



Weak Demand, Rising Input Costs Keep Pressure on Groundwood Mills Despite Improvements in Pricing

U.S. groundwood paper demand slips due to a sluggish economy, weak advertising and consumption losses/shifts. However, aggressive capacity cuts have sustained operating rates, allowing mills to steadily raise prices. While prices may remain high the outlook is muted if demand continues on a downward trajectory.

By Harold M. Cody

The overall feeling or “tone” in the market for groundwood papers (which includes coated and uncoated grades) hasn’t been all that bad during the first three quarters of 2011 in large measure because of a sustained rise in prices since mid-2010 for key grades. These increases have allowed mills in some sectors to at least improve profit margins over 2010. But a quick look at market fundamentals makes it readily apparent that serious structural problems plague the market for these grades and make it difficult to be overly upbeat.

First, and fundamentally, the problem remains poor demand in the big U.S. market and in Europe as well. Sales volumes haven’t been all that bad in certain segments and for some mills, but nevertheless, overall demand has contracted. This weakness has made it impossible for groundwood producers to post significant improvements in the bottom line.

Last year U.S. demand for printing papers posted a modest recovery as the industry dragged itself up by its bootstraps from the depths of the 2008-2009 recession. At the time it provided some hope that after enduring the worst downturn in decades there was reason for optimism. But even the recovery was muted by historical standards and it has become accepted wisdom that some portion of paper demand has been lost and won’t be recovered.

Unfortunately, the rebound was short lived. U.S. demand growth has ground to a halt once again and similar problems are plaguing European markets. Through the first half



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of 2011, printing and writing paper demand is estimated to be down a little less than 5% compared to 2010. Data through May show North American printing and writing paper demand down 4.5% at 9.1 million metric tons, according to the Pulp and Paper Products Council (PPPC). Shipments for the same period were 8.1 million metric tons, down 5.6%, but imports were up by 5.5% at 930,000 tons. The biggest drops in demand were posted by coated groundwood grades, which were off 8% at 1.48 million tons (shipments

were down over 7% over the same period). Uncoated mechanical demand was also off by about 5% at 1.9 million m tons. Shipments in July for uncoated groundwood grades dropped over 10% vs. 2010 levels.

Technology/Market Changes Realign Demand

The demand problem or the lack thereof, is the result of a combination of the effects of a sluggish economy and competition from other media and technology that are combining to hurt printed products and print advertising demand. It’s obvious that a shift in consumption has occurred given that demand is going down while the economy, while weak, is slowing expanding.

Most groundwood grades (except for uses such as books, etc.) are used directly for advertising materials (newspaper inserts, catalogs) or in products where advertising volume directly relates to paper demand (magazines). Essentially

all of these markets continue to consume less paper. While magazine advertising has improved a little, it remains far below prior levels. Demand for catalogs and other direct mail also remain sluggish. According to the U.S. Postal Service standard mail volume is down 2.5% for the three quarters ending in June compared to the prior year level.

Newspaper inserts (a major use of SC grades) continue to suffer due to the demise in the overall newspaper market and losses to other media. Total newspaper advertising revenues, which includes advertising inserts, ROP and classifieds, are down 9.2% through the first six months of 2011 vs. 2010 levels, according to Newspaper Assoc. of America data. And specialized grades such as lightweight grades for directories continue to be hurt by similar competitive factors.

New developments have also emerged that are a challenge to printed products and advertising, notably tablets such as the I-Pad and E-readers. These pose a threat to a variety of print products including magazines, books and newspapers. The adoption of these products, and apps such as Facebook, is occurring far more rapidly than previous technology developments. This is making it not only difficult to gauge their impact on paper use but makes the threat more ominous.

As mentioned, there are a few bright spots, including magazine advertising where pages grew 1.3% during the first two quarters of 2011 for the sixth consecutive quarter according to the PIB.

Price Gains Provide Boost to Offset Cost Increases

In contrast to the dire news on demand, operating rates have remained at the 92% level or well above, which has allowed mills to post price increases on most grades. Prices for uncoated SC grades have recently been flat, but SC producers had earlier completed a \$40/ton increase on SC papers effective April 1. Pricing has been stronger in coated groundwood markets where prices have risen to the \$925 level (40 lb., No. 5). This is a substantial price recovery from August 2010 when prices were close to falling near \$800/ton. SC prices have seen similar increases over the last year and one half, although to a slightly smaller degree.

Coated groundwood mills recently were able to push through a modest price gain as it's been reported they were able to enact most, but not all, of a \$30/ton increase announced for July 1. However, coated groundwood demand remains weak as well, with U.S. shipments down almost 8% for the Jan.-July period compared to the same period last year. If prices rise during the third quarter, as expected, this would be the sixth consecutive quarterly gain, i.e. prices have risen since second quarter 2010.

Cost Pressures on the Rise

While prices have moved up, coated papers in particular (and other grades as well) are facing rising costs for energy and key raw materials. Corn prices have jumped substantially to unheard of levels resulting in much higher prices for starch. Latex prices have also risen substantially due to higher feedstock and energy costs. Pulp prices have also been rising for some time but recently they've eased.

Without doubt the only thing saving the market from falling apart from otherwise weak fundamentals has been the continued effort by producers to cut capacity. Printing paper capacity decreased substantially last year in Europe and North America and recent cuts continue this trend. U.S. capacity for printing and writing papers in 2011 is 22.0 million short tons according to AFPA, down nearly 675,000 tons from 2010. Coated groundwood capacity, at 3.6 million tons, is down almost 10% from a 2010 level of 3.9 million tons. Additional cuts have been enacted or announced that will effectively lower real capacity even further.

Market weakness, as well as the negative impact of rising costs and a strong Canadian dollar, has also driven major capacity closures in Canada. Among the largest is the closure of NewPage's Port Hawkesbury, NS mill (360,000 tpy capacity for SC). A range of other shuts have also been enacted.

Significant additional capacity closures have been announced recently that bode well for mills looking to maintain prices as they strive to maintain margins. UPM announced plans to close capacity in Europe totaling over 1 million tons, including coated groundwood and SC capacity representing roughly 4-5% of industry capacity for each grade. This is another big step in list of many such closures that maintain a healthy balance of supply and demand.

Given the tenuous nature of groundwood paper demand, technologies that pose threats to print products and a growing, nagging worry about the direction of the economy, it's even harder than usual to predict the future and to be overly optimistic. Nevertheless, producers continue to make critical strategic supply decisions in North America and Europe and appear resolved to do whatever it takes.

Thus, despite a level of demand so poor that it would typically, and strongly, suggest that not only are price gains unlikely, but should fall, chances are good that pricing will remain strong. Of course if the economy stumbles and demand really plummets all bets are off. It's just too bad that a little good news on pricing is made possible by mill and machine closures and job cuts. That's the reality today for printing and writing mills. ■

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