

Pulp Production in the Americas – All Eyes Move South

It is no secret that South America has the potential to become a major global player in the forest, paper and packaging industry. Just how big a player the region will become depends on investors' confidence and the actions, or inactions, of the rest of the field.

By Robert Barnden



Although most people may think of tropical rain forests in association with South America, the commercial interest in the region arises mainly from plantation forests. The continent has some of the lowest wood fiber costs in the world which has become a prime competitive advantage in world markets for fast growing forest based industries and in pulp especially.

South America is also home to 400 million mainly middle income people in economies which are growing more quickly than the mature economies of North America and Western Europe. As such, South America is not only interesting in the supply chain, but even as a growing consumer market for forest, paper, and packaging products (FPP).

Of course we must avoid the temptation of treating South America as a homogeneous region. The countries have differing socioeconomic development and political profiles and as such must be considered as a series of distinct national markets.

South America is becoming (or already is) a major global player in the FPP industry. Projections indicate that five of the top 10 market pulp producers will be based in South America compared with two at the end of 2006. In 1986, Brazil produced 3.9 million tons of pulp; by 2006, output had risen to more than 11 million. Over the same period, Chile's pulp output increased more than fourfold to over 3.5 million tons." Although not all projects may materialize, there are projects in the pipeline that could increase production in the next six years by as much as 8-9 million tons in the region. Some estimates say that 30% of the world's pulp production will come from South America by 2015.



Fast Growing Trend. Eucalyptus trees being harvested at a Brazilian plantation. From only 18 million hectares in 1980, the worldwide area of forest plantation has risen to over 250 million hectares by 2005, supplying approximately 40% of the global need for industrial wood fiber.

INVESTMENT FROM VARIOUS SOURCES

Most of the capital for the investment in the region has been provided by companies based in the region. Some of these companies have grown to become significant players in an industry which is now shaped by the forces of global competition.

Even taking into account the strengthening of South American currencies, South America still enjoys a comfortable position at the bottom of the industry's cost curve. The Brazilian Real has already strengthened by over 9% during 2007 (July 2007). The regional cost of BHKP supplied CIF to West Europe in Q2 2007 from Brazil was US \$309 per ton compared to \$495 for the U.S., \$484 for Sweden/Finland and \$561 for Canada (source: *Hawkins Wright*). It is not surprising that South America has drawn the interest from many northern hemisphere companies attracted by the prospect of accessing low cost fiber or by the growing domestic markets of the region or both.

Foreign investors have also played an important role. Many North American forest product companies have invested into the region for several decades, although some have given up and withdrawn either due to reasons at home or because of local challenges. However, others have stayed, including Kimberly-Clark with its pan Latin American presence in tissue and International Paper and Mead-Westvaco, mainly in Brazil and mainly focused on serving local markets.

Maximo Pacheco, executive president of International Paper Brazil, in an interview for PricewaterhouseCoopers (PwC) said that "Companies in mature markets and with

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high production costs, such as Western Europe, Canada and the United States, are migrating their production capacity in part or wholly to countries that have competitive advantage like Brazil, Russia and China."

European companies are more recent arrivals. The longest and largest presence is that of Smurfit Kappa Group (SKG), which has developed a pan Latin American presence. Company data suggest that SKG is the largest producer of corrugated containers across Latin America, notwithstanding its absence from Brazil. Norske Skog (Norway) entered South America by acquisition and is now the largest producer of newsprint in the region through its operations in Brazil and Chile. Significantly, both of these companies are present to serve domestic or regional markets.

In contrast, the most recent wave of major investment has primarily been driven by companies seeking the opportunity to access the region's low cost wood fiber in order to produce pulp for their own use or their owners' paper mills in Europe and Asia. Good examples of this are Finland's Stora Enso and Botnia. Stora Enso's joint venture in Brazil with Aracruz (Veracel pulp mill) is already up and running and shipping pulp to Stora's mills in China. Other inward investors have included financial players such as North American Timber Investment Management Organizations (TIMOs) looking for annuity-type investments in plantations. They have been attracted by the potential returns,

combining rising cash flows from timber harvests with some capital gain upside. Several countries have attracted such investors due to no or limited restrictions on inward investment, often combined with favorable tax treatments.

RAPIDLY GROWING CAPACITY

The region has bold future investment plans. Significant investment is forecast for all parts of the wood value chain—from plantations through to processing capacity—to support future growth. However, as mentioned above, what stands out is the forecast additions to pulp capacity.

RISI data at the end of 2006 indicated that the cumulative announcements of major pulp capacity expansions in South America by local and inward investors totals over 10 million tons for the period 2007-2016. Of this, nearly 5 million tons represented confirmed expansions, with the balance being unconfirmed, i.e. announced, but in study or pending finance/external approvals. Virtually all of this capacity rep-

resents bleached eucalyptus market pulp. If all plans are executed, existing market pulp capacity would effectively double and would add almost 20% to the current global capacity for market pulp. A reasonable estimate of the capital cost of these announced expansions would be in the range of US \$12 billion. On top of this, further unquantified project announcements have been made (mainly in Brazil), which by reasonable inference suggest a further 3 million tons of pulp could be in the pipeline. Of course, it remains to be seen how many of these expansions go ahead.

Botnia, owned by UPM and Metsaliitto (including M-real)—two major Finnish forest products companies—is due to start up a 1 million ton capacity short fiber pulp mill at Fray Bentos, in South-West Uruguay, before the end of 2007. The investment, which totals some US \$1.1 billion, represents the largest industrial project ever undertaken in Uruguay. When complete, the mill will export pulp mainly to its shareholders, including a UPM mill in China. It is also the largest overseas industrial greenfield project ever undertaken by the Finnish private sector.

LOW COST PULP

With new capacity coming on stream in South America in the next five to ten years, the difference in the cost-base between northern hemisphere and Latin American pulp will put substantial pressure on North American mills. The question remains; what direction will North American producers take?

The recently published 2007 edition of the PwC *Global Forest Paper and Packaging Industry Survey* shows that the reinvestment ratio calculated as capital investment as a percentage of depreciation to measure the extent that capital investment is replacing aged assets is less than 1.0 for the industry as a whole. In other words, large forest, paper and packaging companies have been disinvesting for several years. The only exception to this trend is in Latin America and Asia.

It is understandable that the North American industry is out of favor with investors. So far, initiatives in the sector in

Latin America Leads On ROCE		
Region	2006 (%)	2005 (%)
Canada	1.7	4.9
USA	5.3	5.5
Europe	4.9	3.2
Japan	3.9	3.6
Rest of Asia	5.3	6.1
Latin America	9.3	8.3
Global average	5.3	4.9



Not Just Domestic Use. Stora Enso’s joint venture with Aracruz in Brazil (Veracel pulp mill) is already up and running and shipping pulp to Stora’s mills in China.

North America have not reversed the negative trend. Private equity is starting to invest in the industry with a belief that they can turnaround organizations where industrial players have failed. However, one wonders whether the real future of the industry is in the emerging markets, with South America being one of the key players in future development.

Growing competition from South America and Asia will continue to pressure U.S. companies to evaluate their asset portfolio and production capabilities and many U.S. companies are now executing on strategic divestitures of assets in efforts to seek improved performance and returns.

A WORK IN PROGRESS

Although South America presents a picture of a more stable political environment (with some exceptions) and a growing middle class, the region has a chequered history, even in recent times. Only six years ago the Argentine economy nearly collapsed. However, there are few that would predict a return to political unrest and economic instability in Brazil.

For the whole of South America, especially in the southern cone, Brazil’s commitment to political stability and democratic institutions and an openness towards inward investment is crucial. In Brazil, the domestic economy needs to be strengthened to counterbalance export driven growth, create healthier local demand, and, in due course, to stabilize the currency. In particular, there is a need to strengthen public finances and at the same time reduce taxes. Investment in infrastructure is also critical to support growth, especially, for example, in opening up new areas to the forest products industry.

Although Brazil ranks globally high in areas such as innovation and business sophistication, the country must come to grips with high taxes and the burden of regulation, which have spurred a huge informal economy. As with many other



Mad About Pulping. Thousands of people gathered on the Argentine side of the Uruguay River last year to protest the construction at Fray Bentos, Uruguay, of two pulp mills (Botnia and Ence) that the Argentines feared would pollute the river. Spanish forest products producer Ence decided to move the site of its planned 500,000 tpy pulp mill about 40 miles downstream of Fray Bentos.

BRIC countries, Brazil suffers with a ponderous bureaucracy. Many of the challenges and risks associated with doing business in Brazil are to some extent repeated in other South American countries—Chile being the notable exception, standing out as an all-round competitive market economy.

Also to be taken into consideration are some of the socio-economic problems inherent in the region. In Brazil, land invasions spearheaded by the landless workers movement (MST) are far from being a new development. However, recent actions seem to be based more on resentment of inward investment and big business. The risk of land invasion is obviously a risk that must be taken into account by foreign investors unless the administration is prepared to enforce existing laws.

In addition, projects such as Botnia’s pulp mill in Fray Bentos (Uruguay) has attracted extreme hostility from social and environmental groups in Argentina because the mill is sited close to a major river crossing into Argentina. The Argentinean government has also been critical citing environmental concerns. In turn, the mill and its environmental impact have been subject of an extended series of reviews by various international bodies.

The industry has watched the Botnia project with keen interest. It has not doubted the economic merits or the limited environmental impact. However, whether by accident or design, the mill has become the focal point for many socioeconomic grievances stirred by populist politics. Some industry investors will be deterred by such prospects; others will be more sanguine, recognizing that risks and responsi-

bilities must be more broadly considered as the frontiers of the industry extend.

Despite the generally good availability of wood and land, there are bottlenecks appearing in Brazil resulting in so called forest “blackouts.” This is a result of a slowdown in plantations compared to the 1980’s and 1990’s and the rising demand for renewable energy sources and competition for land. However, the major companies in Brazil are aware of the problems and the overall picture is that there is reason to believe wood supplies will be adequate.

There are some obvious risks associated with an investment in Latin America. However, there is a clear climate of welcoming foreign investors. Although the region lacks the fast growth economies of Asia, the southern cone countries are all experiencing growth at on above global average. Overall, superior growth prospects for consumer markets in the region depend upon the Brazilian economy moving into a higher gear. If higher growth levels are achieved we can expect to see a growth in rewarding consumer markets for investors in the forest products industry.

CONCLUSION

South America has clearly moved into the position of being a major global player in the forest, paper and packaging industry. This is especially apparent in the pulp sector where low-cost fiber, linked to advanced research and development

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in silviculture techniques, plant genetics and seed improvement have moved the region—especially Brazil—into the forefront as a supplier of market pulp.

There are obviously some question marks in certain countries in the region regarding political stability. However, most of the major countries in South America in recent years have

recorded a considerable level of democratic and stable political development. This, linked to an increasing middle class, makes the region more attractive for foreign investment. And although there are obviously some serious challenges still to be resolved, especially in the areas of infrastructure improvements and land availability, South America occupies a very attractive position for both continued domestic and foreign investment. ■

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