



# Pulp and paper industry dodges troubled economic scenario

2015 results and perspectives for 2016 point to a positive year and continued investments in the pulp segment, as well as strategies in the paper segment to overcome difficulties stemming from stagnation in the internal market

**T**he latest results on Brazil's Gross Domestic Product (GDP) divulged by the National Institute of Geography and Statistics (IBGE) show a 1.7% drop in the third quarter of 2015, compared to the previous quarter. In the comparison against the third quarter of 2014, the Brazilian economy posted a 4.5% retraction. Considering the entire year of 2015, the indicator that measures the economy's performance points to a 3.8% drop.

According to economist and former finance minister Mailson da Nóbrega, the economic results for 2015 reflect the mistakes of the current economic policy. "The disastrous macroeconomic matrix,

the incredible intervention of the electrical sector, the control over fuel prices and the drop in investments in the petroleum chain are the main causes of the economy's worst recession since the early 1990s," he said.

Also according to Nóbrega, industry was the sector that paid the biggest price for the economic management mistakes. "The diagnosis that there was a demand problem, when in fact there was a supply problem, led the government to implement a series of measures to incentivize consumption: tax exemptions, subsidies without adequate focus and other misguided measures. As a result, an unsustainable

drop in unemployment, salary gains above productivity, inflationary pressures and leak of the excess demand going abroad, increasing imports. The unit cost of labor, measured in dollars, increased more than 50%," he said. The former minister also says that the lack of reform worsened logistics operations due to transport infrastructure deficiencies and that the poor-quality tax system worsened. "All this resulted in a productivity drop in the industrial sector and a dramatic reduction in its competitiveness."

In spite of being inserted in an unfavorable economic context, Brazil's pulp industry posted good results last year. Preliminary data presented by the Brazilian Tree Industry (Ibá) shows that the commodity's production in 2015 amounted to 17.2 million tons, an increase of 4.5% over 2014 volume. Export volume increased 8.6% in relation to last year, totaling 11.5 million tons.

According to Elizabeth de Carvalhaes, CEO of Ibá, the high export volume already demonstrated that the pulp segment would benefit from the current exchange rate. She said, however, that there are many other factors that set pulp apart and practically isolate it from other commodities. "In addition to exporting and counting on a rising US dollar, traditional external markets are very well consolidated and contributed to these results", she said, referring to the economic recovery in the United States, which led pulp sales to undergo a moment similar to this recovery.

Exports to North America totaled US\$984 million, which amount represents an increase of 1% in relation to 2014. Elizabeth also referred to Europe's recovery, which is growing slowly, but stable, and led exports to grow 3.3%, totaling US\$2.1 billion in 2015, as well as China's performance, which posted a significant increase in volume, registering an increase of 8.8% in relation to 2014, totaling US\$1.8 billion.

"If we take an even closer look at the behavior of commodities, it is possible to note that, instead of losing in pricing, like minerals and agricultural commodities, pulp was priced four times in the year, increased volume and consequently revenues, resulting in US\$5.2 billion in 2015 and a 6.3% increase in relation to 2014. This situation ended up benefiting from the fact that Brazil has the lowest production cost in the world and for being the most qualified country to produce and place products made from planted trees in the global market," said Elizabeth, pointing out that the sum of positive factors played a key role in the segment's positive performance last year.

Also, in looking back at the facts that marked the pulp segment last year, Carlos Alberto Farinha, vice-president of Finnish consulting firm Pöyry, points out the good margins conquered by Brazilian players over the last year contributed to the start-up of Celulose Riograndense's mill – which has an annual production capacity of 1.8 million tons, when adding line 1 and line 2 with the Project Guaíba 2 start-up in May 2015 – and did not cause major impacts on prices. *(In January 2015, Celulose Riograndense was the Cover Story of O Papel magazine)*

Even though export-oriented segments are benefited by the current exchange rate and by the stabilization of external markets, the systemic competitiveness that comes from cost reductions, innovation, efficiency gains and higher productivity, continues being hindered by the already well-known "Brazil Cost", which, according to Nóbrega, stems from dysfunctions in the tax system, anachronism of the labor system and infrastructure deficiencies. "In normal conditions of economic balance, companies find expansion opportunities in both the internal and external markets."

Today, however, there is a clear imbalance. The significant exchange rate depreciation offsets a large part of the industry's loss of competitiveness, having also reduced the unit cost of labor in US dollars. A major part of the sector recovered its capacity to explore the external market, which many companies are already doing. In the internal market, notwithstanding the segments that benefit from an exchange rate depreciation (those that substitute imports), industry suffers the consequences of the recession, drop in consumer confidence and reduced demand and credit supply," explained the economist.

The economic situation justifies the very clear difference in performance between the pulp and paper segments submitted to the internal market. According to preliminary Ibá data, total paper production amounted to 10.3 million tons last year, 0.5% below the volume registered in 2014. Domestic sales also posted a decline in relation to the previous year, closing the year at 5.4 million tons and a 4.6% drop.

In looking at the performance of each segment that comprises the country's paper industry, Ibá's figures show that the packaging segment produced 5.4 million tons in 2015, representing an increase of 1.6% in relation to 2014. Exports in the segment also increased in the period: the 727 thousand tons exported represented an increase of 7.9% compared to 2014.

According to Nóbrega, industry is the sector that has paid the biggest price for the economic management mistakes

## Vilas Boas: In terms of toilet papers, two ply continued gaining market over single ply toilet paper, ending the year with 38% of total toilet paper production in 2015

Domestic sales in the segment, however, registered a 0.9% drop in relation to 2014, totaling 1.7 million tons.

Also, according to preliminary data from Ibá, cartonboard production totaled 692 thousand tons last year, which amount represented a 1.4% drop in relation to 2014. Domestic sales of cartonboard registered an even bigger drop, 5.9%, totaling 507 thousand tons in 2015. Exports, however, increased 14.1% compared to 2014, totaling 186 thousand tons.

According to the Brazilian Corrugated Board Association's (ABPO) *Statistical Report*, the shipping of boxes, accessories and cartonboard sheets totaled 3.3 million tons in 2015, representing a 3% drop in relation to the previous year.

In analyzing the data presented by the segments that comprise the packaging sector, Anguti Estatística's director, Pedro Vilas Boas, informs that the sales drop in the segment occurred mainly due to the country's industry performance. "Even though wastepaper, the main raw material of this segment, did not undergo price increases like pulp, which contributed to production costs, the sector ended up being impacted by the reduction in consumption."

In 2015, the packaging sector also underwent some movements that strengthen the consolidation trend, such as the deal established between Suzano Papel e Celulose and Ibema Companhia Brasileira de Papel. The packaging segment was also impacted by the inflow of foreign investment in the country's industry, with International Paper's acquisition of Orsa, and Smurfit Kappa's acquisition of Inpa Embalagens and Paema Embalagens. "It is a clear demonstration that international packaging producers continue with a positive outlook of the sector, in spite of the economic crisis Brazil is experiencing. Brazil's paper market possesses expertise not found in other regions. They are even taking advantage of this crisis moment to make these acquisitions," said Farinha, who has an optimistic medium to long-term outlook.

In turn, production in the printing and writing segment totaled, according to Ibá figures, 2.4 million tons in 2015, representing a 4.8% drop in relation to 2014 production. Domestic sales last year registered an 11.5% drop compared to sales in the previous year, totaling 1.5 million tons. By exporting 945 thousand tons in 2015, the segment posted a 9.5% increase in relation to 2014. "It's a market that is truly saturated. When looking at import rates of these papers in 2015, we can see that they present a major negative scale, of more than 40%.

This demonstrates the clear and expressive slowdown in demand, not just the effects of a higher US dollar rate. Lack of consumption played an important impact on the reduction in imports," said Elizabeth.

Such fact also contributed to tax-exempt paper, which historically faces predatory and unfair competition, given its illegal use for commercial purposes. In addition to the reduction in demand, Levi Ceregato, president of the Brazilian Printing Industry Association (Abigraf Nacional), says that the increase in the import tax rate and in the US dollar exchange rate were natural barriers that led to a significant reduction in the supply of paper that came from abroad. "Nonetheless, Ibá and Abigraf continue working together to prevent fraud related to tax exempt paper," he said about the joint work that's also yielding positive effects.

Manoel Neves, Economic Studies manager at Pöyry, considers that the balance between the drop in imports and the increase in exports in the printing and writing paper segment as a whole had a less-negative result than expected. "We can consider that production remained stable in relation to 2014, due to this dynamic between imports and exports."

According to Ibá statistics, newsprint experienced a decline in production and domestic sales in 2015, producing 97 thousand tons in the year, 7.6% less than in 2014, and selling 95 thousand tons, a reduction of 9.5% in relation to the year before. Newsprint exports last year were similar to the year before, totaling 2 thousand tons.

The production of specialty papers, which comprises a series of different products, totaled 487 thousand tons last year, 1.7% more than produced in 2014. Furthermore, domestic sales fell 0.2%, totaling 411 thousand tons in 2015. Exports grew 39.8% last year, totaling 179 thousand tons.

With regards to the printing industry as a whole, the fourth quarter of 2015 suffered a double-digit drop, shrinking 18.6% in relation to the same period in 2014, according to Abigraf calculations, based on IBGE's Monthly Industrial Survey. For the year, the drop amounted to 13.8%, its worst mark since 2003.

"We expected that, in 2015, we would be able to recover the small losses suffered the previous year. However, given the current economic environment in the country, particularly the lack of confidence at the political level, we experienced a reduction in print paper demand, except in the packaging sector, which was able to remain at the same level in certain segments, and even grow in others," said Abigraf's President. Among

the factors that led to these results, Ceregato pointed out the 12% increase in the price of paper, the +40 percent increase in electricity cost and 20% increase in inputs like sheets and ink. "All this could have been overcome if we had a vibrant market. However, it's actually shrinking. Today we are at 70% of occupied productive capacity, which reflects a 30% idleness rate," he said.

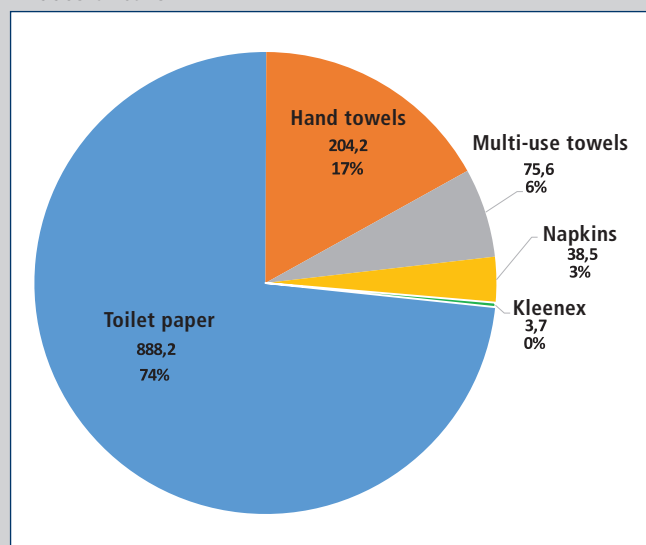
In the tissue segment, all types of paper, except for two-ply toilet paper, registered a drop in production and sales compared to 2014, according to data from Anguti Estatística. In all, 1.21 million tons were produced in 2015, which represented a 2.3% drop in relation to the previous year. "This drop in production and sales volume had not been seen in many years and happened at a moment when the industry was concluding an expansion phase. As a result, companies ended up working with a high idle rate and the balance between supply and demand was achieved by stopping machines and, in the case of smaller companies, stopping

#### Breakdown of Brazilian paper production in 2016, according to type

Category	1,000 t	Share %
Packaging	5,459	52.3%
Printing/ writing	2,588	24.8%
Tissue	1,210	11.6%
Cartonboard	692	6.6%
Others	487	4.7%
<b>Total</b>	<b>10,436</b>	<b>100.0%</b>

Source: Ibá  
Tissue Paper Source: Anguti

#### Breakdown of tissue paper production in Brazil 2015. In 000s of tons



production on weekends and, even, production times during the day when electricity is more expensive," said Vilas Boas.

The segment's participation in total paper production in Brazil amounted to 11.6%, registering a small drop in relation to 2014, when the segment accounted for 11.9% of total paper production in Brazil. "This is basically due to the increase in paper production for packaging, which, benefiting from exports, was able to maintain a positive production performance in 2015, compared to 2014," said Anguti's director.

Among all types of tissue paper, toilet paper (all types) accounted for 74% of production, followed by paper towels, which had a volume of 204.2 thousand tons produced in 2015, representing 17% of total volume.

Vilas Boas also informed that in terms of toilet paper, two ply continued gaining market over single ply toilet paper, ending the year with 38% of total toilet-paper production in 2015, whereas this figure amounted to 37% the year before.

#### Perspectives for 2016 include continuity of investments

In spite of the scenario that involves the next months still being unclear, given uncertainties related to the federal government's strategies to promote economic recovery, 2016 promises to be a difficult year. "The recession is expected to continue with a GDP drop of at least 3% and inflation close to 8% or more. Brazil may experience two consecutive years of recession, which is something that has not happened since 1930-1931. In industry, concerns also refer to the effects of a challenging scenario in the global economy, given the risks of a strong slowdown in China's economy and dubious signals being emitted by the US economy," said Nóbrega.

According to Elizabeth, the external market tends to continue growing, even though economic recovery is not being as swift as desired, which fact could reflect on inflation and exchange rate. "In this first semester of the year, the situation of 2015 will tend to repeat and consolidate itself. There's no forecast that pulp importing will drop in the European, North American or Asian markets, especially China," she said.

Pöyry's vice president agrees with the fact that perspectives for the pulp segment in 2016 are linked to the external scenario, since the entire sector is practically all export-oriented. "The exchange rate continues similar to 2015, and shouldn't change all that quickly, which is also another attractive factor for new investments," he said about the favorable circumstance in the segment.

When talking about the Chinese economy, Farinha says that the most realistic expectations point that growth will no longer be double-digit, resulting in a GDP of between 6.5% and 7%. "It is absolutely natural for an economy of this magnitude to not continue growing at a rate of +10% a year. Nonetheless, it continues having a very big and expressive volume." He pointed out that there are other characteristics involved in this market, such as environmental factors.

"The substitution of fiber continues occurring, leading to the stoppage of small, inefficient production units. Even though it has an expiration date, this substitution that favors hardwood pulp is not expected to cease in 2016." Impact on prices shall also not affect the sector abruptly this year. "Celulose Riograndense's production in Guaíba (RS) shall stabilize yet this first semester. The price ends up suffering some downward pressure, which should stabilize, possibly by the middle of the year," said Farinha.

With regards to the internal market, Ibá's CEO said the following: "We still do not have data that allows us to believe that volume lost can be recovered, since there isn't a satisfactory forecast of stability in the domestic market. To talk about recovery would be audacious in a scenario where the important thing is to halt the fall, and recover idleness at mills on account of the economic difficulties faced in 2015."

A few specific facts, however, can contribute to the leveraging of certain segments, such as printing paper. According to Abigraf's president, the Olympic Games and elections that will take place in the country in the months of August and October, respectively, have the potential to boost sales, not only directly by what is consumed by the organization of these events, but also on account of so-called cascade effect, with increases in the use of paper by businesses working in these events.

"We believe that these factors have the possibility of being multiplying vectors of printing material consumption in 2016," said Ceregato. He points out that investments of US\$5 billion dollars in machinery and equipment on the part of Brazilian businessmen over the last five years demonstrate the strong belief in the printing sector. "In fact, businessmen must be protagonists of purposeful change in the country, believing in the powers set forth in the Constitution, and contributing to the generation of jobs and all other activities executed by industry."

Considering a broader scenario, that considers the pulp and paper industry as a whole, Elizabeth pointed out that the sector was capable of sustaining the investments foreseen, such as the announcement of two major investments made last year. Fibria kicked off Project Horizonte 2 at the end of October 2015. Expansion of the global leader in eucalyptus pulp production will allow the Três Lagoas (MS) production unit to jump from the current 1.3 million tons of pulp produced annually to 3.05 million tons, as it builds its second production line with an annual capacity of 1.75 million tons of pulp. Eldorado Brasil also continued the construction of its second pulp production line in the state of Mato Grosso do Sul (Project Vanguarda). The expansion will add 2 million tons of pulp per year to the current 1.7 million tons produced by the company. **(In May, read the cover story about Eldorado Brasil in O Papel magazine)**

In turn, Klabin inaugurated Project Puma in Ortigueira (PR) earlier this year. The production unit will have an annual pulp production capacity of 1.5 million tons of three types: hardwood, softwood and fluff pulp. **(Next month's Cover Story of O Papel magazine will be on Klabin)**

**Suzano, which was the Cover Story of the February issue of O Papel magazine**, also entered the fluff pulp segment last November, with an initial production capacity of 100 thousand tons/year, to be

produced from hardwood pulp. "These are innovations for the Brazilian market, since, until now, Brazil was not a relevant producer of this type of pulp," said Elizabeth. She informed that in spite of this economic crisis in the country, Brazilian products continue with good demand in the external market, allowing for the consolidation of investments in the sector. "The forestry sector can readjust its dates, accommodate a bit here or there, undergo a big and complex learning curve with a long-term raw material, compared to other industrial sectors, but it needs to continue with its investments," she said.

Expansion of the sector's portfolio and the resulting entry into different segments are more trends that began to unfold in 2015 and should continue over the next years. The investments made by Suzano in the construction of two reel production units for toilet paper conversion in the cities of Mucuri (BA) and Imperatriz (MA), which will total 120 thousand tons per year, and the installation project of the first lignin extraction industrial plant of South America are just a few examples. "It's perfectly logical to avoid having to rely on a single market. But, more than that, it's a path for tapping all the potential of planted forests. There is certainly an integration trend going on between all components of wood that generate countless products and it's highly linked to the future competitiveness of players that comprise the forestry sector," said Neves, of Pöyry.

In looking back at the investments made over the last years by the pulp and paper industry, BNDES manager André da Hora informs that in 2014 investments totaled R\$8.02 billion: R\$ 5.26 billion in pulp, R\$ 1.02 billion in paper and R\$ 1.73 billion in forest base. In 2015, the total amount invested increased to R\$ 8.47 billion, as follows: R\$ 5.66 billion in pulp, R\$ 1.02 billion in paper and R\$ 1.78 billion in forests.

According to the BNDES manager, investment projections for the 2016-2018 period amounts to R\$ 21.72 billion: R\$ 11.57 billion in pulp, R\$ 4.63 billion in paper and R\$ 5.51 billion in forest base. For him, organic growth continues being an important vector of the industry's expansion, as demonstrated by the latest big projects developed in Brazil (Suzano, CMPC and Klabin), as well as those that are in their development phase (Fibria and Eldorado), as well as Arauco/Stora, in Montes del Plata (Uruguay), in 2014, and APP's in Sumatra (Indonesia), which is in its construction phase. "These expansions are based on cost competitiveness, which has as backdrop the substitution of higher-cost market pulp mills; integrated and softwood pulp plants, which is currently being negotiated at a lower price than BHKP," said da Hora.

Continuing with his analysis of market conditions, he points out that behind the investments announced there is also a movement of mergers/ acquisitions/ partnerships occurring around the world. "This trend is already considerably discussed among top players. The logic is the pursuit of synergies, scale gains and, consequently, greater market power, aimed at gaining competitiveness in relation to direct low-cost competitors." Da Hora explains that this movement is more strategic and complex. "It involves a negotiation that requires more than understanding supply *versus* demand, and is not associated to market windows that normally guide capacity expansions," he said, regarding what should occur over the next years. ■