



Weak Demand and Prices Cloud Outlook for Coated Freesheet Markets in 2014

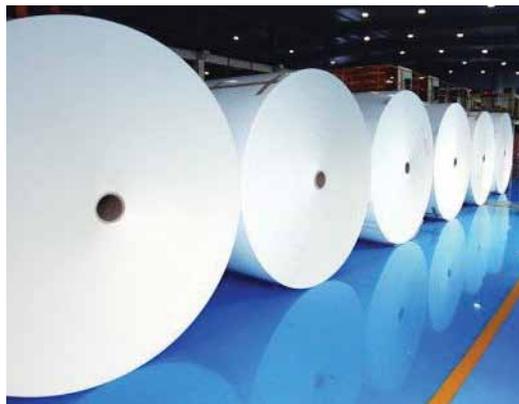
The coated freesheet market has generally performed better recently than that for groundwood grades but the outlook remains challenging as U.S. demand for all coated printing papers continues to contract. Sluggish demand coupled with competition from lower cost grades led to price discounting beginning in late 2013. While a rebound may occur later this year that could lead to improved pricing, coated freesheet demand is expected to continue to contract, making significant gains difficult. A Verso/NewPage merger could have a major impact on the market including the timing and degree of any recovery.

By Harold M. Cody

2013 was a mixed year for coated paper markets: demand was poor, as consumption contracted, but prices held relatively stable for most of the year. It would have been considerably better if an expected seasonal uptick in demand in the fall had materialized. Unfortunately, the fall printing season for many grades was weaker than expected and consumption contracted. As a result, prices slipped for coated freesheet and other publishing papers as well late starting late in the fourth quarter.

The market was also hit with negative news in the form of a 4.3% rate increase by the U.S. Postal Service as it continues to struggle financially as traditional mail continues to be displaced by technology.

North American printing and writing paper demand declined 1.6% in 2013 to 22.3 million tons according to the Pulp and Paper Products Council. Demand for uncoated mechanical grades posted a slight increase but declined for the other three major grades. Demand was down 1.4% for uncoated freesheet, 6.6% for coated groundwood and 2.4% for coated freesheet vs. 2012. Coated freesheet shipments by North American mills were down 2.6% at 3.7 million tons, while imports fell to 933,000 tons, a 1.6% drop. For the year, coated freesheet demand was 4.6 million tons. At year end, coated freesheet inventories were 499,000 tons,



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up slightly from November levels, but significantly higher than prior year levels.

U.S. coated freesheet shipments, at 3.8 million tons, were similarly off by about 2% from the prior year while imports remained flat at about 750,000 tons. As noted, the market for coated mechanical grades weakened even more substantially, resulting in a drop of U.S. shipments of about 9%, and imports were down as well.

Coated freesheet mill operating rates were only 79% in December 2013 which pulled the rate for the year down to 89%. The lower operating rates reflected sluggish demand and were behind price discounts on coated freesheet web grades that reached \$30-\$40/ton in late 2013 according to industry sources. The impact of the discounting wasn't really felt broadly until early 2014 and prices on some grades slid even further and are down almost 10%. Prices on high-end coated freesheet grades remained much steadier as the coated sheet market is holding up better than the market for coated web grades. In particular the lighter weight coated web grades are feeling the pressure from the drop in coated groundwood prices.

Groundwood markets including coated groundwood have been weaker than coated freesheet markets. The major reason for the disparity is that higher quality niche market

magazines and other high end print products that prefer coated freesheet papers have fared better than mass market magazines and inserts which are typically printed on coated and uncoated groundwood grades. It's reported an additional factor behind weakness in groundwood grades was a subpar catalog printing season last fall.

Early 2014 market data clearly show continued weakness on the demand side — possibly in part a result of the extreme cold weather across much of the U.S. — continues to plague all printing and writing grades. North American printing and writing paper demand in first quarter 2014 is down 3.8% vs. prior year levels. Coated freesheet demand is off by 4.1% while coated mechanical paper demand was lagging by over 6%. Freesheet shipments were off by 2.6%.

On an annualized basis using first quarter data and extrapolating, coated freesheet demand would be about 4.4 million tons in 2014. Operating rates remain sluggish as well, with coated freesheet mills operating at just 87% of capacity in March, which pulled the year to date rate down to 92%.

The impact on demand of higher postal rates is a key consideration this year, but assessing the degree of the impact is difficult and opinions vary widely. Some experts predict only a minimal impact while others decry it will further “kill print.” Certainly some impact will be felt for products such as catalogs and magazines as the increase raises the cost of sending out printed materials and provides further impetus to the use of electronic versions of traditional print products.

The increase in postal rates is certainly expected to have more of an impact on mechanical grades – SC uncoated and coated groundwood – than on coated freesheet papers because it will have a more detrimental impact on magazines and catalogs which are the major groundwood markets. However, continued weakness in pricing for coated groundwood may also shift some coated freesheet users to the lower cost paper if the price differential widens.

U.S. Postal Service mail volume data are an indicator of paper demand and the data clearly parallel the downturn in coated paper demand. For the USPS fiscal year ending in September 2014, first class mail volume in pieces of mail was down 4.2% vs. the prior year at 66.7 billion pieces, with volume by weight off 3.6%. Standard mail volume data was better with mail volume in pieces up by 1.5% at 80.9 billion pieces but weight was down 1.1%. First class mail is a major user of envelope and several printing grades as well as cut-size papers, while standard mail volume is a large user of printing papers such as coated and uncoated groundwood. For the USPS first quarter (Oct. 1, 2013 – Dec. 31, 2013) first class piece volume was off by 4.6% and weight was

down 2%. Standard mail pieces and weight were down by 2.8% and up 0.1%, respectively, compared to the same period in the prior year.

Developments across the pond are also expected to have a larger than usual impact on the North American coated paper market as a significant amount of coated groundwood capacity will be shut in Europe this year. An estimated 745,000 tons of capacity will be idled as mills try to adjust to a rapid shrinking in demand. In turn, this is likely to reduce U.S. imports from Europe, which run at about one-half million tons per year. A stronger Euro has also had an impact by raising costs in Europe relative to the U.S. Lower imports would reduce supply and could provide some support to flagging prices.

The drop in pricing is also likely to force the shutdown of additional capacity in North America as well. A combination of these reductions and an improvement in demand in the fall due to seasonal factors may support some price recovery during the second half of this year.

However, any forecast of the North American market this year is unusually uncertain because a lot will depend on the outcome of the Verso purchase of NewPage. If the deal goes forward it would create a much larger producer, since Verso and New Page are North America's top two producers of coated papers. The combined operations would have \$4.5 billion in sales and 4 million tons of capacity, including 2.3 million tons of coated freesheet and nearly 2 million tons of coated groundwood capacity, representing just over 50% of the capacity for coated papers.

The merger's biggest impact would likely be seen in capacity reductions or grade shifts by the combined company. These shifts or reductions could, for example, have a major impact on coated groundwood, where capacity will exceed demand by at least 200,000 tons this year alone if demand continues to contract at the current run rate. The deal continues to run into snags and it's unclear if it will receive government approval.

With demand expected to continue to decline for coated papers in North America this year, both for groundwood and freesheet grades, the outlook isn't rosy. However, capacity reductions by Verso/NewPage or other mills would certainly go a long way and will be needed to balance supply and demand. If operating rates can be returned to reasonable levels, producers may have a chance to stabilize pricing later in the year. ■

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