



External Factors Squeezing Coated Freesheet Profits, Driving Supply/Capacity Shifts and Price Changes

By Harold M. Cody

Demand has finally begun to improve and unprecedented shocks to world pulp supplies coupled with trade disputes have provided a strong cost push for price gains in 2010. However, despite overall U.S. economic growth, graphic paper demand remains weak and far below “normal” levels, casting doubt about a sustainable market recovery. Once cost pressures ease and the effect of inventory restocking ends, the current upturn may falter.

Paper mills are to some extent generally insulated from external factors such as natural disasters, which are normally localized events. However, Mother Nature literally exploded onto the scene earlier this year as the earthquake in Chile set into motion a series of events akin to throwing a rock into a pool and watching the waves from it expand in an ever growing and unending circle from the impact point. The impact of rising pulp costs have lapped onto the shores of every continent and the effects are expected to continue to spread for some time even after mills in the region come back online.

Using our crystal ball to look at the coated freesheet outlook would, at the least, be a bit easier barring such unusual external factors. Things are steadily albeit slowly improving, but there is little to suggest the strong gains needed for a true market recovery are on the horizon this year. That’s because weak demand remains a significant problem. Major coated freesheet end uses — catalogs, magazines and other advertising — have improved incrementally from record low levels reached last year, but paper consumption levels remain far below pre-recession levels.

Following a plunge in magazine advertising of over 25% last year which came on the heels of a smaller but still significant drop in 2008, ad pages appear to have stabilized

at a new lower level. Following the closure of many titles in 2008/2009, fewer titles are expected to disappear, helping to halt the fall in magazine circulation. Following an estimated 15% drop in 2009, equating to over 2.5 billion catalogs, catalogs are starting to show signs of life and may post a slight gain in 2010. A “firming” of these key markets

slowed the plummet in coated freesheet demand, which fell at a rate of about 25% for all of 2009, to an estimated 12% decline in Q4 2009. It’s hard to fathom but all of that is GOOD news — at least we’re headed in the right direction.

Nevertheless, U.S. coated freesheet demand and shipments have been improving over 2009’s record low levels. Total U.S. print-

ing and writing paper shipments rose 12% in March, the fifth consecutive rise from year earlier levels, according to AF&PA. Coated paper volumes are starting to rebound as well, as shipments rose for the fourth time at double digit growth rates compared to last year. For the year through March, PPPC reports N.A. coated freesheet shipments of 889,000 tons, an 18% gain vs. 2009. Demand is also up 18% at about 1.1 million tons which equates to 4.4 million tons on an annualized rate basis.

However, these gains mask the fact that demand clearly remains well below 2007 levels. U.S. coated freesheet ship-

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ments in 2009 were 3.25 million tons, 18.6% lower than 2008. That's a lot of ground yet to be made up and it's generally the view that a significant portion of this lost demand is permanent. Estimates by Verso, the No. 2 North American coated paper producer indicate that 12% or 675,000 tpy of U.S. coated freesheet demand has been permanently lost, while another 17% of the decline in recent years was the result of inventory de-stocking as printers cut coated freesheet stocks to record low levels in the face of a precipitous drop in business. The drawdown is estimated to equal nearly a million tons. The current rebound is certainly partly due to inventory building.

On the supply side, U.S. mills have cut capacity enough that operating rates are back over 90%, which is beginning to mark a more positive tone. According to AF&PA, U.S. coated freesheet capacity fell 11.8% in 2009 and the drop in 2010 is pegged at 4.3%. This is probably optimistic, i.e. even more capacity, particularly higher cost marginal mills in North America that have to buy pulp, may close. In late 2009 it's estimated that capacity was one-third higher than demand.

Unfortunately the global picture is worse, particularly in China where 4.6 million tons of new fine paper are scheduled to come online in 2010-2011, including 2.6 million tons of coated woodfree paper. Over the mid-term, growth in Chinese demand may absorb this capacity, but in the short term there appears to be too much capacity that will end up in other markets. Capacity has also been cut dramatically in Europe, but demand in Europe has plunged as well.

Nevertheless, these factors pale into insignificance compared to the dramatic impact that the sudden tightening of chemical pulp supplies is having on coated fine paper mills. The earthquake and a strike in Finland cut out about 10% of world supply pulp. As a result, pulp prices have skyrocketed and appear headed over \$1,000/ton. Tight pulp supply is affecting all markets and also impacting trade flows by making areas such as Europe and even Asian mills, which buy a lot of pulp, less competitive. Historically, coated paper prices closely track pulp prices due to the fact that a lot of mills have to buy pulp and this is driving up prices.

Price Gains Likely as Margin Squeeze Tightens

As demand collapsed, coated prices posted steep declines between the latter part of 2008 and mid-2009 but they remained relatively stable with a slight downward direction from mid-2009 until 1st quarter 2010. As fiber and energy costs squeeze profits, prices appear to be headed up. During the 1st quarter, producer volumes rose significantly over prior year levels but many operated at a loss due to higher costs. Mills are starting a push for price gains and will

likely target July when demand is seasonally strong. They've begun to announce increases which should end up raising overall prices.

An additional wild card that has the potential for far reaching change that needs to be considered is the ongoing trade dispute over imported coated paper. Without a doubt this can have a major impact on the U.S. market. Imports have plunged in recent months, although much of this is simply due to weak demand. The duties imposed in late April on U.S. imports from China and Indonesia — if they remain in effect — are significant. On paper produced at Chinese mills it adds 31% to 90% to the modest duties already in place, while paper from Indonesia faces an additional 11% on top of an 18% duty previously levied. It seems without a doubt that this will result in lower U.S. imports from these regions, further contributing to producer pricing power.

Beyond the Current Upswing the Market May Revert

It appears likely that demand will continue to post gains and for the year to achieve a minor increase over severely depressed 2009 levels. With the market for pulp very tight, prices are on the rise and if North American pulp prices rise again in May/June, they would reach among the highest levels ever attained in nominal terms. In turn, paper prices will rise as we go forward driven by the resultant profit squeeze. The "Chile Effect" may see resolution as the mills restart, but most analysts expect the effect of this, coupled with recent labor strikes that shut down Finnish shipments, to linger. Pulp inventories dropped to half of prior year levels providing producers the power to push up pulp prices. As a result, coated freesheet prices are likely to move up \$40 to \$60/ton over the lows of 1st quarter 2010.

High pulp costs also have an impact on trade. Producers in Europe for example are not fully integrated. While there are a couple of major non-integrated U.S. mills, several of the larger producers are fully integrated into pulp, providing them a significant cost advantage over offshore mills. The strong Euro has also made these mills less competitive in recent months although it's hard to know where exchange rates are headed given the on-going fiscal crisis revolving around Greece in Europe.

While the market seems to be moving in a positive direction for producers, doubt lingers about whether a painfully slow recovery in demand will be sufficient to sustain market and price gains if, as expected, pulp costs ease later this year. ■

Harold Cody is a contributing writer for PaperAge. He can be reached by email at: HCody@paperage.com.