



Coated Freesheet Market Faces Supply & Weak Demand Challenges

Coated demand continues to shrink but prices have, surprisingly, remained stable following a modest decline last year. However, additional capacity adjustments may be needed in order to avoid a steeper decline in operating rates which are already the lowest among graphic papers.

By Harold M. Cody

The overall printing and writing paper market continues to struggle to adjust to two major factors: exchange rates and declining demand. The degree to which each individual grade sector has been impacted by these two factors, however, varies widely. Coated freesheet grades have been more stable than some but continue to face price pressures and concerns about an excess of supply.

During the first quarter of 2016, North American printing and writing paper demand was about 4.9 million tons, or an annualized rate of 20 million tons, down about 3.5% compared to the first quarter of 2015. The decline in demand by grade varied widely, however. Uncoated freesheet demand fell by a modest amount declining just under 1% vs. 2015 levels. In contrast, uncoated mechanical demand was off by about 4% while demand for coated mechanical plunged almost 10%. Total imports were off nearly 20% vs prior year levels.

Coated freesheet demand was down a little over 4% year



Coated freesheet demand was down a little over 4% year over year in the first quarter at 1.1 million tons as shipments were off by 1.8% and imports were down over 10%.

over year in the first quarter at 1.1 million tons as shipments were off by 1.8% and imports were down over 10%. The freesheet market has been troubled by weak demand and over supply concerns, although during the latter part of 2015 shipments and operating rates improved a bit. Prices slipped modestly during the second half of last year, falling about \$25 to \$35 per ton, although it's reported spot prices showed

larger declines. Since the beginning of 2016, prices are reported to have stabilized despite the tepid level of demand.

Full year demand and shipment data for 2015 were in line with overall expectations that demand in the big U.S. market, and other developed regions, would continue to contract. Printing and writing paper demand and shipments were both down about 5% vs. 2014 levels, a slightly larger drop than the longer term trend of an annual drop of 3% to 3.5%. Overall demand was suppressed by a nearly double digit decline in demand for coated mechanical and uncoated mechanical grades. Freesheet grades posted considerably better results, with coated freesheet demand down 4.2% and uncoated free demand off by about 1% vs. prior year levels. Operating rates are a good indication of challenges facing the coated freesheet sector as U.S. mills ran at or about 90% in early 2016 after averaging well under 90% for 2015.

U.S. PRODUCERS CHALLENGED BY STRONG DOLLAR

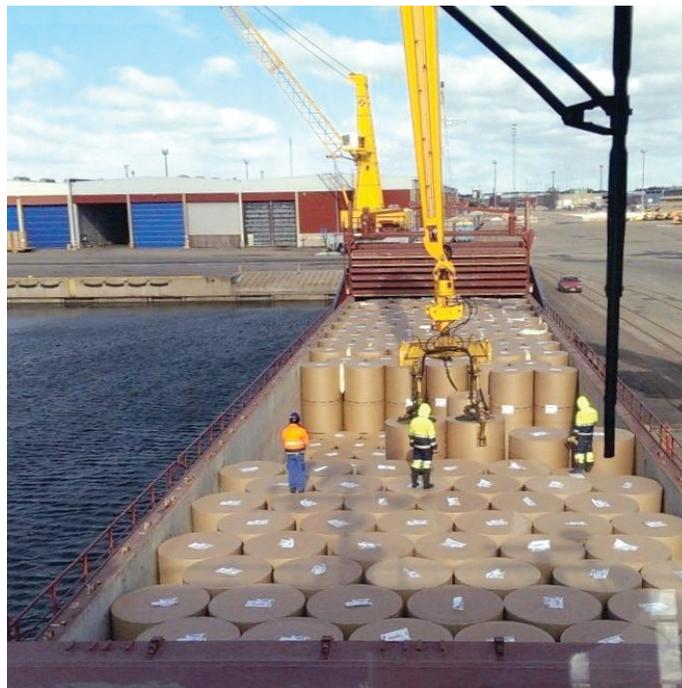
The overall tone of the market, from a price standpoint, has remained surprisingly good given the weakness in demand for most grades including coated papers. Coated mechanical demand is faring considerably worse than the coated freesheet sector as key markets for mechanical grades, such as magazines and inserts, continue to struggle to maintain market share against steadily rising use of digital advertising. In turn, demand has sharply contracted for mechanical grades.

Also contributing to the more pronounced weakness in coated groundwood markets has been a surge in off shore imports, which rose by almost one-third vs. 2014 levels, as off shore mills took advantage of the strong dollar. The strong dollar has changed the competitive cost situation by effectively making U.S. mills currently higher cost vs. mills in Europe for example, making it much easier for off shore mills to compete in the U.S. market. Similarly, it has reduced the ability of U.S. mills to export tonnage.

Imports of coated freesheet last year fell by a minor amount while coated groundwood imports rose almost 10%. However, exports of coated freesheet last year declined about 15% and contributed to the weakness in operating rates and in turn pricing. Exports of coated freesheet have been trending downward recently, falling by 150,000 tons over the last two years. Both the strong dollar and a decline in U.S. capacity contributed to the drop.

OUTLOOK

The outlook for the remainder of 2016 and into 2017 remains difficult to predict. First, there appears to be little cost driven incentive for higher prices although recent gains



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in market pulp prices and a minor movement upwards in oil prices during the second quarter bear watching. This, coupled with price pressures from imported paper, would tend to mean that any major gain in coated free pricing is unlikely.

The wild card to the outlook, of course, would be if additional adjustments to supply are enacted. Verso's permanent closure of the Wickliffe, Kentucky mill, which was idled last year, along with other closures, helped to keep over supply of coated freesheet to a minimum. It's expected, however, that as demand shrinks, further reductions will be needed unless exports can pick up the slack, which is unlikely given current exchange rates.

The recent entry of Verso — the top U.S. coated freesheet producer — into bankruptcy in early 2016 makes it harder to predict when additional closures may occur. Verso and Sappi control about two-thirds of U.S. coated free capacity. Industry observers note that Verso will be in a tight spot when they emerge from bankruptcy, noting that it will be difficult to invest in existing facilities to maintain competitiveness when bond and debt holders will be demanding money.

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