three months of the year vs. 2007 levels. A decrease of

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<b>– U.S. Printing And Writing Paper Shipments –</b>				
(000 tons)	Dec. 2008	Change % from yr. ago	Year to date	Change % from yr. ago
Uncoated Freesheet	808	-12.8	10985	-8.0
Coated Freesheet	306	-24.9	4512	-9.7
Coated Mechanical	276	-32.7	4165	-10.7
Uncoated Mechanical	147	-24.4	2196	5.0
Total (includes other grades)	1626	-20.2	23025	-7.5
Source: AF&PA				
<b>– European Uncoated Woodfree –</b>				
(000 metric tons)				
Total	582	-8.8	8385	-3.5
to Europe	513	-7.1	7322	-4.8
to outside Europe	69	-19.8	1063	6.7
European Demand	550	-8.2	8277	-5.5

this scale, in particular the November fall, hasn't been seen since the mid-1970s. A 14% drop in shipments registered in January was the thirteenth straight decline in shipments. Other printing and writing papers posted similar declines in late 2008 and into 2009. For the year, U.S. printing and writing demand fell 8% to 23 million tons. Uncoated freesheet shipments dropped 7% to 10.9 million tons, the lowest level since 1986. That's a one million ton drop in one year.

The severity of the fall-off in uncoated freesheet demand varied widely by grade. As would be expected, the sharpest declines were for grades sensitive to advertising, such as off-set grades used in a wide variety of applications such as direct mail and other advertising, where demand fell by double digit amounts vs. the prior year.

And it's not likely to get better, rather it will be worse. Ad spending is expected to take a major plunge in 2009, falling a projected 7.4% according to Veronis Suhler Stevenson and reported in DM News, marking the first two-year decline ever in ad spending, according to the company. Bond and writing papers, which includes cut-size grades used in homes and business, fell by a more modest amount, or about 4%.

Imports were off slightly vs. 2007 thru November. Freesheet imports from Asia were way down, but this was offset by a nearly one-quarter increase of paper from Brazil. However, more tonnage could be finding its way into North America as over supplied mills in other regions seek customers. Fine paper markets in Europe haven't fared quite as badly, while markets in Asia are struggling as well. European

uncoated fine paper output was down about 3% in 2008, with shipments to Europe off nearly 5%.

In last year's freesheet column I noted that 2008 looked to be a challenging year due to uncertainty about the strength of the U.S. economy. Looking back we can see that producers did quite a good job of staying ahead of the game, aided by intense upward cost pressures that resulted in prices rising and then holding for most of the year despite overall lackluster demand. Similar to what happened in most paper and board markets, the bottom fell out in the fourth, and uncoated freesheet demand fell at the fastest rate likely ever seen.

### Producers Slash Output and Close Mills

In response to the quick erosion in demand, mills have taken over 2 million tons of downtime since the third quarter as they seek to balance output with demand. This has been the major reason that as of early 2009, only a modest slippage in prices had occurred. We may also be seeing one impact of a long term consolidation in the fine paper industry, as capacity is now heavily concentrated at the top, similar to that in grades such as containerboard, and this has likely meant better control of supply. The top four producers (Domtar, IP, Boise and GP) control three quarters of capacity in North America, vs. about one-half ten years ago.

There isn't much doubt that demand will stay in the doldrums for the foreseeable future. It remains to be seen whether producers can stay ahead of the curve enough on supply control to keep prices, which have trended up steadily since the last bottom in pricing in late 2005, from plummeting down to costs. In 2005, prices fell to under \$800/ton for copy paper, vs. a level of \$1100/ton at the peak in 2008. Prices in early 2009 were reported to be down, with roll stock the worse, and the cut-size sector holding up better but some slippage still reported.

The most optimistic scenario for the economy is for it to bottom about mid-year before posting minor gains during the second half. If this were the case, it's likely that uncoated freesheet demand, if it contracts at the current rate of about 10%, would fall another 500,000 tons over the next 6 months, requiring further downtime and closures. Prices are likely to drift down into the summer and then the hope would be print activity picks up later in the year. Otherwise, paper industry executives may need to go to Washington—and I hope they drive and not fly—to look for a handout to help keep them running. ■

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