

State of the North American Pulp and Paper Industry

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Abstract

The North American Pulp and Paper Industry, once the center of the world's industry has suffered hard times due in large part to its inability to successfully deal with the changing global and competitive dynamics. North America has belatedly begun to address the situation by restructuring and trimming excess, old and higher cost capacity to better match true demand levels as balanced against a changing import and export picture. However, despite these efforts, the North American industry is still facing challenging times.

Overview

North America is the world's largest consumer of pulp and paper products, both in terms of in total tons per year; and in terms of consumption per capita. The North American (NA) Pulp & Paper Industry has persistent flaws in the eyes of many stakeholders -- including:

- Capital Intensive and fragmented;
- Monolithic and slow to adapt;
- Focus is more on what it does instead of figuring out what it should be doing;
- Key into lower costs, economies of scale, market share, marginal returns; and
- Production technology and production output driven.

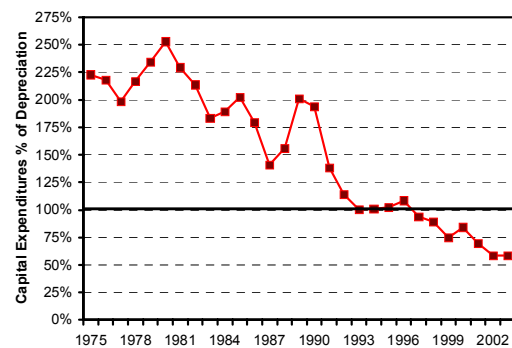
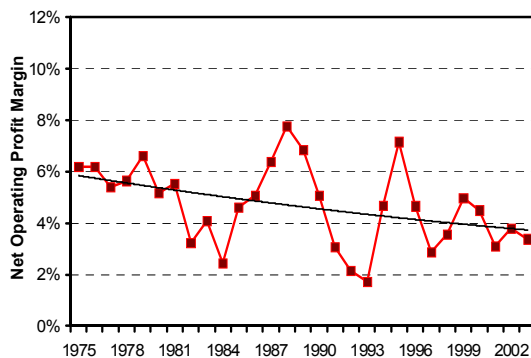
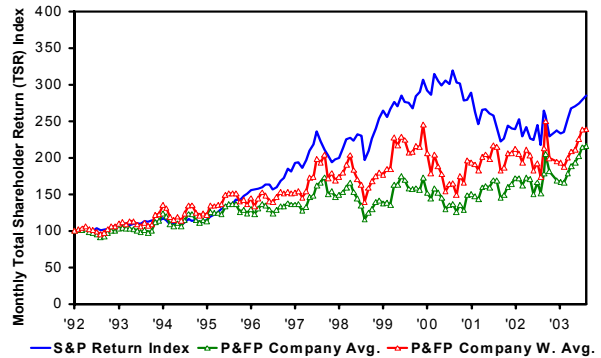
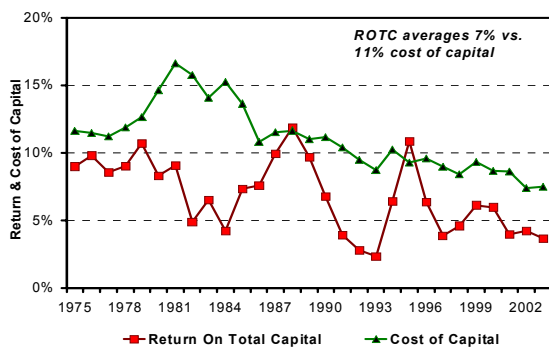
Pulp & Paper in NA is a mature industry characterized by:

- Highest per capita consumption in world across all grades;

- Slower growth than GDP and slowing overall GDP growth;
- High capital intensity;
- Intense Cost and price based competition;
- Cyclical and declining pricing and profitability;
- Below cost of capital returns; and
- Depressed investors' values and returns

The industry did not recognize the change in the competitive landscape until the mid 90's and then for the most part continued to operate as if nothing had changed. During this period, the regions of Europe, Latin America, and Asia began to start an aggressive export campaign to NA. This created an even greater problem with the domestic supply and demand balance. NA responded by restructuring in order to compete well -- both at home and in the global market.

As can be seen in the following graphs, the NA industry has not been performing well compared to normal benchmarks. The US industry continues to have dismal profitability while capital spending is below levels requires to sustain the business.



Of course, a key part of the reason for this poor outcome of late is the lagging performance of key industry drivers. Note, however, that in the following table, this poor level of drivers' performance has begun to turn around, and the near term prognosis for the industry is somewhat rosier in terms of the improvements in the noted key industry output drivers:

Economic Segment	Industry Segment Impacted	2001-2002 Real Growth	Q2 2003 Real Growth vs. 2002
Food & Beverage	Boxboard/Containerboard	-2.0%	+3.6%
Restaurant / Recreation	Boxboard, Tissue	-3.0%	+1.6%
Durable Goods	Containerboard	-5.1%	+8.2%
Non-Durable Goods	Containerboard	-4.1%	+3.3%
Computer & Peripheral Investment	P&W Papers	-11.5%	+31.0%
Advertising	P&W & Newsprint	-29.5%	+6.8%
Housing Starts	Tissue, Forest Prods	+5.7%	+11.8%
Private Investment	All Mfg. Industries incl. P&P	-21.7%	+8.0%
Industrial Production	All Mfg. Industries incl. P&P	-4.0%	0.0%

Regardless, of the improving outlook, the weakness in demand drivers for the last two years has had a major impact on the building of significant excess inventories.

Looking at the capacity of NA -- despite the clear efforts at capacity adjustment (i.e., shutting down older and/or higher cost paper machines) has been somewhat offset by productivity creep. And, meanwhile, new offshore capacity -- especially in China -- continues to grow and put pressure on the domestic market -- and hence, the NA producers.

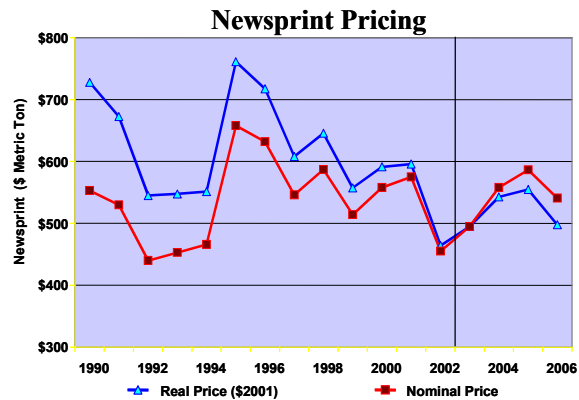
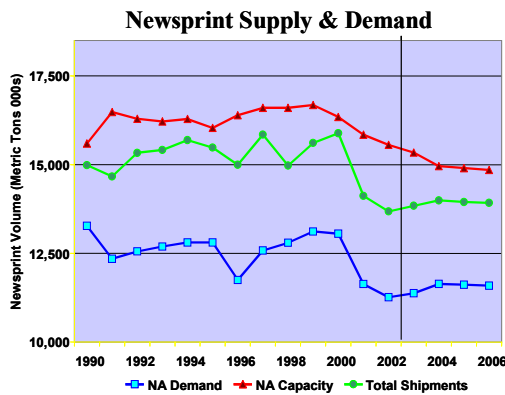
2003-2005 Change In China's Capacity (Short Tons 000s)	
Containerboard	2,035
Newsprint	781
Printing & Writing	1,480
Tissue	33
Packaging & Industrial	2,387
Pulp	1,513
Total Change	8,228

Grade Outlook

Newsprint

Newsprint remains as weak as the North American market. Continued substitution by alternative media and reduction in page count and size remains an issue. The decline in newsprint is moderating but is still a long-term issue. There will be a need for further capacity reductions.

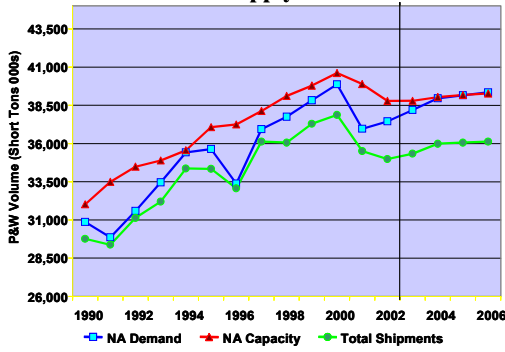
Grade Segment	Change In Capacity (Short Tons 000s)	
	2001-2003	2004-2006
Containerboard	-1,319	-150
Newsprint	-1,388	-491
Printing & Writing	-1,820	476
Tissue	587	377
Packaging & Industrial	-435	-250
Pulp	-1,714	-875
Total Change	-6,089	-913



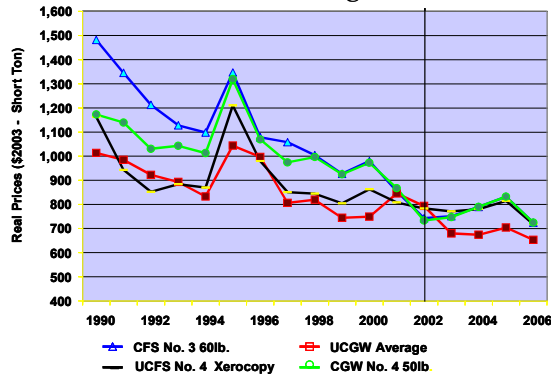
Printing and Writing Papers

The recent economic slow down and continued alternative substitution will continue to impact P&W demand. High end users are still being replaced/substituted by electronic versions. The perceived value of coated grades has eroded and the substitution of uncoated free and groundwood containing grades continue to put pressure on pricing. Certain segments will continue to suffer net capacity reductions.

P & W Supply & Demand



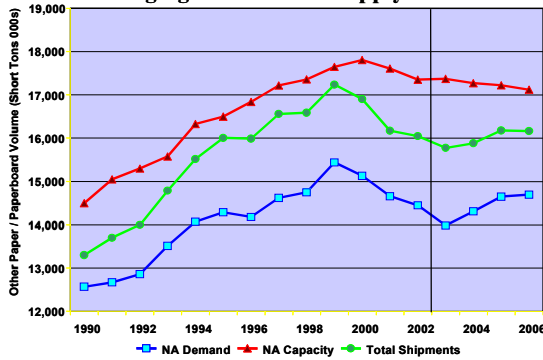
P & W Pricing



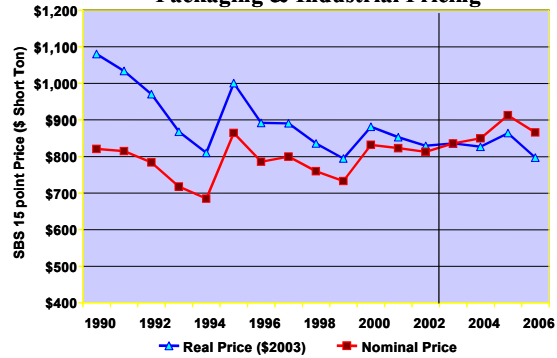
Packaging & Industrial

Grade group remains weak in North America, however the good news is that no substitution or major expansions are on the horizon. Profitability/returns better than average.

Packaging & Industrial Supply & Demand



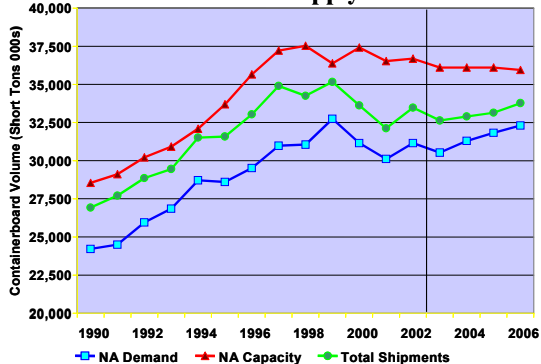
Packaging & Industrial Pricing



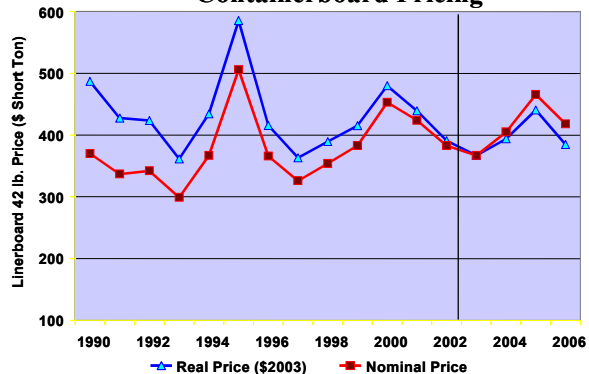
Containerboard

Concentration of the top producers has shifted from the lowest to the highest. Acquisitions are still probable to further concentrate this segment. This segment has undergone significant restructuring Grade still faces serious challenges with manufacturing of goods moving out of North America.

Containerboard Supply & Demand

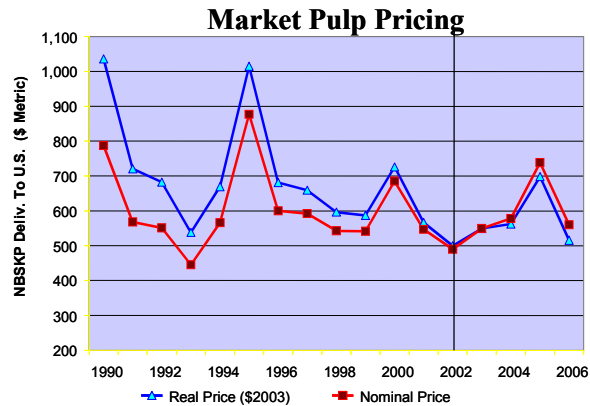
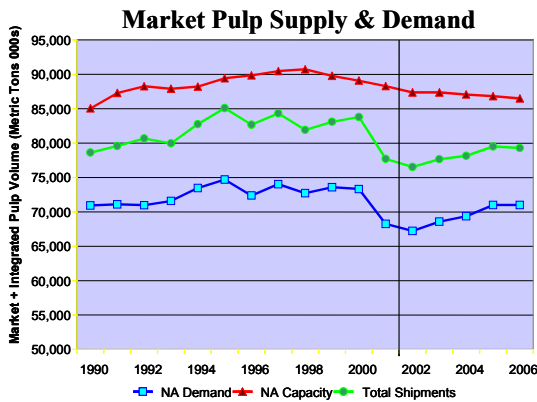


Containerboard Pricing



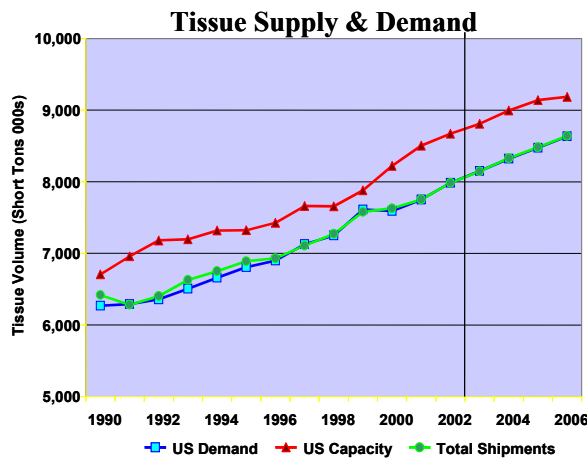
Market Pulp

This grade remains in serious difficulty due to the commodity nature and global low cost producers. Pricing will remain strained and low.



Tissue

This is the best performing segment. Expansions and upgrades (TAD) continue to lead the industry. However recent expansions may lead to over capacity and lower pricing.



Major Issues Facing North America

Despite difficult situation – the North American industry is positioned for some performance improvements during 2003 and more in 2004. But there remain significant risks to a sustained profitable North American industry sector --

- Expanded Substitution of North American produced P&P by International competitors and non-fiber based products;
- Continued over capacity – globally & domestic – with failure to maintain capacity management discipline;

- Declining North American asset quality [w/o renewal investments];
- Not seeking innovative & new ways of operating; and
- Failure to address fundamental question -- How do North American manufacturers of commodity products remain profitable long term against lower cost int'l competition?

Even with an economic and industry rebound at hand – The North American P&P industry's future remains a point of extensive debate.

Some believe the pulp and paper North America industry sector has begun a long-term, irreversible decline and as such: --

- Will follow in the path of US steel and textiles –
- Others believe it will restructure and reassert itself – like some parts of textiles & steel have begun to do
Truth – The real North American industry path is not clear –
- The degree to which North American demand returns, and North American capacity fulfills the demand and the way firms operate
- Plus – the way the global industry extends and exerts itself will collectively have major impacts on this path

Summary

North America and Europe (later in the Century) were the centers of the worldwide paper industry in the 1900s. As we exited the 1900s -- The North American demand and supply base had become very mature. Producer growth expectations are now slow at best, declining at worst. Western European demand and capacity growth has been more robust of late than that of North America, but is expected to lose momentum over the next decade.

This leaves Asia, Latin America, and Eastern Europe as the new Millennium engines of the world pulp and paper growth. A close watch of the North American industry will be a key in determining how far these emerging regions can go in capturing world pulp and paper share.