

Battling the Paper Markets

Whether demand for a certain paper grade is growing, flat, in decline, or simply shifting to another region of the world, paper producers continue to hammer away at the age-old challenge of balancing supply and demand.

By John O'Brien, Managing Editor



The North American paper markets in 2007 have been, for lack of a better term, a mixed bag. Capacity cuts by producers in all major grades of coated and uncoated paper, along with newsprint, have helped keep supply better aligned with demand.

Newsprint of course faces the toughest road, and although producers have worked hard balancing capacity to consumption, it has been extremely difficult to anticipate the drop-off level in demand. Reduction in what newspaper publishers refer to as “ad lineage” is the main culprit, keeping in mind that the quantity of advertising in each issue dictates the number of editorial pages a publisher can cost-effectively print. And those pages of editorial fall-off quickly when advertising isn't there to support them.

Below, PaperAge takes a look at the operating conditions for North American uncoated/coated paper and newsprint producers and the factors influencing the ups and downs of the markets.

Editor's Note: We didn't forget about the pulp market. Harold Cody covers it on page 20.

UNCOATED FREESHEET

The uncoated freesheet market continued its downward track in September as U.S. shipments dropped 6% year-over-year and was down 3% in the nine months ending September compared to the same period one year ago according to AF&PA data. Demand is being hurt this year by further losses to electronic data storage and bill/invoice presentation and payment sparked, in part, by rising postal costs for large mailers and retailers. In addition, recently finalized SEC guidelines give companies the option of providing proxy statements electronically, which may be removing additional uncoated freesheet tonnage although the amount is probably minimal. Finally, some uncoated freesheet demand is being threatened by new high-quality uncoated groundwood hi-brites such as Abitibi's AO/EO grades and Xerox's new High Yield Business Paper™ that is suitable for digital printing in non-archival applications.

Despite the weak demand picture, the U.S. uncoated freesheet market has remained tight for much of the year in the wake of supply reductions. Capacity removals/conversions by IP, Boise and GP this year removed approximately 700,000 tons of uncoated freesheet capacity from the market. And IP's recent announcement to convert its Bastrop Louisiana mill to market/fluff pulp will remove an additional 250,000 tons by this time next year.

On balance, the supply reductions have kept pace with the downturn in demand, keeping the market generally tight. The shipments/capacity ratio in the U.S. uncoated freesheet segment has averaged 93% thus far this year with cut-size papers being particularly tight.

On the pricing front, producers implemented a \$60/ton price increase on cut-size papers in November and will begin to implement price increases in the \$45 - \$60/ton range for offset and converting grades (envelope, formbond, tablet, MOCR, etc.) in the fourth quarter.

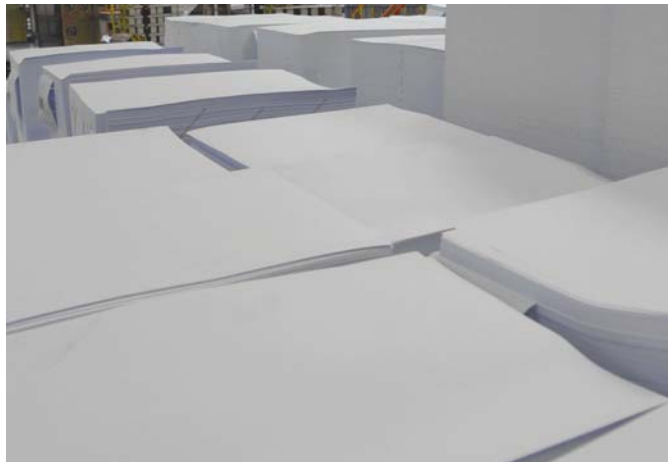
Looking to 2008, demand for uncoated freesheet and related converting papers will largely be a function of eco-

nomie growth and general business/commercial activity. Over the longer term, technological, generational and demographic factors also come into play. In general, demand for uncoated freesheet is expected to fall by 1.5% - 2% annually for the foreseeable future. Market health will, therefore, be a function of further capacity rationalization and production discipline by the segment's market leaders.

COATED PAPERS

Coated Mechanical. The U.S. coated mechanical paper market is currently experiencing extremely tight conditions. Lead times are the longest they've been in recent memory and mills are reportedly overbooked through the end of the year. The shipment/capacity figure for the sector came in at over 100% in September and has averaged 96% in the first nine months of the year, compared to 92% in the January-September period 2006. Not surprisingly, the bullish conditions are pushing up prices.

The strength in the U.S. coated mechanical market is very much a supply-side phenomenon. Indeed, U.S. ship-



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ments were up only 1.2% in the nine months ending September compared to the January-September period 2006. Demand for coated mechanicals is being hurt this year from higher postal rates, sluggish growth in magazine ad pages and also by rising paper prices. Market strength this year is coming from the closure of Miramichi, St. Francisville and Fraser Paper's retreat from the coated mechanical business which, in sum, removed nearly 750,000 tons of coated mechanical capacity on an annualized basis.

Paper buyers may have been counting on European suppliers, and on UPM in particular, to replace some of this lost tonnage with increased shipments from Europe. To date, that hasn't happened due to the strength of the Euro, paper prices in Europe that are \$50/ton higher than in the U.S., and higher transport charges from Europe to the U.S. east coast. That combination of economic factors has kept European shipments to

the U.S. on a downward track for much of the year. As a result, buyers have been scrambling for tonnage in preparation for the busy catalog season only to be told that mills are sold out (and over-sold in some cases). The U.S. coated mechanical sector has tightened considerably over the last few months and is expected to remain tight through the end of the year.

Looking forward, relief (for buyers) may come in the form of additional tonnage from the four new LWC machines starting up in Japan. Nippon, Daio, Hokuetsu and Oji are separately starting new LWC machines and have been pre-seeding tonnage in the U.S. West Coast. While the West Coast market for coated mechanical papers is quite small, Japanese suppliers really have no choice but to ship to that market as they do not have competitive shipping rates to the much larger U.S. east coast market. In addition to these machines, there are two new LWC machines coming on-stream in China this year, while a third machine is slated for 2009. While most of that paper will be consumed domestically, the ripple effect may push as much as 100,000 tons to the United States having been driven out of China due to competitive pressures.

Coated Freesheet. While the coated freesheet market has also become quite snug as of late, it is not quite as tight as the coated mechanical sector. Lead times are approaching four weeks, but buyers can at least get paper which is not guaranteed for those in search of coated groundwood grades. According to the AF&PA, U.S. coated freesheet shipments were down 6.0% year-over-year in September and are down 2.2% through nine months compared to the same period 2006.

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The poor performance of coated freesheet demand this year owes itself to the decline in magazine ad pages and only tepid growth in general commercial printing. Yet another factor may be grade substitution to coated mechanicals earlier in the year.

Looking forward, the health of the coated paper market will continue to be a function of the demand for ink on paper. In the near term, coated paper demand will be determined by advertising expenditures, catalog circulation, gen-

eral commercial printing and postal rates. Longer term, coated paper demand will be affected by changes in digital technology that may allow pages previously reserved to offset applications to migrate to digital format.

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NEWSPRINT

Ouch! Talk about piling on. Newsprint producers look like many of the New England Patriots' gridiron opponents these days—beaten, battered and bruised. U.S. newsprint demand dropped another 9% in September, continuing a 4.5-year trend. Year-to-date, demand is down nearly 11% with dailies taking a particular beating.

To offset weak domestic demand, North American producers have turned their attention to offshore export markets. While Canadian shipments to the United States are

down 14% year-to-date, North American offshore exports are up nearly 10% through September led by a 61% increase in shipments to Europe. Despite the improvement, exports are not going to be the magic elixir North American producers need. In fact, exports would have to rise from the 600,000 ton annual rate to nearly 1.4 million tons annually to offset the drop in domestic demand.

Lower circulation and conservation measures by publishers are certainly factors behind this year's miserable demand performance, but the principal reason has been newspaper print advertising, which is poised to make its largest drop since 2001. According to the Newspaper Association of America (NAA), total print advertising in newspapers totaled \$3.4 billion in the second quarter, down 16%. In the same period, total online advertising amounted to \$795 million, up 19%.

The rapid downturn in newspaper consumption is, on the one hand, easy to understand given the prevalence of the internet in our daily lives combined with generational attitudes on the use of electronic media. This powerful dynamic has removed pages from the newspaper over the last several years, most notably in the automotive, help wanted, real estate and financial sections.

On the other hand, the decline in newspaper advertising may be somewhat puzzling for those of us who still actually read the newspaper. For instance, according to figures from MORI Research in its 2006 study *How America Shops & Spends*, "52% of adults say that newspapers are their primary medium for checking advertising. No other medium comes close; with any age group." Respondents cited factors such as efficiency in comparing prices and the credibility of the ad. Moreover, 87% of readers reported viewing advertising inserts, which are a primarily found in Sunday editions. Perhaps the tell-tale sign here is that the study focused on



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adults and newspaper readers. The real challenge, for newspaper publishers and their newsprint suppliers, will be to attract a new generation of young readers who prefer to get their news from the internet (whether that be their laptop computer or iPhone).

Irrespective of these survey findings, the data on newsprint consumption is hard to ignore. Yet newsprint producers have, until last month, yet to respond as newsprint production continued to outpace demand for much of 2007 resulting in rising mill inventories. However, September's operating rate fell to 86%, pushing mill stocks down 85,000 tons according to data from the Pulp and Paper Products Council (PPPC).

STRONG CANADIAN DOLLAR HASN'T HELPED

The strong Canadian dollar, which reached parity against the USD in September, combined with rising prices and availability issues for wood fiber, has pushed nearly 65% of Canadian newsprint producers

below cash cost levels. At some point, and given the strength of Canadian producers' balance sheets, this will necessitate capacity rationalization on the part of Canadian producers. Indeed, the temporary closures of Howe Sound and Elk Falls this summer, removing approximately 650,000 tons on an annual basis, are examples of the economic pressures facing Canadian suppliers. More recently, Kruger's October announcement to indefinitely close its PM 1 machine at Corner Brook will remove an additional 80,000 metric tons of annual capacity. Now that the Abitibi/Bowater merger is a done deal and the company has agreed to sell its Snowflake, Arizona mill, the marketplace will be looking to this emerging market leader for much-needed capacity rationalization. A merger of so-called "second tier" players and/or the conversion of newsprint to uncoated mechanical/SC grades wouldn't hurt producers' chances either. ■