EUROPE CAPACITY RISK

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We've all heard of e-media substitution and how it is causing declines in paper consumption. It affects mainly communication papers – coated and uncoated, woodfree and wood-containing, and newsprint – but at different rates. The rate of decline is also changing over time. In Europe, now, the decline is still accelerating. Today, on average, the annual decline is about five percent.

Within only five years, European communication papers will have to shed 9 million or more tonnes of printing and writing paper capacity, or the equivalent of 60 medium-size paper machines. And our models suggest that e-media substitution will continue to have significant adverse impact for many years after that.

The stakes are high for everyone. Smart producers need to decide which assets to support, and for how long. Suppliers invest in relationships with mills which must survive to repay the investment. Financial investors look to place their money where it will hopefully make money, but, at the very least, expect not to lose it in bankruptcy.

So, it's important to know which machines will close and which will survive; how long the decline will last and who will be healthy and profitable afterward; and whether industry consolidation will cushion the decline. In other words, how the European industry decline will unfold.

A confluence of events and conditions in Europe will lead to a painful period in the paper industry over the next several years. The pain will include bankruptcies, closures, job losses, and low or negative returns for shareholders. Consolidation is unlikely to mitigate the risks as much as it has been for the North American industry. Why?

A CLASSIC CASE OF A MATURED INDUSTRY

European demand for paper has finally matured. The population is no longer growing and the amount of paper used by each person is no longer increasing. In communication grades, e-media is doing jobs that paper has done for centuries causing not only demand to

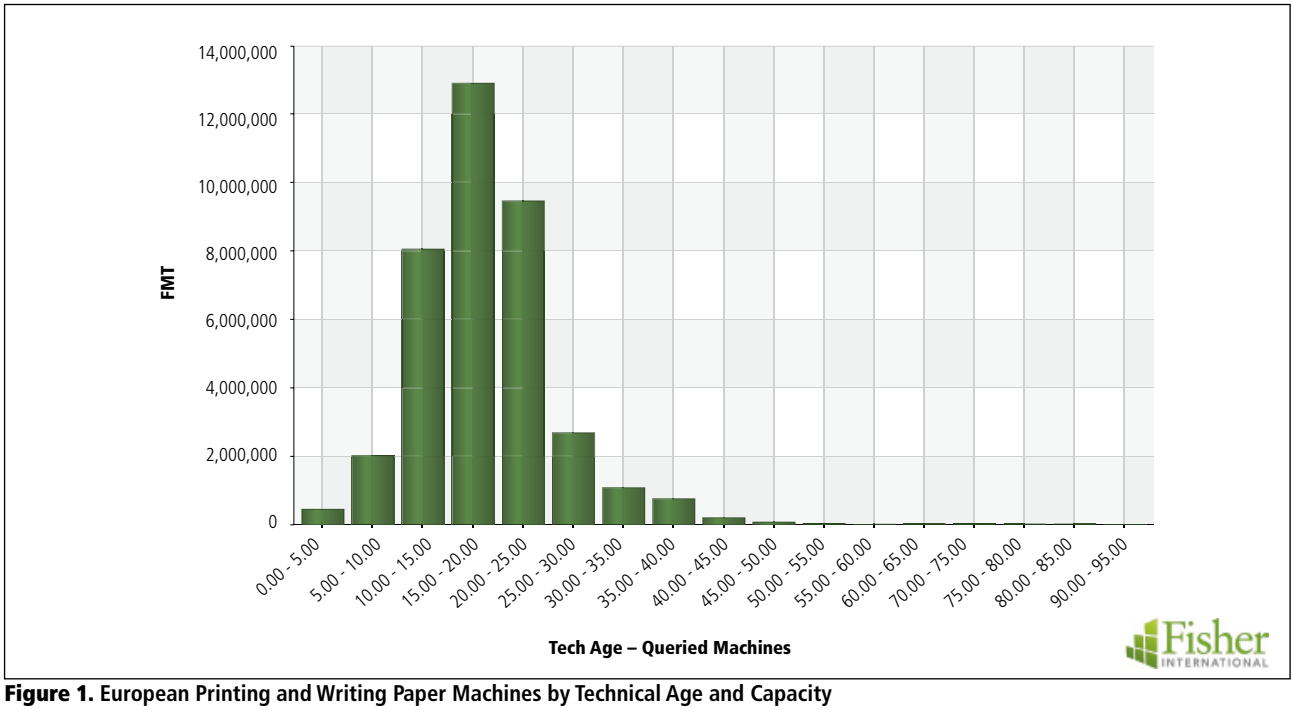

Figure 1. European Printing and Writing Paper Machines by Technical Age and Capacity
Source: Fisher*Solve*™. ©2013 Fisher International, Inc.

decline in the near-term, but also causing fundamental changes in habits of younger generations that will change paper demand forever. The rate of decline will even increase for a few years more before declining more gradually for a decade or two more. Ultimately, the industry will produce many fewer millions of tonnes 15 to 20 years from now than it does today.

Capacity, on the other hand, will not simply close to match the decline in demand. There are a number of forces preventing capacity decline. Pulp and paper mills physically can last a long time of course, and European producers have by and large invested in keeping equipment productive and up-to-date. Even if every machine whose Technical Age (as defined in Fisher*Solve*™) is over 25 years were to close, it would only solve half of the problem (see **Figure 1**). In other words, capacity withdrawals will have to include machines that are still young and competitive.

A REVERSAL OF FORTUNES IN THE EXPORT MARKETS

Moreover, Europe has long had more capacity than it needs to supply domestic demand. The region's productivity allowed it to export to other parts of the world, in both emerging and developed regions. Unfortunately, paper demand in other developed market economies is also flat or declining.

In North America, the decline started even before that of Europe. In emerging markets, particularly Asia and Latin America, a wave of investment in new capacity has diminished or eliminated the need for European exports. Even worse, overcapacity in some grades causes large producers in China and elsewhere to seek to export to Europe. The export market no longer functions as an effective outlet for excess capacity. A gradual strengthening of the euro against the US dollar over the last five years has added to the difficulty of finding export markets for Europe's excess capacity.

VESTIGES OF A PRE-EU INDUSTRY STRUCTURE

Lastly, there are few European producers – if any – who have enough market share today and who, therefore, can afford to close capacity to get supply and demand into balance. **Figure 2** shows a still highly-fragmented European industry. UPM may have just barely enough share in wood-containing grades to make a first set of closures pay. But the very act of closing its own capacity would soon lower the company's share below the threshold.

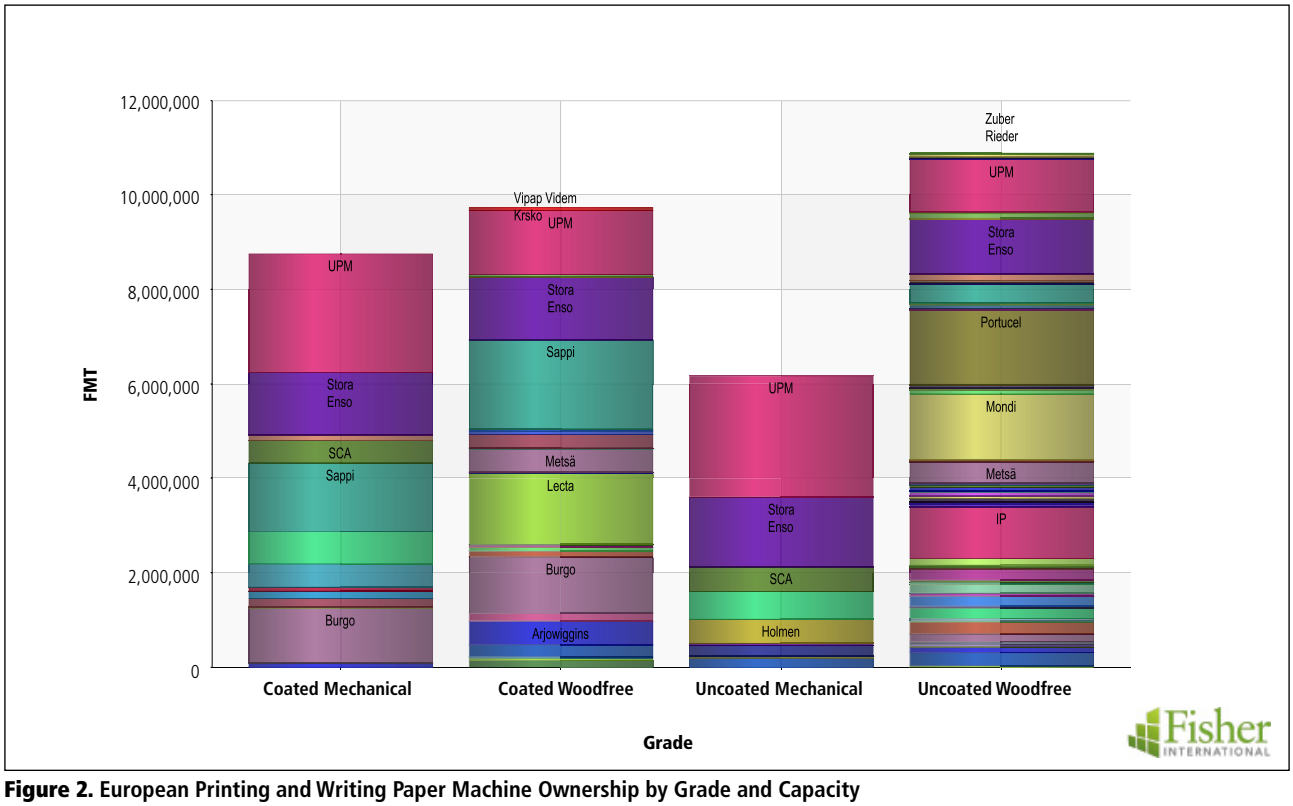

Figure 2. European Printing and Writing Paper Machine Ownership by Grade and Capacity
Source: Fisher*Solve*™. ©2013 Fisher International, Inc.

THE RESULT

The practical effect of overcapacity is that prices will remain at unsustainable low levels. One of every four machines operating today will either close, find a new export market or find another product to make outside of communication papers. However, since the traditional methods for managing overcapacity are no longer available and most grades do not have clear market leaders whose market share is large enough to permit them to close their own capacity, there is a kind of stalemate developing. No one is prepared to close capacity for the industry's good, so everyone will continue to suffer in hopes of surviving until someone else solves the overcapacity problem.

The logical result is that, failing major merger activity, the overcapacity problem will be solved through forced bankruptcies. Since Europe lacks "Chapter 11" type bankruptcy laws, which would allow companies to shed debt and return to production, capacity reduction is likely to take time and forced closures are more likely to be accompanied by painful economic losses.

NAVIGATING THE FUTURE

There are basically three ways for a segment to reduce its capacity, through closures, repurposing, and export. Since exports are no longer as feasible as earlier, repurposing is the only other major alternative to closure. How much is possible and where will it occur?

Repurposing is limited by the technical and resource capabilities of any given mill and machine, the economic capabilities of the owner, and the ability of the new market to absorb new capacity without forcing prices to unprofitable levels. Taking these factors into account, analysis using Fisher*Solve* shows that at most 10 to 20 percent of the communication papers overcapacity problem can be addressed through repurposing.

The most likely area for repurposing is packaging, containerboard in particular. The most likely machines to be repurposed are those integrated with fiber production, and whose equipment configuration is closest to the needs of packaging grades. Stora Enso, for example, recently announced that it hopes to convert a fine paper machine at Varkaus to make containerboard. An analysis in Fisher*Solve* shows a small handful of other machines that might succeed economically in the packaging segment.

Specialty papers can also be targets for repurposed machines, but specialty paper market sizes limit the amount of capacity that can be converted profitably. Moreover, repurposing well could lead to overcapacity in specialty segments, resulting in additional closures.

Most of the region's overcapacity problem will be solved through closures. While many analysts tend to look at cash cost of production

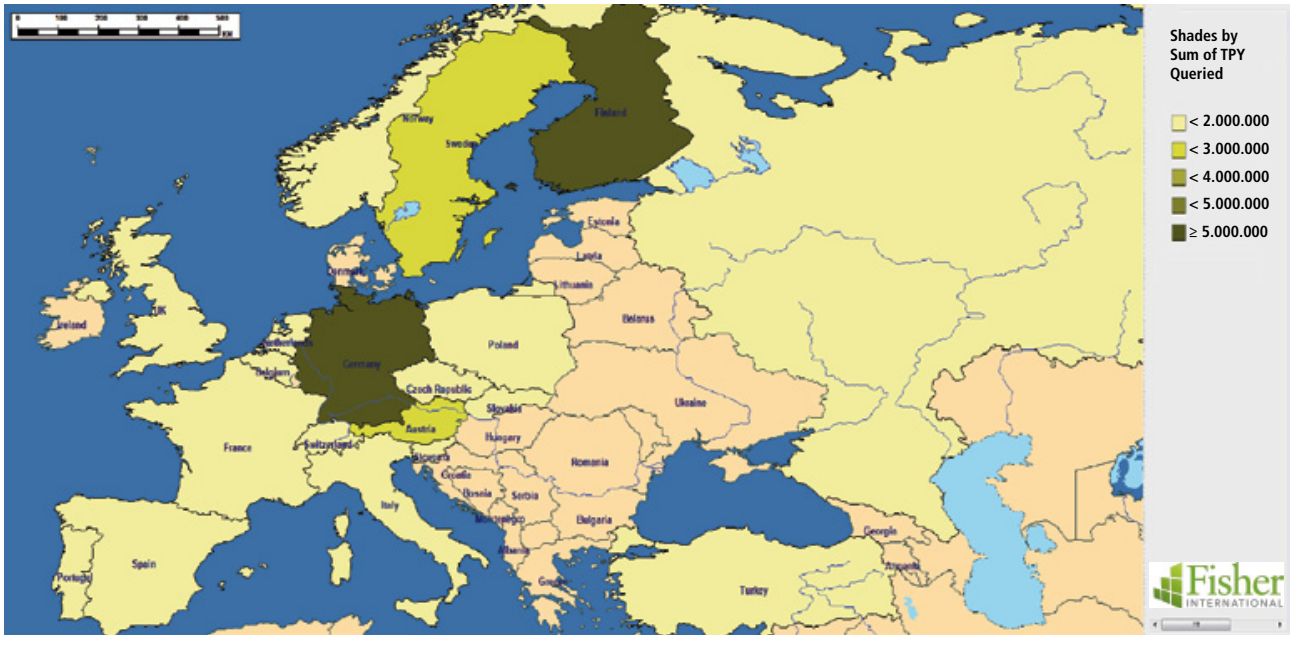

Figure 3. Projected European Printing and Writing Paper Capacity by Region
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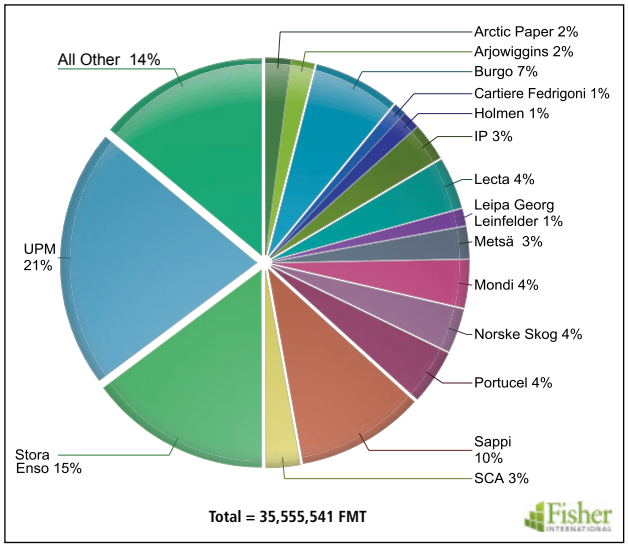

Figure 4. European Printing and Writing Paper Market Share Today
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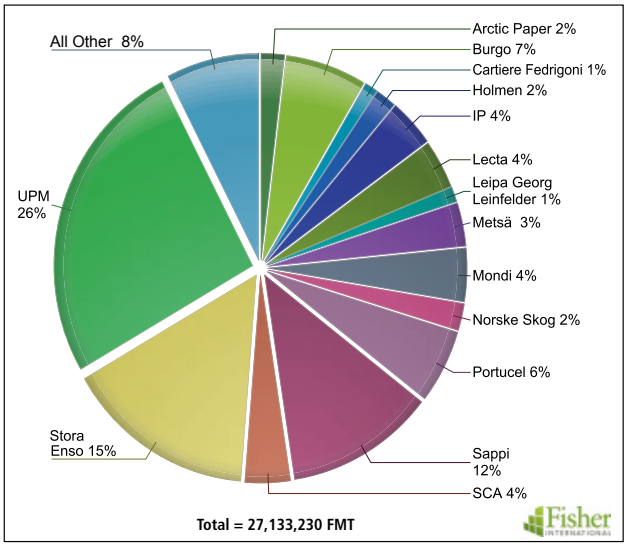

Figure 5. European Printing and Writing Paper Market Share, 10 Year Projection
Source: Fisher*Solve*™. ©2013 Fisher International, Inc.

to predict closures, we, at Fisher, have found a more complex calculus that explains how owners think about managing their assets during market declines. A Viability Benchmarking system inside Fisher*Solve* models the competitiveness and likely future of each paper machine making each of its products.

Using the FisherSolve Viability Benchmarking module, we have created a view of what the European paper industry may look like in future years. As weaker machines close, market shares, the geographic distribution of machines, and many other factors will change. **Figure 3**, for example, shows how production would be distributed across Europe if the riskiest quartile of machines closed, with darker shades indicating greater remaining capacity.

Yet, there is some hope. As European capacity is reduced over the next 5 to 10 years, even before merger and acquisition activity, communication papers segments will become somewhat more consolidated. Fisher*Solve*'s Viability Benchmarking analysis suggests that machines owned by smaller players will close at a greater rate than those of larger players. In addition to the net effect of consolidating the industry, this will make future M&A activity more profitable, because it will put many segments closer to the threshold where market leadership makes prices more sustainable.

Figure 4 shows overall European shares in Printing and Writing today. **Figure 5** shows how market shares would look in 10 years, if the least viable mills closed in sufficient quantity to balance supply and demand.

UPM's share would have grown five percent to 27 percent through such closures alone. Although not sufficient by itself to solve the capacity problem, a combination of selected M&A activity and closure of weaker machines is likely to be the outcome for Europe over the next decade. ■

Note: Fisher International is a leading consulting firm supporting the pulp and paper industry with business intelligence and management consulting services since 1985. With research resources in nearly every pulp and paper producing country in the world, Fisher International's expert consultants, proprietary databases, analytical technologies, and business management tools are used by pulp and paper producers, suppliers, investors, and buyers around the world every day. Data and analyses for this article are from Fisher*Solve*™, the pulp and paper industry's premier market intelligence resource. To learn more, please visit www.fisheri.com