Financial Pressures Restructuring Groundwood Papers Industry May Set Stage for Upturn

The high-valued Canadian dollar has made many mills unprofitable leading to wide spread capacity closures. Concurrently, higher U.S. postal rates are suppressing catalog mailings while the housing problem hangover hurts advertising, including newspaper pre-prints, the largest uncoated groundwood market and major use for SC grades. Is all this bad news setting the stage for a 2008 upturn?

By Harold Cody

Last year the groundwood paper market was shaken by supply disruptions due to labor problems—some of these began in 2005—coupled with sluggish demand. While those problems have been resolved, a range of other and even more significant challenges have arisen. Maybe the good news for North American uncoated groundwood paper markets is simply that all the news isn't bad and it's possible that after a long period of decline, prices may be rising again.

NORTH AMERICAN PRINTING/WRITING PAPER STATISTICS

(000 tonnes)	June 2007	% chg. year ago	Year-to-date 2007	% chg. year ago
Uncoated mechanical				
Shipments	441	-5.4%	2,821	1.3%
Operating rate	79	89 (1)	85	89 (1)
Imports	51	-8.2	288	-9.4
Demand	457	-8.3	2,935	-0.9
Total printing & writing				
Shipments	2,249	-3.3	13,456	-1.8
Operating rate	92	94 (1)	91	92 (1)
Imports	258	-21.0	1,575	-12.0
Demand	2,396	-6.9	14,420	-4.1

1. Shipments/capacity. Actual figure, not a percentage change.
Source: Pulp and Paper Products Council.

MILL INVENTORIES

Tonne change from	June 2007	May 2007	June 2006	Month ago	Year ago
Uncoated mechanical	357	327	220	28	137
Uncoated freesheet	1270	1,276	1,102	-17	168
Coated freesheet	629	653	609	-24	20
Coated mechanical	302	322	306	-20	-4
Total printing & writing	2558	2,578	2,237	-33	321

But a lot of the news has been bad including tepid demand and tremendous cost pressures and subsequent poor profitability facing Canadian mills due to the huge surge in the Canadian dollar, particularly acute since early 2007. These factors have wreaked havoc on the producer side and led to a wave of closures in uncoated and coated mechanical paper capacity. The good news resulting in large part from the bad is a better alignment of capacity with demand. Hopefully the worst is over.

The outlook isn't at what one would call rosy, but recently there has been some good news, as several producers have announced modest price increases on higher end mechanical grades (both coated and uncoated). Several mills announced \$60/ton increases on SC-A grades, or a 7% increase by some mills, effective October 1. Transaction prices were reported at about \$730/ton for 35-lb SC-A in mid-summer, down about 9% from year earlier levels. Prices for several printing paper grades began sliding late last summer—some such as coated groundwood fell even earlier—and fell steadily until bottoming out earlier in 2007

As noted, the first challenge has been poor demand or the lack of demand growth for most uncoated groundwood grades, notably the higher quality printing grades. Lightweight grades and MF grades have faired better. Through June 2007, North American uncoated groundwood demand was lagging about 1% behind 2006 levels, according to PPPC. Shipments were up just over 1% while imports were off almost 10%. Overall N.A. printing and writing paper demand is off about 4% from 2006 levels through June, mainly due to very weak demand for freesheet grades. In July, uncoated groundwood shipments by

U.S. mills rose modestly and for the January to July period were about equal to 2006 levels. Imports were down as well. European SC-magazine paper shipments in the January-July period rose 4.3% vs. 2006, but exports were off by 1.4%.

Uncoated groundwood demand is unlikely to improve significantly in the short term as two key markets for uncoated groundwood face challenges in 2007. One major use is catalogs, where the rise in postal rates is pinching catalog mailers, meaning volumes will likely be flat or up slightly at best this year. Standard mail volume reported by the USPS (which includes catalogs) rose by a minor amount in 2006 and through the third quarter (which for the USPS ends June 30) year-to-date volume was up 1.8%, but weight was up just 0.7%, indicating some reduction in pages.

In addition, an overall weak advertising climate is hurting newspaper pre-print demand, another major use for SC grades. For example, publisher Gannet reports that pre-print volume dropped 1% in 2006, following a 3% gain in 2005, but that through early August 2007 pre-print volume was down 2.5% year over year. Total ROP advertising was off 6.9% over the same period according to Gannett. Inserts consume about 45% of uncoated groundwood paper consumption and are the largest use of SC grades, with the remainder of demand spread among miscellaneous printing, catalogs, directories and books and magazines. As noted, high-brightness MF grades that are used as a lower cost replacement for uncoated freesheet papers are doing better. These products continue to find widespread use, including a recent introduction as a low cost alternative to copy and laser paper for digital printing.

Exchange Rates Heart of Problem

A weak underpinning in terms of demand is bad enough, but it's only half of the equation. External factors, notably exchange rates, are having an even more critical impact on groundwood markets by leading to a major restructuring of the supply side. The impetus has been a very high Canadian dollar, which went from about C$0.85 per U.S. dollar in the first quarter of 2007 to over C$0.95 by July. This is simply a continuation of a trend that has seen the Canadian dollar go from about 75 cents/dollar in mid-2004, to the low 80s in 2005 up to 85 to 90 cents in 2006. The result has been to make whole segments of Canadian industry that sells in U.S. dollars—like paper mills—unprofitable. The resulting major capacity withdrawals include uncoated groundwood producers St. Marys Paper, Kruger (SC PM at Wayagamack mill) and a number of coated mills including

U.S. PRINTING/WRITING PAPER STATISTICS

Shipments (000 short tons)	July 2007	June 2007	% chg. year ago	Year-to-date	% chg. year ago
Uncoated freesheet	986	975	-0.6%	7,032	-2.5%
Coated freesheet	411	424	3.5	2,797	-0.7
Coated mechanical	415	390	15.5	2,564	0.4
Uncoated mechanical	168	150	1.3	1,112	0.1
Total printing/writing	1,981	1,939	3.5%	13,504	-1.4%

Source: AF&PA

NORTH AMERICAN PRINTING/WRITING PAPER STATISTICS

(000 tonnes)	Dec. 2006	% chg. year ago	Year-to-date 2006	% chg. year ago
Uncoated mechanical				
Shipments	471	-0.1%	5,734	-3.9%
Operating rate	89	93[1]	90	96[1]
Imports	42	8.9	739	39.4
Demand	487	0.2	6,139	-0.3
Total printing & writing				
Shipments	2,176	-2.8	27,316	-2.2
Operating rate	87	86[1]	92	90[1]
Imports	280	14.5	3,767	19.0
Demand	2,377	-1.3	30,143	0.1

1. Shipments/capacity. Actual figure, not a percentage change.
Source: Pulp and Paper Products Council

UPM's entire 450,000 mtpy Miramichi LWC mill in Canada, which was shutdown in August for 9-12 months, and smaller shuts including the Bowater, Benton Harbor, MI facility. The restart last fall of Stora's big SC machine at Port Hawkesbury was one exception.

With the U.S. economy struggling to shake off the impact of a huge drop off in the housing market and lingering impact of higher energy prices, underlying demand for magazines and catalogs is unlikely to improve before 2008. However, it appears producers—the ones that survive at least—can hope that capacity reductions are sufficient to support and sustain the recent round of price increases. Some observers note that 2008 could be a year of recovery not only in prices but also in demand, due to the potential boost in demand from a presidential election and the long awaited upturn in housing, which has pulled down the economy. A demand boost could really add fuel to the fire that was started by the closures recently put into place and pricing could recover further in 2008 and even into 2009.

Now if those idle groundwood mills don't all prematurely restart.... ■

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