



ECONOMY IS SHOWING IMPROVEMENT, BUT STILL CALLS FOR CAUTION ON THE PART OF THE COUNTRY'S INDUSTRY

In addition to the domestic market, analysts and spokespeople of the sector analyze the international scenario and point out which aspects should impact pulp and paper players in 2020

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Having faced the challenges caused by last year's economic stagnation — according to the Brazilian Institute of Geography and Statistics (IBGE), the country's Gross Domestic

Product (GDP) grew 1.1% in 2019 —, the country's industry prepares for a more positive scenario in coming months. According to Marcio Funchal, Director of consultancy Consufor, the expectation is that GDP will grow slightly above 2%

in 2020, while global growth expectations are in the 3% to 3.5% range.

Despite the improvement, the economic outlook projected calls for caution. It is still early to celebrate and expect expressive results. "Perhaps the

most prudent strategy of companies for the next short-term cycle is to maintain the financial health of businesses, preparing for a new window of growth for the global economy,” says Funchal.

According to the contextualization of Consufor’s director, perspectives for the hardwood pulp segment indicate a challenging period ahead. The Asian market is currently undergoing a profound restructuring of its production chains. As a result, we see an excess global supply of pulp. “Balancing inventories of bleached-pulp consuming plants will take a few more months,” says, Funchal. “Additionally, China in particular, has suffered an increase of contaminations in the food production chain, which led to the new coronavirus problem worldwide. This will negatively impact various segments of the global industry such as food and immediate-consumption items mainly, but also pulp and other commodities,” he said.

The fact that inventories in China’s supply chain are well above normal, combined with the uncertainties surrounding global growth and the trade war with the United States, caused 2019 to be different than expected in terms of volumes and prices. According to data presented in the Brazilian Tree Association’s (IBÁ) latest issue of Cenários Ibá, Brazilian pulp production totaled 19.6 million tons last year, a negative variation of 6.6% in relation to the volume produced in 2018 (21 million tons).

According to Marcio Farid, Basic Materials Analyst for Latin America at J.P. Morgan, pulp prices in China (both hardwood and softwood) fell roughly 40% between the peak high in late 2018 and the lowest quotations at the end of 2019. The bank credits the significant drop to two key factors: weak paper demand in Europe and the inventory reduction cycle in China. “European demand fell 10% (which represents a loss

of more than 1.5 million tons of pulp), especially because of weaker domestic demand, due to slower economic activity and increased competition in the export market,” said Farid about the first reason.

In China, pulp producers restocked both pulp and paper in 2017 and 2018, when prices were rising and country sentiment was positive. “The trade war escalation between China and United States at the end of 2019 weighed on sentiment and the overall consumption of pulp and paper leading to an inventory reduction in the supply chain by paper producers. This occurred at the same time when global pulp production was recovering from record disruptions in supply reported in 2017 and 2018,” said Farid about the second reason behind the drop in prices.

The increasing normalization in pulp production, coupled with the inventory-reduction cycle in China, resulted in a very challenging scenario for pulp sellers in the fourth quarter of 2018. “Suzano and Fibria, two distinct companies at the time, decided to hold off on sales to Chinese

customers, foreseeing that buyers would return to the market after the inventory-reduction cycle. However, shipments from Brazil, and particularly from Europe, continued very strong and volumes began to accumulate at ports in China and Europe,” said J.P. Morgan’s Basic Materials Analyst for Latin America. Inventories at European ports reached a peak of 2 million tons of pulp compared to normal levels between 1.1 and 1.3 million tons, having reached 2.4 million tons in China compared to a normal volume of 800 thousand tons,” he said about the situation observed last year.

Also according to Farid’s retrospective, Suzano continued to limit sales to China in the first semester of 2019. All other global producers, however, continued selling to China at market prices, causing Suzano to lose market share. “When Suzano announced that it would cut production in Brazil and reduce shipments to China, surplus inventory was already very high. High inventories and being so close to end consumers in China provided buyers a certain level of comfort – they were in no hurry to buy since there was a lot



KLABIN/OSCOSURE

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CONSULFOR DISCLOSURE

In verticalized companies, there are several examples of investments relating to productivity increase, production efficiency and forest management

of product volume real-close to them, when usually they have to wait 40 to 60 days for shipments to arrive from Brazil.” Purchasing activities began to improve when Suzano decided to be more flexible in its commercial strategy. “The result was an aggressive drop in pulp prices, but we also began to see inventories in ports declining,” said Farid.

At the end of 2019, the risks of a trade war also diminished, which improved business and consumer sentiment in China, making it the right moment to begin restocking. Customers also took into consideration the fact that pulp prices were at a record low.

According to the Basic Materials Analyst for Latin America at J.P. Morgan, the fourth quarter of 2019 was also marked by an improvement in demand, due to the printing season preceding the 2020 school year and the 70th anniversary of China’s Communist Party. This season allowed for restocking activities to continue until the end of 2019, causing the sentiment of global

pulp sellers and buyers to improve at the beginning of 2020.

This year, informs Farid, potential disruptions in the supply of pulp, such as the strike in Finland and low water levels in Indonesia, are also providing a better perspective for pulp prices. But the risk of pulp prices remaining low continues latent, extending for longer than expected. “The main concern is demand in Europe, which still has uncertain perspectives for 2020. Brazilian companies have been able to gain market share in the United States on account of several mill-production closings and increased demand for tissue, but strong competition in the United States and China could limit future growth,” said J.P. Morgan’s Basic Materials Analyst for Latin America.

The scenario that developed throughout 2019 and led to the significant drop in pulp prices — at the beginning of the year, the price per ton of hardwood pulp began being sold for USD 770 in China and closed the year at a price of

USD 450 — should have consequences this year. “Unless there’s a very strong and very quick recovery in the next few months, the average price for this year will be low since the starting point is very low,” said Thiago Lofiego, Senior Analyst responsible for the Pulp and Paper, Steel and Mining sectors at Bradesco BBI. While the average price for hardwood pulp was USD 570, the estimated average for this year is around USD 490. For 2021, says Lofiego, the average increases to USD 550, as a result of the gradual recovery that will begin as of the second quarter of this year.

In terms of expected demand for 2020, Lofiego says that the United States should maintain its habitual consumption, with stable behavior in relation to what happened last year. Europe, in turn, still offers the risk of a drop in consumption, in view that inventories continue high in these countries. “The key player in the market, as has been in recent years, is China. This year, papermakers began to restock pulp, for having reached a

consensus that the price of USD 450, seen at the end of 2019, had hit the bottom. When this happens, we usually see a restocking process take place. This year, however, should be one of increased pulp demand in China, with potential capacity adjustments on account of lower prices,” said Bradesco BBI’s senior analyst, adding that global demand should increase around 1.1 million tons in 2020, an average considered normal.

Focusing on supply, what there is to be adsorbed by the market is basically Suzano’s volume, which is now using its entire production capacity again. “The company should begin to fight for market share. With this, capacities that were idle should resume production, leading to an increase in relation to the supply volume registered last year,” said Lofiego, justifying the reasons that lead the market to bet on a gradual recovery in prices. “If on one hand demand tends to improve, on the other, supply should grow too.”

The coronavirus factor can also be relevant in the global scenario, as pointed out by the senior analyst at Bradesco BBI: “the first quarter of this year will potentially be weaker than expected on account of this pandemic. The level of activity in China should be much weaker and, consequently, pulp and paper consumption also.” This could weigh on the decision of producers to increase prices in the short-term and even cause changes to the market trajectory expected.

In looking at the main investments announced for Latin America, Lofiego points out that none should occur over the next months. The Arauco MAPA expansion project in Chile, with a production capacity of 1.3 million tons of softwood pulp, is expected to start in 2021. In turn, startup of the UPM project in Uruguay, with a production volume of 2.1 million tons of softwood pulp, is scheduled for 2022.

In Funchal’s opinion, since the very short-term scenario does not show significant market or regulatory changes within the national and international contexts, pulp players should continue working along the strategic lines adopted in 2019. M&As are among such strategies. “The consolidation of operations was visible both in the pulp (brown and white) and paper segments, which fact demonstrates that even in a scenario of uncertainty such as we see in the short-term, investors and managers of corporations believe in the soundness of activities,” said Consufor’s Director.

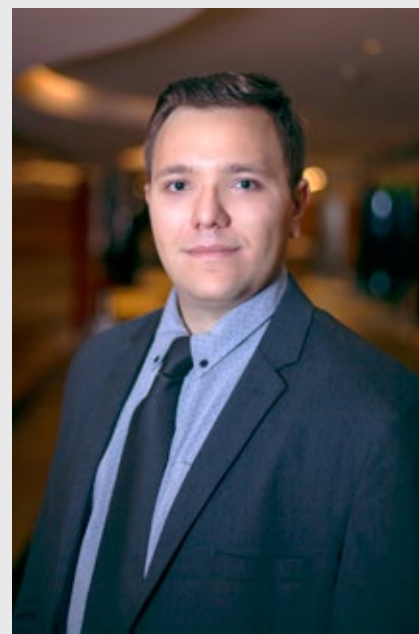
Process optimizations in the pursuit of productivity and operational-efficiency gains is another strategic front adopted by companies in the sector. “In verticalized companies (forest + industry), there are several examples of investments relating to productivity increase, production efficiency and forest management, such as the intensive use of drones, meteorological sensors, sensors for measuring production, and development of new machinery for wood harvesting and transporting. In the industrial niche, we see projects aimed at utilizing water from boilers, efficient waste treatment, energy efficiency, automated control of production and various others,” said Funchal.

Another trend observed among verticalized companies is a reduced dependence on wood coming from the regional market. “Important purchases of forest assets were made and major long-term wood-supply agreements were signed with big professional forest producers (big foresters and investment funds),” said Funchal, pointing out that such actions impacted the purchase and sale market of unsawn wood in several states, in a clear signal of concern about the future of the business in face of new industrial expansions.

Paper segments to expect a less-friendly year for foreign trade

Focusing on growth projections for Brazil’s economy in 2020, Rafael Barisauskas, Economist for Latin America at Fastmarkets RISI, informs that family consumption is expected to improve in relation to last year, thanks to job creation and more credit. “We also believe that industrial production will improve compared to the 2017-2019 period when performance was very weak and below what the market expected as a whole,” he said, pointing out that this should have a positive impact on packaging demand since the top segments in terms of demand are expected to grow (food, pharmaceuticals, hygiene and cleaning, plastics and rubber).

The scenario, however, presents a few risks, such as confidence, both on the business and consumer side, which continues lacking drive and limiting bigger long-term investments. “As a result, job creation tends to be slow and the economy’s recovery rate sluggish,”



FASTMARKETS RISI DISCLOSURE

Barisauskas: Despite all the instability, important sectors that demand packaging (food, pharmaceuticals, retail) performed well

said Barisauskas. He also pointed out that there are still some pending issues related to public indebtedness and fiscal adjustment, which factors also hinder public investment capacity and Brazil's attractiveness for long-term private investment in many key sectors.

In looking at last year's performance of the paper and packaging segment, Barisauskas said that, in general, it's a sector that accompanies the rhythm of the country's economy. "Clearly, there are some sectors that are less sensitive to economic oscillations, but the trend of following GDP is valid. When 2019 started out, the expectation was for a quicker, more consistent recovery of the economy as a whole, which did not happen. Nonetheless, despite all the instability, important sectors that demand packaging (food, pharmaceuticals, retail) performed well."

Ibá's latest analysis shows that packaging-paper production totaled 5.4 million tons in 2019, representing

a 2.4% increase in relation to 2018 production. Paperboard production also grew 2.8% versus the previous year, closing 2019 with a production volume of 761 thousand tons.

According to the analysis by Fastmarkets RISI's Economist, the political and social debate involving economic reforms proposed by the government generated considerable uncertainty in the internal market and halted, in large part, the rhythm of demand and private investments in 2019. From a government spend perspective, the impacts were even more negative, in view that public investing was limited. The delay in defining themes also contributed to make the landscape even more volatile.

Challenges aside, the packaging sector's result for 2019 was positive. Pedro Vilas Boas, director of Anguti Estatística, informs that packaging paper producers benefitted from strong demand in the last quarter of

the year. "In December, the Brazilian Corrugated Board Association (ABPO) registered shipments of 286 thousand tons in paperboard boxes, sheets and accessories, which was 7.5% more than the same month in 2018," he said, reinforcing the excellent result achieved.

The good sales performance was accompanied by a drop in raw-material prices. The combination led to a margin-recovery year, also favored by paper-price increases in the last months of the year.

The positive sales volume at the end of 2019 and beginning of this year led industries to reduce paper reel inventories, including a reduction in wastepaper prices. "This situation may suffer changes as of the second quarter, when we may see a shortage of wastepaper. This could pressure the production cost of paper and lead to eventual increases in raw-material prices," said Vilas Boas.

The political crises in neighboring Latin American countries also played an important role in the sector's



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performance in Brazil last year and promises new impacts this year. According to Barisaukas, foreign investors perceive Latin America as a whole with less confidence when there's a problem in a given country in the region, also impacting Brazil.

The fact is that the export scenario continues permeated with uncertainties. "Globally, 2020 tends to be less friendly for external trade than previous years. There are several factors that should limit international trade and demand for packaging in 2020, such as trade/tariff disputes involving mature economies, Brexit effects in Europe and even the risks of a global pandemic following the fast increase of coronavirus contaminations in China," said Barisaukas.

In Latin America, the scenario is also not very clear. Even though perspectives are positive for the main markets in the region – Chile, Colombia, Peru and Mexico –, they are negative for Argentina. "There always exists a risk relative to political instability in the region, in view that things can get out of control very quickly. Additionally, it's common that, when things do not go well in Argentina, Brazilian exporters are affected, since the country is a big consumer of Brazilian manufactured products, which in a way affects the packaging segment," said Fastmarkets RISI's economist.

Vilas Boas points out another mitigating factor: "after years without news, we may have the startup this year of major production expansions at two Brazilian mills, whereby the two new capacities are relying on the external market to absorb their production. As such, the packaging sector should have a challenging year, particularly in the kraftliner market, as well as the recycled paper market. Nonetheless, since these capacities should only begin to appear in the market in the last months of the year, their impacts will be felt more profoundly in 2021".

According to Ibá, Klabin accounts for BRL 9.1 billion of the BRL 32.9 billion in investments projected or underway until 2023 by the cultivated trees sector. The company's investment is earmarked for a new line in Santa Catarina that will produce kraftliner cardboard and paperboard. In turn, WestRock, which inaugurated a kraftliner cardboard mill in São Paulo in 2019, expects to invest another BRL 1.3 billion to increase production of the same product at its Santa Catarina unit.

In looking at the tissue segment, expectations are optimistic considering the expected growth of Brazil's economy in 2020. "With all economic indicators showing a recovery in internal consumption, the tissue industry should continue being favored. Additionally, economic recovery should also provide for an improvement in the institutional segment, which sales are more dependent on the growth of other economic sectors," said Vilas Boas.

According to the Ibá newsletter, the tissue segment produced 1.3 million tons in 2019, representing a 6.2% increase in relation to 2018 production.

Should these positive forecasts come true, hand towels should also perform well this year. The problem, Vilas Boas regrets, is that the sector faces a chronic problem: difficulty negotiating its products, particularly with supermarkets, which tend to have greater negotiation power. "This means we may see a drop in prices over the next months," said Anguti Estatística's director.

The prices of raw materials used to produce tissue — which allowed the segment to recover its margins in 2019 — should continue stable. "Even though pulp stopped losing value abroad, economic conditions outside Brazil do not point to strong growth recovery, which should maintain prices stable or with moderate and manageable increases



ANGUTI ESTATÍSTICA DISCLOSURE

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for consumers. As such, we should not see supply problems in the next months. The same goes for white wastepaper, even though volume is low due to stagnation in printing and writing paper consumption," said Vilas Boas.

The printing and writing segment resorted to exports to overcome the weak economic moment in Brazil. According to Paulo Hartung, CEO of Ibá, more than one-third of total production (2.4 million tons) in 2019 was exported, which resulted in a 4.3% increase in relation to 2018 exports. "Internally, the market did not warm up sufficiently, which impacted sales. According to the National Union of Book Publishers (SNEL), non-didactic book sales fell 6% in 2019," he said about the segment's performance.

Also according to Hartung, the country should present a small consumption increase throughout the year, which could make the market grow. "Albeit timid, greater consumption could lead non-didactic books to sell more," he said about perspectives for the next months. ■