



NOVEMBER 2012

# REEL TIME

SPECIAL REPORT

Presented by Verle Sutton

## SCA AND COATED FORECAST FOR 2013: It All Revolves Around Port Hawkesbury

### THE BASICS OF FORECASTING PAPER PRICES

There are absolute truths...in all realms. When prognosticating paper prices, it is helpful to consider the following absolute truths:

First, economic growth is important, but generally overemphasized. This has always been the case, but is even more so in recent years with paper demand in secular decline. As an aside, the financial crisis in 2008 was a dramatic exception, and one that was recognized at the time.

Second, disregard the myth that costs have a significant impact on prices when prices are above variable costs. We have proven the poverty of that theory over and over during the last thirteen years.

Third, remember that the supply/demand balance is the primary determinant of prices. It is not easy to always know whether supply or demand will come out on top, particularly since both supply and demand are dynamic factors that never remain stable. However, if we knew the precise supply/demand balance — under all conditions and at all times — we would always know the pricing direction.

Fourth, substitution between grades is substantial, so an analysis of the supply/demand balance must consider a continuum of grades and not just individual grades.

Fifth, in an oversupplied market, pricing will fall to around cash costs (usually a little below the cash-cost levels of the high-cost producers). The forecasting questions that remain are as follows: 1) exactly where is that cash-cost level?; and 2) are high-cost producers willing to go below this level for a time in order to preserve their market positions?

Sixth, the negotiating strengths or weaknesses of the larger producers (versus the larger buyers) have either a positive or negative effect on prices. This impact is significant, but it does not control pricing direction.

Seventh, never underestimate the power of customer inventories.

Eighth, currency swings are not predictable but, when they do occur, can alter cost curves and supply dynamics dramatically.

### DEMAND FACTORS

#### 1. Economic Growth

I had planned a more extensive review of the economy as an introduction to this report, but that review will be delayed.

Briefly, however, the re-election of Obama will mean that the president will continue in his efforts to subsidize pulp companies, windmills, solar power, and ethanol, while he discourages the exploration and development of fossil fuels that have resulted in tens of thousands of new, high-paying jobs in recent years, added billions of dollars in tax revenues, and prevented our economy from falling into a full-blown depression. Obama will do everything he can to tax these “dirty” companies to their knees, while he tilts at windmills and relies on the sun to battle the make-believe demon of global warming. Thankfully, the Republican majority in the house will force the government into gridlock. In spite of the president’s efforts, the power of private enterprise will enable North America to become completely energy self-sufficient within 15–20 years.

The national debt will continue to expand exponentially, while taxes increase.

*(continued)*



Annual welfare costs have risen by 33% just since Obama took office, and now exceed one trillion dollars. Total annual welfare costs now equal the budgets for defense and medicare combined. Under Obama, welfare will continue to be a more and more attractive form of “employment.”

Medicaid will continue its rapid growth so that those people who supposedly *don't* have medical insurance will have, in most instances, better coverage than those who *do* have medical insurance.

Business regulations will increase and business growth will be discouraged.

Meanwhile, the ticking time bomb of massive debt connected to municipal, state, and federal retirement plans will not be addressed and will become an ever-increasing nightmare.

Nevertheless, gridlock, heavy government spending, massive private energy expenditures, a rebound in housing, and what's left of the free enterprise system will result in GDP growth of about 2.5% in 2013. We are not Greece... not yet.

## 2. Electronic Communication

Advances in electronic communication are, of course, the reason that the paper, print, and publishing industries are in such a perilous state. We have, on past occasions, written about the three phases of the electronic revolution: 1) the pre-2000 technologies that resulted in total graphic paper grades peaking; 2) the turn-of-the-century availability of high-speed Internet access that sent paper demand into secular decline;

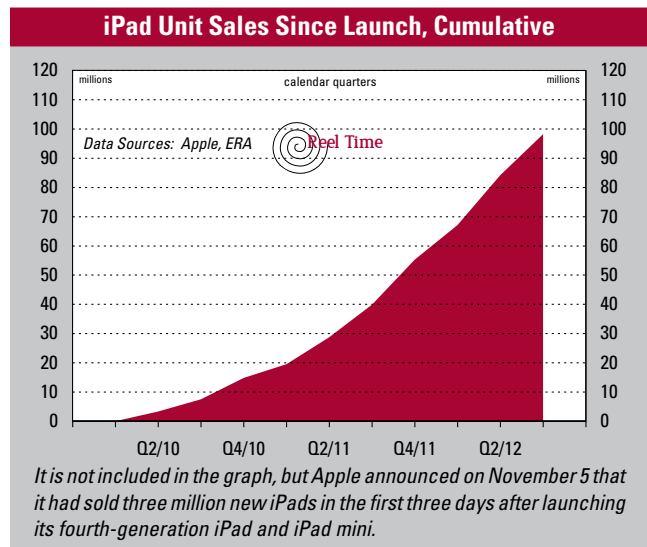
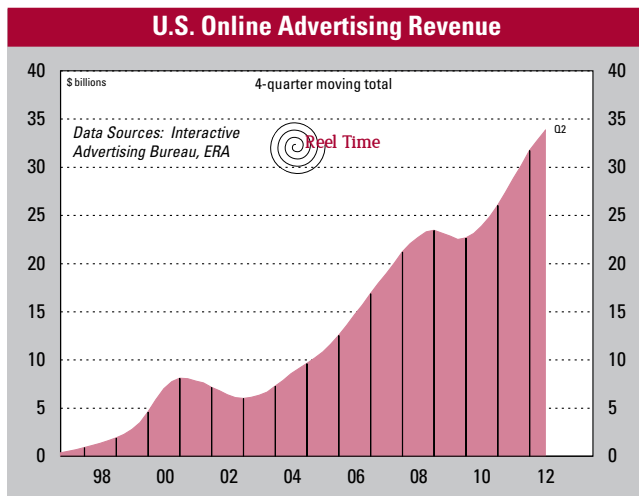
and 3) the development of user-friendly electronic tablets beginning in about 2010.

The impact of these three phases of the electronic revolution on paper demand is both cumulative and ongoing. Today, however, tablets are the primary concern. Prior to 2010, there was no suitable electronic method for delivering paginated media to consumers, e.g., newspapers and magazines. PCs and the Internet did not work very well. Even though print volumes continued to fall, it seemed likely that printed newspapers and magazines still had a lengthy future.

That hope soured, however, as tablets were introduced and we saw how well they worked. Tablets are an effective vehicle for delivering electronic paginated media, and further improvements will be made in the years to come.

The acceptance of tablets by the public has been historic; no other consumer electronics product has grown so rapidly. Growth in worldwide Q3/12 shipments was up (y/y) 43%, with 25 million tablets delivered. GBI, a research firm, expects shipment levels to expand by 400% between 2012 and 2016.

It is hard to believe, but another research company, Strategic Analytics, claims that there are one billion smart phones in use worldwide — out of seven billion total earthlings. It took only sixteen years to reach that level. Smart phones also erode the demand for paper in a number of ways, but that statistic is mentioned here just to intuitively compare smart phones with tablets. Tablets, in the early years, are growing



so much more quickly than smart phones that it would not be surprising for that billion-person level to be reached in half the time (perhaps by 2018).

Erosion of the printed newspaper and magazine will continue in 2013. Tablet growth will impact the volume of catalogs and inserts printed as well.

Electronic substitution is different from other demand factors in that the loss is permanent. Other demand factors — such as the economy and mill/customer inventories — cycle up and down. Not this one. We can never know exactly what the “electronic” loss will be in any single year, but whatever is lost will not be coming back.

### 3. Consumer Inventories...the Difference Between Demand and Consumption

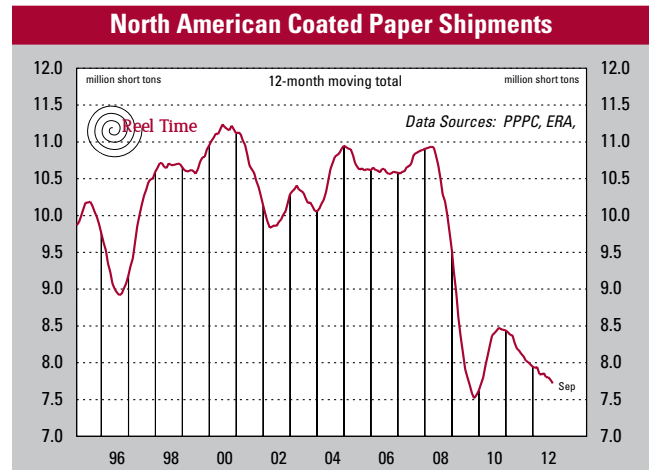
Low consumer inventories are a form of powerful pent-up demand!

My mentor, Ross Hay-Roe, taught us (back in the early '80s) that it is impossible to understand the publication paper markets, and forecast pricing, without recognizing the central role played by inventories — particularly consumer/publisher inventories. When I was new in the coated paper business back then, Ross was the only analyst aware of this piece of the puzzle. That knowledge was crucial: it enabled companies that paid attention to develop pricing strategies that added millions of dollars to the bottom line.

Nevertheless, after all these years, few market participants give inventories their proper due. While it is true that inventories have been reduced in significance — as catalog and especially magazine volumes decline, and as the secular decline in demand gains momentum — the consumer inventory cycle still has the power to propel pricing up, and, at other times, to drive pricing lower.

The best recent example of the control the coated inventory cycle exerts on the market occurred in 2009 and 2010 (see the following graph, which includes both coated grades). During 2009, demand suffered dramatically due to 1) much less actual consumption (from the impact of the financial crisis), and 2) the fact that buyers purchased even less than their companies consumed, driving inventories to rock bottom.

(Consumer inventories tend to decline while prices are falling and increase when prices are rising.)



Then came 2010 (the demand bounce in coated paper actually started in late 2009). Based on our analysis of demand data in 2010 (print shipments, ad-page data, catalog mailings, etc.), we concluded that actual consumption of coated paper in 2010 increased little, if at all. All, or almost all, of the 2010 demand spike was due to the inventory cycle, and pent-up demand. Rather than consumers buying less than they consumed (as in 2009), they purchased more than they consumed in 2010. The inventory cycle difference was roughly 1,000,000 tons (13%). Obviously, a 13% increase in coated demand will almost always lead to a pricing up-cycle, and it did in 2010.

We combined both coated grades for this inventory discussion. We should note, however, that consumer inventory cycles are more pronounced for coated groundwood than coated free sheet. Coated groundwood inventories are primarily dependent on magazine publishing and catalogs, which are less of a factor with coated free sheet. On the other hand, coated free sheet consumer inventories are also greatly influenced by movement in merchant sheet-fed inventories.

We tend to ignore SCA when discussions revolve around inventories, because SCA has always been primarily an insert grade, and insert customers tend not to have the consistent roll sizes required to be inventory-building candidates. It should be mentioned, however, that SCA grades are making deeper inroads into magazines and catalogs than had previously been the case. As such, we might have to bring SCA into this “inventory” conversation before too long.



**Current Coated Groundwood Market Conditions and Consumer Inventories at the Close of 2012:**

Coated groundwood consumer inventories were very low in the summer when the market turned. It was obvious that consumers would have to add to inventory levels, and that this behavior would lead to a very tight market. That is why, in spite of the fact that the supply/demand balance was just barely in favor of producers, we were so certain that pricing improvement in coated groundwood could not be a short-term phenomenon.

But where are consumer inventory levels today? Are they still very low? If they are, then that will help support the current coated groundwood pricing up-cycle.

We all know that coated groundwood supply has been generally hard to source since late July, so buyers did not add as much inventory as they would have liked. Nevertheless, there is no doubt that coated groundwood consumer inventories, in total, are somewhat higher than in late July. In addition, it is clear there are lots of reservation orders in producer backlogs — some that will ultimately not result in firm orders.

On the other hand, just about all coated groundwood mill backlogs are out until January, and sales teams are doing the best they can to ferret out dummy orders and/or overcommit their capacity levels with the expectation that some orders will fall out along the way. In addition, Resolute's coated mill (Catawba, SC) has been running very poorly. Many of Resolute's customers have been forced to scramble, and do their best to find other supply options. I don't know how much paper has been lost by Resolute, but it has been significant.

This additional supply issue (Resolute's production problems) has made it much more difficult for consumers to catch up and build a little inventory security.

In summary, coated groundwood inventories are not at the extremely low July level, but they are still on the low side. Demand during the first quarter of 2013 could be boosted by inventory growth. If inventory-building does add 15,000 tons a month or more to demand in Q1, then coated groundwood pricing will remain firm through Q1/13. A price increase for January is even possible.

However, if buyers do not expect the market to remain strong in 2013, then the current low buyer inventory levels might change very little.

The bottom line is that we can be certain that relatively low consumer inventory levels are a substantial benefit for producers as 2012 winds down. On the other hand, other market factors could offset the pent-up demand benefits of low consumer inventories. Pricing strength into Q1/13 is far from certain.

**Current Coated Free Sheet Market Conditions and Consumer Inventories at the Close of 2012:**

Let's take a few paragraphs now for the neglected coated free sheet market. Strength in coated groundwood pricing did not carry over into coated free sheet. However, once coated groundwood prices began to move up in August, this did halt the decline of coated free sheet prices (which subsequently remained pretty much stable).

When coated free sheet prices were declining early in the year, so were buyer inventories. But since coated free sheet was never in short supply during the second half of 2012, buyer inventories lingered on the low side, where they remain today.

Once again, low consumer inventories represent pent-up coated free sheet demand waiting to be released. However, that potential benefit is not likely to translate into better coated free sheet pricing anytime soon.

## DEMAND FORECAST

### 1. Review of Coated Demand in 2012 and the Forecast For 2013

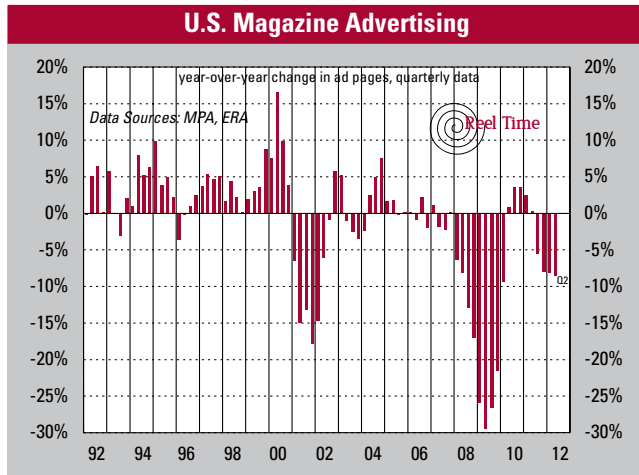
**Demand/Shipments 2012:** A year ago we forecasted that coated demand would fall by 5% in 2012. Through September, the PPPC reports a 5.2% decline in total coated demand. By grade, the PPPC shows demand for coated groundwood off by 4.1% and coated free sheet down 6.2%.

Shipments to North America (by North American producers) have fared a little better, with coated groundwood lower by 4.0% and coated free sheet down by 4.5%. This measure is probably more reflective of the health of the domestic coated market. At the current rate of decline, total coated shipments to North America (by North American producers) will fall by about 320,000 tons in 2012. Consumer inventories might be a little lower (relative to a year ago) as 2012 nears its end, but most of the decline in coated shipments is simply a function of lower consumption associated with the ongoing reduction in publishing and print advertising.



**Demand/Shipments Forecast 2013:** On the positive side, retail sales have been encouraging lately. Second-quarter catalog mailings were also up by more than 2%, a pleasant surprise after falling by 9% and 4% in the two previous quarters.

Offsetting those positives are the rapidly declining prospects of the printed magazine. Ad pages plunged in the last three quarters (y/y) by 8.0%, 8.2%, and 8.5% in Q2/12. Meanwhile, newsstand circulation was down by another 10% in the first half of 2012. The Audit Bureau of Circulations also reported that overall magazine circulation was flat, but that claim includes digital subscriptions. Obviously, print circulation is falling rapidly.



In addition, it is understood that Irving Paper's new 45# SCA grade, the SCA++ grade that will be coming out of Port Hawkesbury, and the general oversupply of SCA will add to the "demand" problems of the coated groundwood mills in 2013.

The net result will be that coated groundwood demand will decline much more steeply in 2013 than 2012. Coated free sheet, however, should fall similarly in 2013 to this year's level.

We are going to assume that consumer inventories will end 2013 at about the same level they end 2012, so we will not complicate our demand projection by making allowances for changes in inventory. Our coated demand forecast for 2013 is for a decline of 7.0% (10.0% for coated groundwood and 4.5% for coated free sheet). This would take shipments of North American coated producers (to North America) down by another 465,000 tons or so, with a loss in coated groundwood of about 310,000 tons and a coated free sheet loss of 155,000 tons.

## 2. Review of SCA Demand in 2012 and the Forecast For 2013

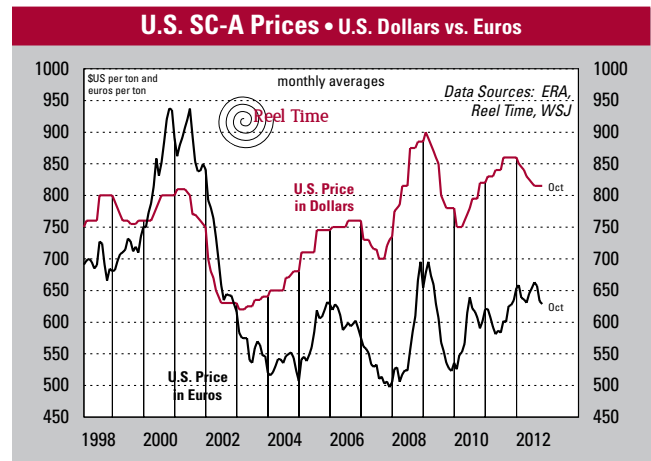
**Demand in 2012:** Whether related or unrelated, the closure of Port Hawkesbury in September 2011 coincided with a remarkable decline in SC demand. JC Penney and Sears Canada were the two largest accounts that moved away from SCA, but there were several others.

In addition, major retail accounts moved down in average basis weight in 2012, thus making the terrible SCA demand data appear even worse than it was. Our estimate is that 5%–6% of the demand decline in 2012 is basis-weight-related — a positive development for most mills.

When Port Hawkesbury closed, we expected a shortage of SCA and a surge in imports. Neither situation developed. Pricing fell by about \$45/ton during the first half of 2012, but pricing has been firm in the second half. Were it not for the pending restart, and now actual start-up of Port Hawkesbury, SCA prices would have moved up in October.

Although SCA demand has declined by 24.5% through September, SCA companies have been running full for most of the year; certainly that has been the case since mid-year. Offshore imports have plunged almost as much as domestic shipments: down 21.9% so far this year. Full-year North American SCA demand will be about 1.2 million tons (see table, page 6).

**Demand Forecast 2013:** Demand for SCA will increase in 2013 because it will be relatively inexpensive compared to other grades. There will be a significant shift from coated groundwood to SCA.





The highly competitive market in the U.S. will result in offshore imports of SCA falling again in 2013, in spite of the fact that U.S. prices of SCA in euros are relatively strong right now (see graph, previous page). Of course, U.S. prices will not be at these high levels for very long.

SCA demand will increase by about 15% (180,000 tons) next year. I have not heard of any large retail paper consumers switching their programs to SCA from some other grade, although there are reports of a number of magazines moving in that direction. If JC Penney would come back to SCA, for example (when current management is replaced), then our SCA demand estimate could be too low.

Overall paper consumption will fall again in 2013, so the gains made by SCA will be lost by other grades — mostly coated groundwood, but also SCB and even high-bright.

## SUPPLY FACTORS

### 1. North American Capacity

**Coated Groundwood:** The Verso and Resolute closures of coated groundwood capacity were substantial enough (in combination with low consumers inventories) to jumpstart the market at mid-year (see table below).

SCA Shipments to North America* • (000 short tons)				
Year	From N.A.	From Europe	Total	% European Supply
1984	250	245	495	49.5%
1985	240	355	595	59.7%
1986	240	280	520	53.8%
1987	250	366	616	59.4%
1988	505	414	919	45.0%
1989	570	384	954	40.3%
1990	671	344	1,015	33.9%
1991	707	274	981	27.9%
1992	681	356	1,037	34.3%
1993	752	461	1,213	38.0%
1994	812	489	1,301	37.6%
1995	799	528	1,327	39.8%
1996	676	445	1,121	39.7%
1997	712	516	1,228	42.0%
1998	829	504	1,333	37.8%
1999	1,034	450	1,484	30.3%
2000	1,071	458	1,529	30.0%
2001	1,307	456	1,763	25.9%
2002	1,505	483	1,988	24.3%
2003	1,503	553	2,056	26.9%
2004	1,559	489	2,048	23.9%
2005	1,703	411	2,114	19.4%
2006	1,452	591	2,043	28.9%
2007	1,686	528	2,214	23.8%
2008	1,610	476	2,086	22.8%
2009	1,267	305	1,572	19.4%
2010	1,205	419	1,624	25.8%
2011	1,074	424	1,498	28.3%
2012 (current fcst)	875	325	1,200	27.1%

Average: 39%

Average: 25%

*\*There was a strike in Finland in 2005 and a strike at NewPage Port Hawkesbury in 2006 that impacted the data for those years.*

*Sources: SC Council, PPPC*

North American Coated Capacity Reductions • 2007–2012			
Company/Mill Location	Capacity (000 tons)	Grade	Date Closed
NewPage — Luke, MD	100	CFS	Jan/2007
Tembec — St. Francisville, LA	325	CFS	Jul/2007
UPM — Miramichi, NB	495	CGW	Aug/2007
Domtar — Hull, QC	100	CFS	Oct/2007
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Fraser Papers — Madawaska, ME	80	CGW	2008
NewPage — No. 11 Rumford, ME	90	CGW/CFS	Feb/2008
NewPage — Niagara, WI	230	CGW	Jul/2008
NewPage — No. 95 Kimberly, WI	130	CFS	May/2008
NewPage — No. 96 and 97 Kimberly, WI	500	CGW/CFS	Aug/2008
Verso — Bucksport, ME	85	CGW	Sep/2008
AbitibiBowater — Covington, TN	75	CGW	Nov/2008
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Sappi — Muskegon, MI	170	CFS	Mar/2009
Kruger — Trois-Rivières, QC	70	CGW	Oct/2009
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Domtar — Columbus, MS	235	CGW	Apr/2010
Kruger — Trois-Rivières, QC	90	CGW	Jun/2010
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NewPage — Whiting, WI	250	CGW	Feb/2011
Verso — Bucksport, ME	90	CGW	Oct/2011
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Verso — Sartell, MN	190	CGW/SCA	May/2012
Resolute — Catawba, SC	150	CGW	Jun/2012
<b>Total</b>	<b>3,455</b>		

But what about next year? Our estimate is that there will be further erosion in coated groundwood shipments to North America of about 310,000 tons. Unless more capacity is eliminated, there will be excess supply and coated groundwood prices will fall.

**Coated Free Sheet:** Even though coated free sheet shipments (to North America) are down by 4.5% in 2012, there has been no removal of capacity so far during the year. That is a key reason, of course, why coated free sheet prices have not been raised along with coated groundwood.



Coated free sheet manufacturers do have uncoated free sheet options that have helped them deal with declining coated free sheet demand, but those options are likely to shrink in the future along with uncoated demand. With coated ground-wood weak in 2013, and additional coated free sheet demand losses in 2013 almost a certainty, prices will fall if capacity is not eliminated.

**SCA and SCB Capacity:** The easy ones first: Resolute started up 165,000 tons of SCB capacity at Dolbeau in October and will shut down 135,000 tons of SCB capacity at Grand Mere/Laurentide in late November. (I wrote in our last *Reel Time* that the Dolbeau machine added 150,000 tons of SCB capacity, but we used a 165,000-ton capacity number for that machine when it was initially closed, so we will stick to that estimate.)

The Verso Sartell “coated groundwood closure” also reduced SCA shipments by about 40,000 tons, and Verso shut down 100,000 tons of SCB/SCA in December 2011 (see table below).

SC Closures, Permanent and Indefinite • 2007–2012					
Supplier	Mill	Grade	Official Capacity (tons)	Date	
Kruger	Wayagamack	Soft-Nip	68,000	Sep/07	
Kruger	Trois-Rivières #5	SCC	77,000	Nov/07	
Catalyst	Elk Falls #2	Soft-Nip	160,000	Q1/09	
AbitibiBowater	Dolbeau	SCB	<del>165,000</del>	<del>Q2/09</del>	
St. Marys	Sault Ste. Marie	SCB	100,000	Dec/09	
Kruger	Trois-Rivières	SCC	<u>72,000</u>	Jun/10	
Resolute	Kenogami	SCB	80,000	Dec/11	
Resolute	Grand Mere	SCB	135,000	Nov/12	
<b>Subtotal</b>			<b>692,000</b>		
AbitibiBowater	Donnacona	SCA	175,000	Feb/08	
Katahdin	Millinocket	SCA	190,000	Jul/08	
AbitibiBowater	Fort Frances #6	SCA	80,000	Dec/09	
St. Marys	Sault Ste. Marie	SCA	140,000	Mar/11	
<del>NewPage</del>	<del>Port Hawkesbury</del>	<del>SCA</del>	<del>415,000</del>	<del>Sep/11</del>	
Verso	Sartell #1 & #2	SCA	<u>100,000</u>	Dec/11	
<b>Subtotal</b>			<b>1,106,000</b>		<i>685,000</i>

The big news, of course, which will dominate the entire value-added market in 2013, is the restart of Port Hawkesbury’s 415,000-ton SCA machine. (The machine can produce about 415,000 tons annually, but since some of this output will be SCB and perhaps even lower grades, I am not sure how their output will be reported to the PPPC, and whether all 415,000 tons of capacity will officially be considered SCA.)

Note in the tables that follow how the addition of Port Hawkesbury will impact the overall capacity data. Adding 415,000 tons to a 1.2-million-ton market will obviously lead to chaos.

North American SCA Capacity at the End of 2011 • By company		
Company	Short tons	Market Share
NewPage	240,000	28.4%
Irving	225,000	26.6%
Madison	210,000	24.9%
Resolute	<u>170,000</u>	<u>20.1%</u>
<b>Total</b>	<b>845,000</b>	<b>100.0%</b>

*Note: North American SCA capacity does not include SC produced on coated machines.*

North American SCA Capacity at the End of 2012 • By company		
Company	Short tons	Market Share
<b>Port Hawkesbury</b>	<b>415,000</b>	<b>32.9%</b>
NewPage	240,000	19.0%
Irving	225,000	17.9%
Madison	210,000	16.7%
Resolute	<u>170,000</u>	<u>13.5%</u>
<b>Total</b>	<b>1,260,000</b>	<b>100.0%</b>

*Note: North American SCA capacity does not include SC produced on coated machines.*

North American SCB and SCA Capacity • By company		
Company	SCB	SCA
NewPage	—	240,000
Madison	—	210,000
Irving	230,000	225,000
Resolute	230,000	170,000
Catalyst	165,000	—
<i>Port Hawkesbury</i>	—	<i>415,000</i>
<b>Total</b>	<b>625,000</b>	<del>845,000</del> <i>1,260,000</i>

## 2. Coated Imports

**U.S. Imports from Canada:** It has become a tradition to include the next table (page 8) in the annual forecast issue. It reminds us how difficult it is for coated and SC paper producers to survive in Canada with the Canadian dollar so strong. The table shows that U.S. SCA pricing is currently \$5/ton higher than in January 2000. However, **the U.S. SCA price in Canadian dollars is \$394/ton lower than in January 2000.**

Currency values continue to work against north-of-the-border paper mills. However, the Canadian coated groundwood and SC capacity that remains is relatively low-cost (except for



currency). That is no guarantee of continuity, of course, but neither are there mills openly recognized as cash drains — as was the case with Port Hawkesbury prior to its 2011 closure.

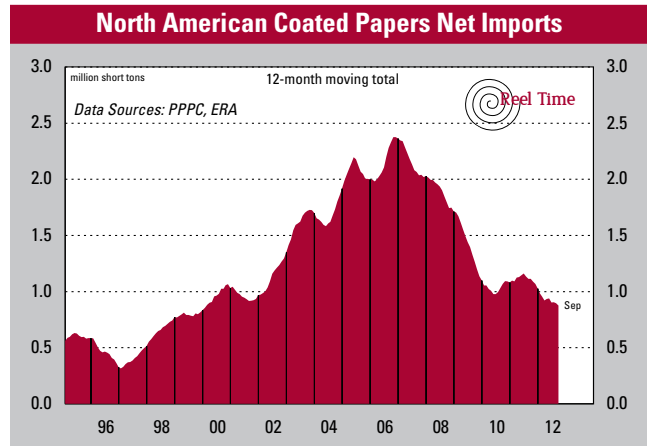
Catalyst and Kruger have the only two coated machines left in Canada. Both are modern and low-cost by North American standards, but the strong Canadian dollar still makes viability a struggle.

SC-A (35#) Pricing in U.S. & Canadian Dollars			
Date	Value Canadian Currency vs. U.S. Dollar	U.S. Pricing	U.S. Pricing Converted to Canadian Dollars
Jan. 1, 2001	0.67	810	1,209
Jan. 1, 2002	0.63	700	1,111
Jan. 1, 2003	0.64	620	969
Jan. 1, 2004	0.77	650	844
Jan. 1, 2005	0.83	710	855
Jan. 1, 2006	0.85	765	900
Jan. 1, 2007	0.86	730	849
May 28, 2007	0.93	715	769
Nov. 5, 2007	1.07	730	682
Jan. 1, 2008	1.02	775	760
Jan. 1, 2009	0.82	900	1,098
Jan. 1, 2010	0.95	750	789
Jan. 1, 2011	1.00	830	830
Jan. 1, 2012	0.98	850	867
Nov. 8, 2012	1.00	815	815

**U.S. Imports From Europe:** There is usually a substantial risk as far as Europe is concerned. There is always a chance, actually a fairly good chance, that the euro will fall in value and encourage dramatic increases in coated and SCA exports to North America. And there is a precedent for such an explosion in the growth of North American coated imports. Just take a look at the next graph, which shows North American coated imports increasing by two million tons from 1996 to 2006, with most of these imports coming from Europe.

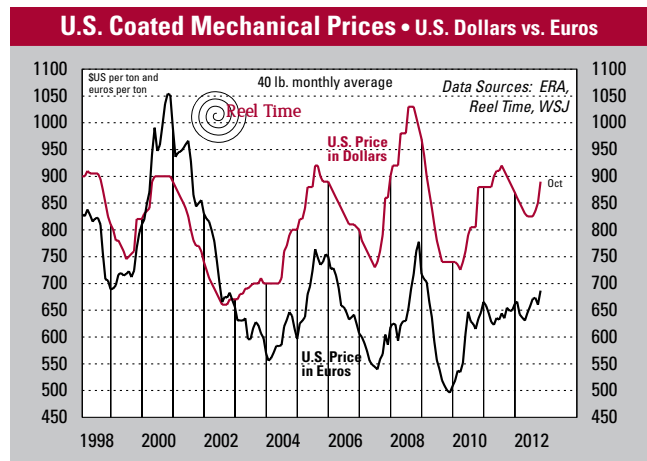
It should also be kept in mind that the large majority of paper machines remaining in operation in Europe are newer and much more efficient than any machines we have in North America (with the exception of Port Hawkesbury).

Also note in the second graph that the current U.S. price for coated groundwood, in euros, is much higher than has generally been the case since late in 2002.



In spite of the “European risk,” there is no indication that imports of coated grades will take a big jump in the near future (see the import tables for coated groundwood and coated free sheet on page 9). Imports of both coated grades are basically flat this year.

We will cross our fingers and once again project that the volume of coated imports from Europe will move down similarly to domestic shipments, or at least not increase significantly in 2013.



**U.S. Coated Imports From Asia:** In spite of large duties on Chinese exports to the U.S., we see that imports from China have bounced up in 2012 (see graph and tables on page 9). The current volumes are not a major concern, and it is unlikely that imports from China will continue to grow while the tariffs are in place...but it is interesting.





U.S. Coated Groundwood Imports, Country of Origin • 000 tons									
Year	Finland	Germany	Other Europe	Asia	Other Countries	Total Offshore	Canada	Total	
2006	494	179	176	31	4	884	919	1,803	
2007	457	157	155	288	1	1,058	813	1,870	
2008	365	144	168	313	—	990	506	1,496	
Year	Finland	Germany	Other Europe	China	Indonesia	Other Countries	Total Offshore	Canada	Total
2009	277	80	85	261	44	12	759	391	1,150
2010	306	68	89	57	17	21	557	364	921
2011	306	68	89	57	17	21	557	364	921
Year-to-Date Aug/11 vs. Aug/12									
2011 (Aug)	173	63	60	4	6	10	316	226	542
2012 (Aug)	182	56	59	19	5	70	391	239	630
% Change	+5%	-11%	—	+357%	negl.	+571%	+24%	+6%	+16%

Source: U.S. Census Bureau via AF&PA

Other than Europe, South Korea is currently the only other country/region that exports large volumes of coated grades to the United States. All of this paper is being sold to coated free sheet, sheet-fed consumers, but in 2012 some of it is being designated as coated groundwood. So, although imports of coated free sheet from South Korea are down by 27% in 2012, we also see that imports of coated groundwood from “other countries” are up dramatically. Most of this is from South Korea and is functionally coated free sheet.

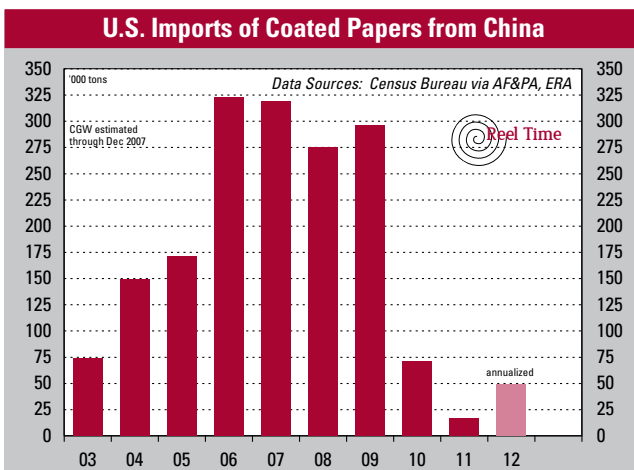
U.S. Coated Free Sheet Imports, Country of Origin • 000 tons												
Year	Scand.	Germany	Other Europe	Japan	China	South Korea	Other Asia	Total Asia	Other Countries	Total Offshore	Canada	Total
2005	203	108	237	95	160	410	33	698	1	1,244	243	1,487
2006	244	136	276	87	292	462	61	902	2	1,560	141	1,701
2007	197	115	218	85	74	437	14	610	3	1,143	79	1,222
2008	139	85	188	91	19	375	11	496	1	909	11	920
Year	Finland	Germany	Other Europe	Japan	South Korea	China	Other Asia	Other Countries	Canada	Total		
2009	68	48	132	76	207	35	17	1	3	587		
2010	72	166	163	73	333	14	13	1	5	840		
2011	65	196	152	56	350	6	7	4	n/a	836		
Year-to-date Aug/11 vs. Aug/12										Source: AF&PA		
2011 (Aug)	41	138	108	39	248	4	5	3	—	586		
2012 (Aug)	58	128	75	37	182	14	3	2	—	499		
% Chg.	+42%	-7%	-31%	-5%	-27%	+288%	negl.	negl.	—	-15%		

A large 360,000-ton coated free sheet mill in South Korea has been shut down by a labor dispute for about a month. That will make room for growth in sheet-fed coated free sheet shipments of U.S. companies and European exporters to the U.S. (for as long as the shutdown lasts). When that mill returns to full operation, we would expect coated free sheet imports from South Korea to rebound and be similar to 2011.

### 3. Consolidation and Supply Control


Supply and price control have never worked well in the coated segment. NewPage and Verso have done the best they could in recent years, trying to take the high road on pricing and willing to take some market-related downtime. However, they were never fully committed, and these aborted attempts at supporting pricing were, at least for NewPage, a contributing factor in the company’s inconsistent market behavior.

The primary supply-control obstacles in coated paper are as follows: 1) the coated groundwood segment is still too fragmented; 2) demand declines, even since 2010, have been too steep to manage well; 3) imports are always a threat to take market share from the disciplined market players; and 4) Sappi is very large in coated free sheet and does not understand the supply-control concept.




In fact, the market conditions faced by Verso and NewPage during the last few years made even attempting consolidation a losing strategy. The only reason attempting supply control made sense for these companies, and still does for Verso, is their precarious financial situations. In other words, being aggressive and trying to drive out high-cost competition has a steep short-term cost.

The bottom line here is that there will be no supply control in 2013. The coated free sheet segment is consolidated enough to make supply control work, but Sappi has always (in recent years, at least) worked against NewPage, undermining pricing rather than supporting it. (Perhaps I don't give Sappi enough credit; maybe they are intentionally disruptive of market pricing with the objective of driving out marginal capacity.)

North American Coated Free Sheet Capacity • By company			
Company	000 tons	Market Share	
NewPage	1,800	42.2%	
Sappi	1,240	29.1%	
Verso	585	13.7%	
Appleton Coated	390	9.1%	
West Linn	250	5.9%	
	<b>4,265</b>	<b>100.0%</b>	

As mentioned above, the coated groundwood segment is too fragmented for consolidation to work at the present time, especially considering the other obstacles (see following table).

North American Coated Mechanical Capacity • By company			
Company	000 tons	Market Share	
NewPage	1,160	31.6%	
Verso	705	19.2%	
Resolute	545	14.9%	
UPM	390	10.6%	
Kruger	275	7.4%	
Catalyst	225	6.1%	
Evergreen Packaging — Pine Bluff	195	5.4%	
FutureMark	175	4.8%	
	<b>3,670</b>	<b>100.0%</b>	

#### 4. Coated Mill Inventories

Mill inventories are not nearly as crucial as consumer inventories, but are still very important. The mill inventory levels determine when producers must lower prices or take downtime. In other words, when mill inventories are low, producers have

the flexibility to continue running machines full (for a while) even when they are short of orders.

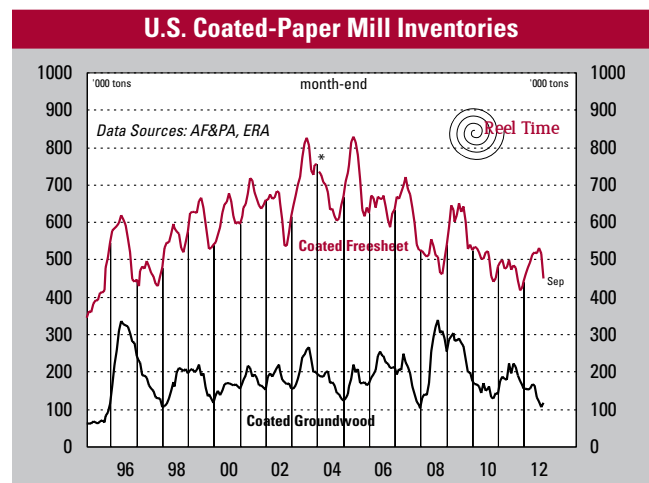
#### Coated Groundwood Mill Inventory Impact in 2013:

For example, coated groundwood mill inventories are very low right now — and will likely remain at the lowest levels possible through year-end. Therefore, when the coated groundwood market begins to soften (probably in Q1), coated groundwood producers can allow their inventory levels to increase for two to three months before reaching uncomfortable levels. It is only after those uncomfortably high inventory levels are reached that company managers must decide whether to try to steal business from the competition (lower prices) or take market-related downtime. Once predatory pricing behavior begins, of course, then even those mills willing to take the high road are forced to defend their business by reducing prices to increasingly lower competitive levels.

#### Coated Free Sheet Mill Inventory Impact in 2013:

The mill inventory swings are much greater for coated free sheet than for coated groundwood. Depending on how large the order shortfall is, coated groundwood mills generally have two to three months from low to high inventories.

For coated free sheet producers, mill inventory levels are even more important. Although there is great variation due to other supply/demand factors, coated free sheet inventories tend to begin increasing late each year and continue to sputter higher until about May of the following year. Then mill inventories come down for about five months. You can see this tendency in the graph that follows. (The pattern for coated groundwood is similar, but mill inventory changes are not as volatile.)



Thanks to a very large 66,000-ton inventory reduction in September, it appears that coated free sheet inventories will fall to typically low late-fall levels this year. As discussed above, that will provide producers with some pricing staying power as the market softens at year-end.

## 5. Substitution

This is the big story and the big unknown in 2013. Actually there are at least three big unknowns:

- 1) How soon will coated groundwood demand be impacted by the huge excess of SCA supply?
- 2) How dramatic will that impact ultimately be?
- 3) How good will the PH SCA++ grade really be? Will it pretty much pass for coated in appearance?

Irving Paper's quality seems to be well established. Its SCA+ grade continues to get high marks for quality, and the initial 45# runs have been very impressive. We expect Irving Paper to convert a significant volume of formerly coated demand to SCA in 2013.

NewPage in Duluth and some European imports also produce high-quality SCA grades that will provide options for coated buyers.

**Substitution Impact in 2013:** The aforementioned quality question at Port Hawkesbury is huge. I am assuming, for this forecast, that the quality of the Port Hawkesbury SCA++ grade will be at least equal to the Irving SCA+ grade, and an excellent substitute for coated groundwood, both in offset and rotogravure. If my working assumption is wrong and the Port Hawkesbury SCA++ quality is inferior to Irving's product, then the impact on the coated market will be less profound than forecasted in this report.

**The inescapable fact, however, is that it is not possible to have high coated groundwood prices and very low SCA prices for an extended period of time.** Substitution on the margins will occur; there is no doubt about this. The better the SCA quality, the sooner the impact is felt and the closer the grades move in tandem — and vice versa with lesser-quality SCA.

## PRICING FORECAST FOR 2013

### SCA

Obviously, the SCA and SCB markets will be massively over-supplied as the Port Hawkesbury impact hits the market. SCA prices in January will be \$30–\$35/ton lower for major retailers. Other buyers, with less concern over long-term supply, will see even greater price reductions. Our high-side-of-average price estimate (35#) for January will fall to \$770/ton from the current \$815 level.

As orders for SCA become harder to obtain, SCB and high-bright markets will also be flooded with supply and prices will fall. Newsprint supply/demand will even be impacted modestly as producers lose some high-bright orders and must replace them with newsprint.

Our market intelligence indicates that Port Hawkesbury will receive only relatively small positions at the major retailers in 2013. There might be an exception or two of which we have not been informed, but my current assumption, in 2013, is that Port Hawkesbury will receive fewer than 50,000 tons (perhaps *far* fewer) from large SCA retailers that make up half of the SCA market. If this assumption is correct, it will increase the competitive intensity in the rest of the SCA market and in the lower-quality uncoated groundwood grades.

The SC market will not recover, of course, until substantial closures occur. There must be at least one significant SC closure. Then, depending on the success of the SCA++ grade, it could be possible to eliminate the remaining SC excess supply through coated and/or SCB capacity eliminations, in addition to reduced imports.

Keep in mind that 415,000 tons of capacity is coming into the value-added market at the same time that demand is falling by perhaps 4%–6%. It is necessary, then, for much more than 415,000 tons of supply to be removed from the value-added groundwood markets in order to balance supply and demand, and get pricing moving back up again.

We know prices will fall to around cash costs — probably a little below the cash-cost level of the high-cost producers. Unfortunately for the accuracy of our forecast, we don't know exactly where that moving target is, but we do take a stab at it in our forecast on page 12.



Neither do we know how long paper companies will endure financial losses before some of them give in. Everyone hopes to outlast their competitors, of course, but some mills will have to lose.

An additional complication is the possibility of a trade dispute developing that could ultimately impact the viability of Port Hawkesbury. This hope could keep SCA mills open longer.

Lastly, the financial strength of Port Hawkesbury is unknown. If Port Hawkesbury must sell a great deal of low-priced SCB and even high-bright grades for an extended period of time, will the mill be able to survive?

Deeply depressed pricing does not usually last for more than six months. Our forecast is for capacity to be withdrawn and the market balanced by the end of the third quarter, plus or minus three months. Therefore, we show SCA prices falling \$10/ton further in Q2 and again in Q3 to absolute cash costs, before beginning to recover in Q4.

### Coated Groundwood

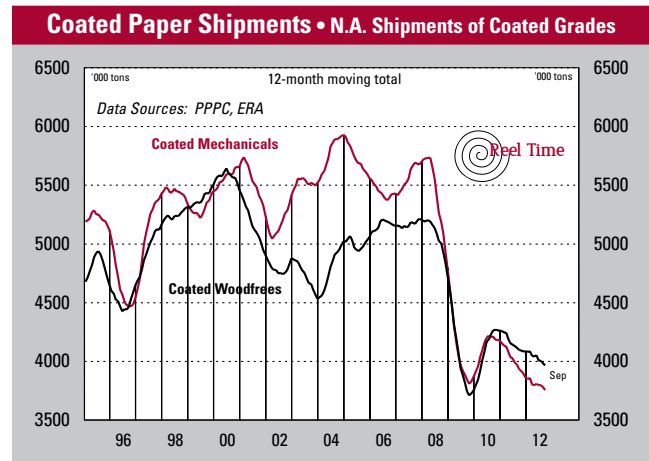
The continued momentum of the inventory-induced pricing up-cycle that began in July, low mill inventories, stable imports, and a delayed Port Hawkesbury impact could combine to allow coated prices to hold steady until Q2 — probably only until the start of Q2. That is our forecast, but our first-quarter coated groundwood price forecast has a large error factor. If prices are not stable, they could actually go up or down during Q1, although down is more likely than up.

If our forecast is correct, the first quarter will show a very large difference between coated and SCA prices. As mentioned earlier, however, such a large spread is not possible over an extended period of time.

By the second quarter, the impacts of the continuing secular demand decline, substitution to SCA, and consumer inventory depletion will upset the current favorable coated groundwood supply/demand balance. The resulting price decline will not be a slow one, as others suggest; pricing seldom moves down slowly. Coated groundwood prices will fall to around the cash-cost level, and by about the same amount they recently increased, or perhaps a little more. (We showed coated groundwood prices increasing by \$65/ton between Q2/12 and Q4/12.)

The only thing that could prevent this pricing downturn is preemptive capacity removals. That is not likely.

As is always the case these days, capacity must be eliminated before the coated groundwood downturn expected in 2013 can be reversed. The question is always... *when*. Our forecast suggests that the most likely timing would be sometime in Q4 (see the pricing table below for quarterly pricing forecasts in 2013).



### Coated Free Sheet

Expected coated groundwood pricing strength early in 2013, low consumer inventories, and uncoated free sheet options will likely enable coated free sheet companies to maintain current price levels through Q1/13, and perhaps well into Q2.

On the other hand, with coated free sheet demand continuing to decline, weak coated groundwood pricing expected in Q2/13, and an already tenuous supply/demand balance going into 2013, pricing will probably be under pressure in Q2. Since coated free sheet pricing did not increase during the second

Reel Time Price Forecast for 2013				
Reel Time	Newsprint 30#	SCA 35#	Coated Groundwood 40#	Coated Free Sheet 60#
Current	640	815	890	930
Q1/13	620	770	890	930
Q2/13	600	760	840	915
Q3/13	580	750	810	900
Q4/13	610	785	840	910
Annual 2013	603	766	845	914



half of 2013, it has less room to fall. Note in the price graph at right that coated free sheet bottomed just below \$900/ton in 2005, 2007 and 2010. Based on that history, we will forecast coated free sheet pricing dropping to \$900/ton — although we always think the bottom should be lower. It is not a certainty in this case, but pricing will not likely recover until capacity is removed. We can't know when this will occur, but we will forecast it for the fourth quarter. ●

— Verle Sutton

