



By Harold Cody

Poor 2009 Advertising Outlook Means a Tough Year for Coated Freesheet Mills

Print advertising, the key driver to coated paper consumption, fell apart in 2008. As the economy soured, ad spending fell 4% for the year with particularly severe declines posted by newspapers and magazines. The volatile economy makes current ad spending forecasts unreliable, along with pegging the timeline for recovery.

It goes without saying that 2008 was a tough year for coated paper mills and it's also pretty easy to foretell that 2009 won't be much better and, in fact, could be even worse.

An unprecedented falloff in advertising demand across all media, including a severe decline in all forms of print advertising, has resulted in a huge falloff in demand for coated printing papers. With the advertising outlook bleak for the foreseeable future, the important questions on the outlook for coated free sheet center on when a recovery might occur and on the unsettling question of whether or not the current downturn will result in a permanent downshift in coated papers demand.

Beginning of the Slide

The current demise began for real in the second quarter of last year as troubles in the economy became apparent and a whole range of businesses began to cut advertising and marketing spending in the face of a rapidly deteriorating economic climate. By fall, print ad spending was falling at a frightening pace as companies severely contracted spending. Magazine ad pages, for example, dropped 17% in the fourth quarter of 2008, resulting in a full year drop of 12%. Through February 2009, the decline



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continued, as ad pages were down 19% vs. the same period in 2008. The magnitude of the drop is hard to overstate.

Beginning in the third quarter 2008, printer and merchant inventories of coated paper were also significantly reduced vs. prior year levels in the face of an evaporation of business and decimated order books, falling by an estimated 85,000 tons, or 10% of demand according to NewPage Corp. This inventory drawdown and an expected continuation of it in the fourth quarter, contributed to a consumption decline that was akin to falling off a cliff – down 19% in the third quarter. In response, mills cut back output dramatically, and U.S. coated paper output fell 10%, the largest decline posted by any grade. Coated freesheet shipments were down 12% for the year at 4.08 million tons (based on preliminary data).

Will Demand Ever Recover?

These severe market conditions resulted in a contraction of overall coated paper demand in North America from a level of about ten million tons just a couple of years ago to a current annual level of about seven million tons. Weak conditions continue to persist in 2009, with North American coated

paper shipments down 36.6% in March and off by 35% in the first quarter vs., last year, according to the PPPC. March coated paper demand fell 34% and was down 32% year-to-date. Coated groundwood shipments in March were 280,000 tons, down 38.1% from the prior year, while coated freesheet shipments were off 35% at 283,000 tons. Operating rates in March were 69% for coated groundwood and 74% for coated freesheet grades vs. year ago rates of 100% for coated free sheet.

It is likely — or at least hoped — that once the economy has more stable footing that underlying demand for coated papers will be higher than the current radically reduced levels, but it's also uncertain if it can ever regain previous levels. Several factors suggest that consumption will settle at a lower level including a contraction in the magazine market, as many marginal titles are disappearing.

Another fly in the ointment is that the far reaching changes being wrought in industries as diverse as auto manufacturing, banking and financial services will mean fewer advertisers in the future. Unfortunately, while it is difficult to quantify statistically, I think it does mean demand will permanently downshift and that previous levels of consumption are likely only a fond memory.

Coated paper producers have fought hard to keep abreast of the deterioration in their marketplace and sustain the market's fundamental balance. Mills aggressively cut capacity in the second half of 2008, and announced first quarter 2009 reductions — some temporary — of an additional 700,000 tons. AF&PA officially estimates 2009 U.S. coated freesheet paper capacity at 4.8 million tons, vs. 5.3 million tons in 2007. Mills in Europe are also shuttering large chunks of capacity as they face similar problems.

Unfortunately, demand has decreased so far that despite these cuts, additional and significant capacity closures are likely to be required. It's estimated that on the order of one million additional tons in the near term will face closure. These additional closures will be even more difficult than in the past because the high cost, easy to close capacity has already disappeared, meaning only relatively competitive mills remain and many of them produce positive cash flow.

Prices Slip Then Head Down

While coated paper prices held up initially as producers rapidly pulled back on output in the face of precipitous declines in demand, prices began to weaken, and by the

fourth quarter were slipping. By January, coated mechanical grade prices had fallen about \$100 from the peak levels reached in August/September and coated freesheet web grades were off about \$75 per ton. This marked a change in direction after a steady gain in prices that began in mid-2007 across all major coated paper and publication grades. By April of this year, prices had fallen off by \$165 per ton from peak fourth quarter levels, according to various sources.

Global Overcapacity Too

Another challenge is that coated paper is a global business and excess capacity in Asia is finding its way into the U.S. market, as well as pushing into Europe and displacing European tonnage, which in turn is being sold into North America. Imports gained market share in the last few months at the expense of domestic mills, as there is simply far too much global capacity right now.

Hunker Down 'til 2010?

Put it all together and 2009 will be a very tough year which will see additional, painful, mill closures in the U.S. and Europe. U.S. prices might avoid a full fledged run down to the bottom if there is some positive sign that results in printers and publishers re-building inventories. Pricing might encounter a temporary bump at some point, but a largely deflationary environment, including for market pulp, means the pricing outlook doesn't appear all that rosy in North America if you produce paper.

Any substantial recovery in demand is forecast to take until 2010 if history is any guide. For example, the last downturn in magazine pages required three years to recover, which puts a rebound from the current downturn into late 2010. With North American demand running at roughly seven million tons annually, and capacity at about ten million tons (2009 U.S. coated paper capacity according to AFPA is about 9.2 million tons), a lot of big changes will be required.

Looking further out, added closures may be required to balance supply even if demand gains some ground and recovers and to account for competition from low-cost paper from Asia, which will continue to be a factor. It's a lot like the outlook for stocks if you are a regular consumer — just hunker down and get through it. ■

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