

# CURRENT INDUSTRY PROFITABILITY LEVELS STUBBORNLY LOW, AND THE CONSEQUENCES ON THE INDUSTRY GOING FORWARD

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Industry profitability levels for the main graphic paper grades in Western Europe have been in decline ever since the financial crisis started to impact the markets during late 2008. This year will be no exception as profitability levels in Europe will (probably) reach their lowest point in modern papermaking history. We at RISI believe profitability levels will start to rise again during the next two to three years, a rise that will be fueled by better pricing trends going forward as industry players continue to address the overcapacity problem affecting the current market balance. Despite this expected recovery in profitability, levels will only reach the low profitability level seen during the crisis period (2008-2012), clearly failing to get back to pre-crisis (1992-2007) or long-term levels (1992-2012) during the next five years.

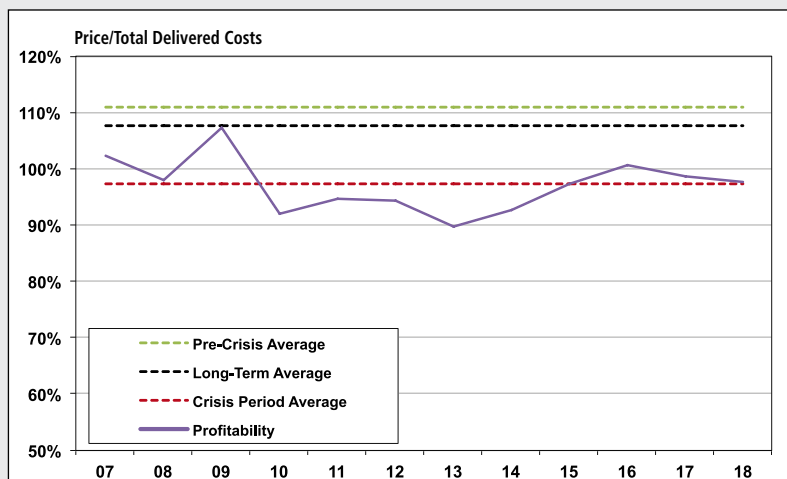
Upon examination of the details, every grade tells a slightly different story. Uncoated woodfree papers are currently enjoying higher profitability levels. Some of the reasons for this higher than average profitability have to do with the industry dynamics of this grade, especially in the cutsize segment. Generally speaking, the uncoated woodfree industry is a bit more concentrated on the selling side, but also slightly less concentrated on the buying side when compared to other grades. This brings more balance in price negotiations, favoring margins for papermakers.

In addition, OEM brands prevailing in the cutsize market will also bring additional "brand value", helping to bring overall profitability levels up for intermediaries and retailers as well. That said, and in spite of the higher than average profitability levels, uncoated woodfree papers will probably be the ones showing the weakest performance going forward. Profitability will barely reach the crisis average during the next two to three years, after being considerably down from that level since 2011.

Newsprint and mechanical grades are expected to perform significantly better during the next three years, especially newsprint, grade that will see its profitability levels reaching the long term average during that period. After that, profitability will decline once more, not only due to rising costs, but also due to a decline in operating rates going forward. By 2018, profitability levels for newsprint and uncoated mechanical papers will come back to the "crisis period" average. Demand declines will heavily influence this renewed negative trend, a problem the industry will face as long as demand keeps the declining mode. Coated woodfree grades will follow a trend similar to the one experienced by uncoated woodfree papers, differing only at the end with a more flat behavior as opposed to the slight decline expected in the uncoated side.

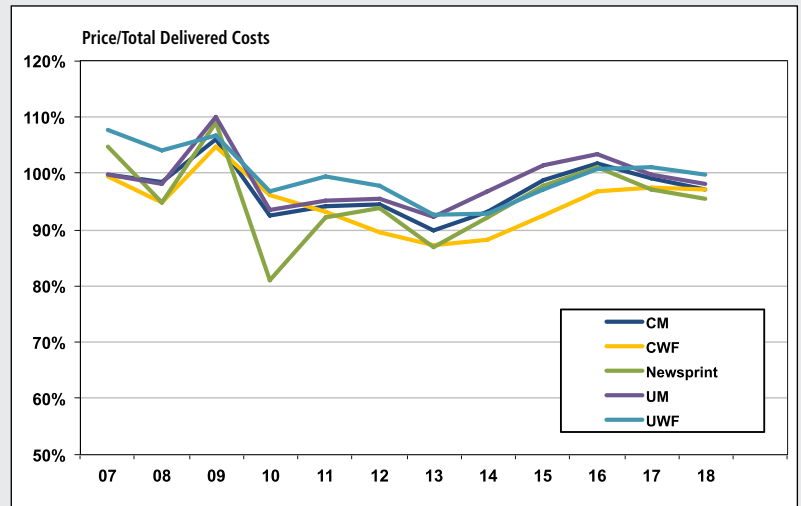
Currently low profitability levels and a grim outlook during the short term will not pass through the industry without consequences. All industry players are struggling not only to keep margins stable, but some of them are also struggling to cover fixed and sometimes even variable costs. On the production side, as would be expected, assets that are on the high end of the industry cost curve are experiencing more pressure than those on the lower end. Generally speaking, small independent producers populate the high end of the various industry cost curves. These small producers are normally running small, non-integrated machines that will incur not only higher variable costs, but also higher fixed costs due to the lower efficiency and productivity levels common among such machines.

**Figure 1 - Average Western European Profitability (All Grades)**



Note: Total costs include mill operating costs, depreciation, interest, SG&A and delivery.  
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Capacity closures and cost reduction programs among paper producers will be a familiar strategy in the years to come. These measures will not only occur among small independent producers and assets on the high end of the industry cost curve, as companies better positioned on the cost curve who are also suffering from low profitability levels are expected to follow similar strategies as well. If the industry is to come out of the profitability problem it is right now, all players in the industry will need to react. Small independent players, besides having significantly less flexibility and alternatives to be more pro-active in addressing capacity and profitability problems, also represent less than 10% of the total industry capacity. Out of the nearly 90 companies in the industry currently, around 60 firms are considered to be in this group, meaning that even if all 60 companies were to shut down, the industry would most probably still suffer from overcapacity. Therefore, it is up to the approximately 30 larger companies to take



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a more decisive approach to the overcapacity problem and alleviate the ongoing profitability issue currently affecting the paper industry.

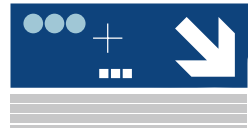
**Figure 2 - Western European Profitability Trends per Grade**  
Price/Total Delivered Costs

\*Author's references: Alejandro Mata, Economist, European Forest Products, author of the *Paper Trader Europe*, the *European Graphic Paper 5-Year Forecast* and the *European Graphic Paper 15-Year Forecast*, works out of RISI's Brussels office and can be reached at Tel: +32 (0)2 536 07 49, Email: amata@risi.com

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