



# Supply/Product Balancing Act Steadies Shrinking Uncoated Freesheet Market

Uncoated freesheet producers are profitable and the market has remained in balance despite a steady, ongoing 3% – 4% annual loss in U.S. demand due to a creative mix of grade shifts, capacity withdrawals and higher exports. Pricing has also been remarkably steady although prices slipped some in late 2012. The outlook for 2013 is for these trends to continue.

By Harold M. Cody

Over the last couple of years the U.S. market for uncoated freesheet (UFS) papers has settled into a predictable pattern that is producing solid if unspectacular financial results and steady income for the major producers. Margins have risen a bit over the last couple of years although they narrowed in the latter part of 2012 due to price slippage and rising costs for fiber and energy. These should seem like odd statements to characterize a business where demand for the key products in question continues to inexorably shrink in the world's biggest market for the product.

Nevertheless, the positive performance in the face of some major headwind is real and the result of masterful management by producers of a complex range of issues including capacity, shifts to more profitable specialty grades, efficiency improvements and cost cutting. The job of managing all this has a close resemblance to a game of cards. A hand is dealt, you consider what cards might work best, you discard the ones you don't want and exchange them for a new set. For example, if demand is dropping for one grade you simply shift a mill or machine to a new grade and move on. Sometimes the cards dealt require a machine or mill to be shutdown in order to balance supply and demand because it simply isn't feasible to shift to another grade or market.

In reviewing the last 12 months, not much has changed in the fundamentals of the business since my column back in March of 2012. As expected, the decline in demand continued last year as North American uncoated freesheet demand was



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down 4.1% through November at 8.9 million tons according to Pulp and Paper Products Council data. This continues the steady decline in demand that has been going on for several years and it's expected to continue into this year and beyond.

The drop in demand in North America is averaging about 3%-4% per year, or roughly 300,000 tpy. Shipments, at 8.37 million tons, are off 4.7%. The year to date operating rate through November was 90%.

Total North American printing and writing paper demand over the same period was down 6.5% to 20.8 million short tons, as demand for uncoated mechanical grades and coated freesheet are down even more, 16% and 4.7%, respectively.

U.S. production over the same eleven-month period was off 2.8% at 8.3 million short tons. December data was even worse, as U.S. mills produced only 694,000 tons of uncoated freesheet production, off 6.8% vs. the prior year, bringing the total for the year to 9.01 million tons, a 3.2% decrease vs. 2011.

## Demand Continues to Slide

Total U.S. printing and writing paper demand fell 6.3% last year to 20.6 million tons and shipments declined by 7%. Demand in the biggest segment, uncoated freesheet, plummeted 4.7% compared to 2011 to 8.8 million tons. Uncoated freesheet shipments were 8.2 million short tons, a 5.2% decline from the prior year level.

One result of the decline in domestic demand has been a surge in U.S. exports, which reached a record one million tons in 2012 — a 9% increase. This is a big increase over levels

that only a few years ago were half that. The biggest increases were in exports to Mexico and South America, which accounted for 450,000 tons or 45% of the total but exports also rose to Europe (up 6% to 200,000 tons).

The drop in demand, and in turn U.S. mill shipments, continues to be wide spread across every grade segment except one, according to AF&PA. In the big bond and writing category, which includes cut-size papers for office uses such as copiers and printers and accounts for 43% of shipments, shipments were down 3.7% vs. 2011. Offset grades, the second largest category accounting for 21% of the total, saw a 4.4% decline. Bond and offset shipments totaled 5.8 million tons. Declines in the range of 6% were posted for envelope and form bond grades, while carbonless and tablet grade shipments plummeted 9%. Total U.S. uncoated freesheet shipments for all of 2012 were off 3.2% at 9.0 million tons. By end use, office reprographics were down just 2% (3.7 million tons), but shipments to commercial printing were off by 8.4% (at 2 million tons) and forms shipments fell 10%. Office repro and commercial printing account for about two-thirds of total shipments.

The only grade showing an improvement was the “other” category, which includes a range of specialty products such as industrial papers and thermal base papers. 2012 shipments of this grade were just short of 900,000 tons, a 16% increase over 2011 levels.

As mentioned in detail in my last column, a wide range of factors including sluggish white collar employment, electronic substitution effects due to rising use of smart phones and tablets, shifts in advertising and weak economic growth are the main culprits behind shrinking demand. Looking globally, demand is also dropping in Europe, but it's increasing in areas such as China and South America.

One key indicator of fine paper use for envelope and offset printing grades is USPS postal volume. Recent data clearly demonstrates how factors have combined to depress mail volumes. For the fiscal year ending in September 2012, first class mail volume was down 5.6% in pieces and 6.0% in weight. First class volume fell over 4 million pieces. Standard mail volume, which includes direct mail and comprises about 50% of volume by weight, was down 7.3% by weight and 4.7% in pieces. In the fourth quarter, first class volume was down 5.9% and 5.2%, by pieces and weight respectively, and standard mail volumes were off by even more, down 8.7% by weight and 5.3% by pieces.

## Capacity Adjustments

As noted above, producers have moved carefully in order to match the decline in demand, and considerable capacity has been shut down or converted to other grades. About 800,000

tons of uncoated freesheet capacity was shut down in the last two years, but about 200,000 tons restarted. Withdrawals include Domtar (59,000 tons), Wausau (175,000 tpy), and Mohawk (70,000). Two mills restarted: Gorham (80,000 tpy) and Grays Harbor (150,000 tpy).

A recent shift is Domtar's conversion of communication paper capacity at the Bennettsville, South Carolina mill to specialty and packaging papers including base stock and packaging grades such as confectionary wraps and similar uses. Domtar will use some of this to supply base paper for Appleton's thermal coater in West Carrollton, Ohio, following the shutdown of the paper mill at the location. Thermal point-of-sale papers (POS) are a growing segment used for many applications including ATM machines, retailers and grocery stores, tag, ticket, label and entertainment applications (lottery tickets, movie theater and event tickets, product labels, parking tickets). The move reduces UFS capacity by 270,000 tpy and switches it to 160,000 tpy of specialty grades.

## Pricing Steady... for the Most Part

As I mentioned earlier, uncoated freesheet pricing held steady for much of 2012 but late in the 3rd quarter some prices slipped for the first time since early 2012. Prices on most major grades are reported to have held steady from March to September and in fact have remained steady over the last several quarters, moving up or down a minor amount, but remaining in a narrow range. Domtar, the largest producer, reported in fourth quarter 2012 that average transaction prices on uncoated freesheet were down \$14/ton vs. the third quarter, and off \$26 per ton vs. fourth quarter 2011 levels.

An extremely weak month of December helps explain the late year price slippage to some extent. North American uncoated freesheet shipments plummeted 7.9% to just 740,000 tons and resulted in an 80% operating rate. This is the weakest level of shipments in a long time. Early in 2013, uncoated freesheet prices appear to have stabilized despite poor demand and weak levels of production.

For 2013 it appears little should change in the overall tone and direction of the market. As demand shrinks producers will shift grades and shut down capacity as needed. Prices are likely to remain steady although the rise in pulp prices and energy may entice producers to try for an increase in the spring. There is some concern that the restarted capacity will unbalance the market as will coated mills making uncoated paper. Growing capacity in China is also of some concern. As long as producers continue to play the hand they are dealt — and play it well — the market should remain calm and on a steady course. ■

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