

Forest Products Industry Outlook

VERSION 01 | YEAR 13

OUTLOOK:  Signs of Weakness

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Key points

- Lower-priced imports from China and the increasing shift toward electronic communication and media have created fierce competition.
- Industry consolidation continues as major players seek to increase market share and pricing power through mergers and acquisitions.
- Paper producers continue to look for best practices for energy conservation and sustainable forest management.



Overview

The forest products industry consists of a variety of key players but a primary focus of this report is on the companies who use wood to produce pulp, paper, and board products, and the companies who package products. Paper consumption in most developed markets is falling and in the U.S., paper consumption has dropped roughly 19%. In 2008, the U.S. traded positions with China, who now reigns as the world's largest producer of paper. China, who historically struggled with a timber deficit, has now tripled production by creating innovative ways to produce paper at low cost, thereby putting enormous pressures on U.S. paper pricing. The global pulp and paper industry is estimated at \$909 billion in annual revenue, with annual volume growth of 1.8%. The disparity in market conditions between China and the U.S. is evidenced by robust 7.3% growth in the Chinese market while the U.S. contracted by 1.1%.

The shift toward electronic communication has certainly cut demand for paper products and ultimately reduced revenue. In order to compete, many U.S. companies have restructured, closed loss-making production facilities or merged with larger companies. Survivors in this industry will also have to negotiate the added costs of environmental responsibility. The industry has long been criticized by environmental groups for unsustainable deforestation and clear cutting. The push from the current administration for clean energy has prompted companies to look for innovative ways to protect the environment by conserving the trees, water, energy and chemicals needed to produce paper.

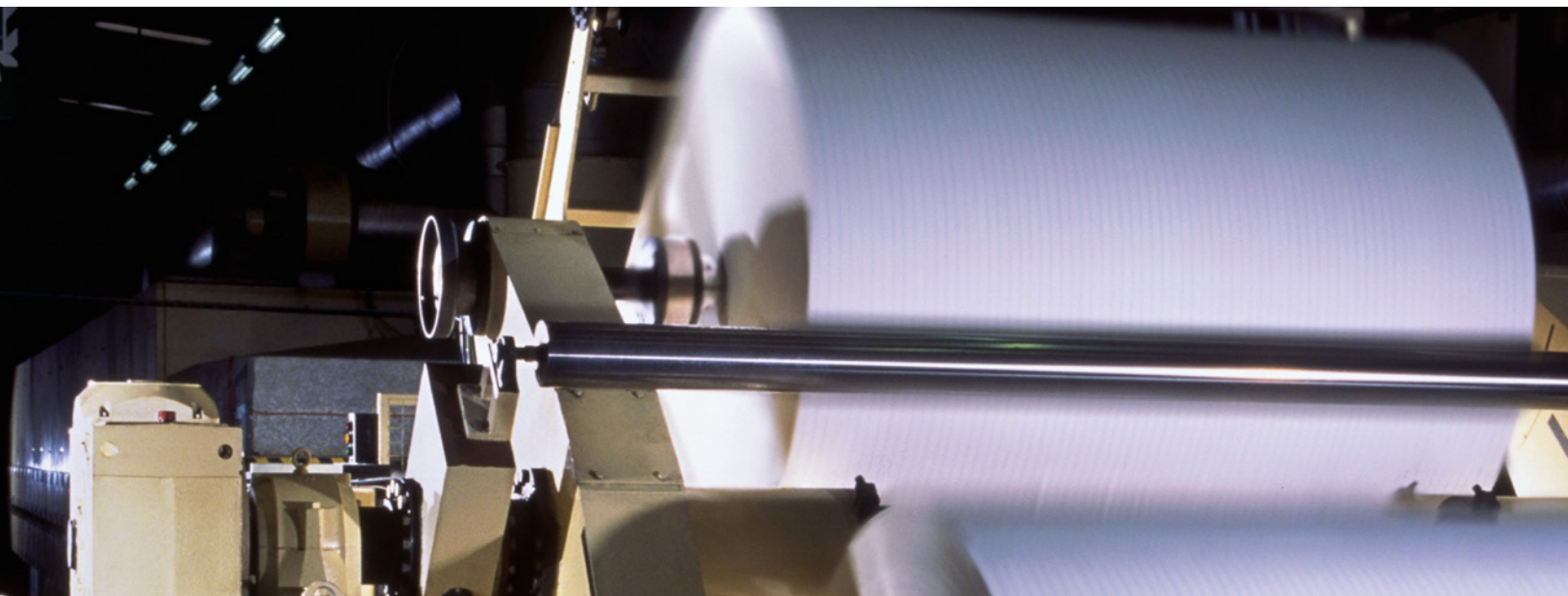


Current Situation

There are several factors that contributed to the growth in the global paper and forest products industry. Paper packaging and tissue is the largest segment and represents the majority of global operating income. This category includes containerboard and boxboard items for consumer packaging of food and non-food items like toilet tissue, paper towels, facial tissues, disposable diapers and personal care products. These consumer staples provide stability to the market and are targets for price increases as long as oversupply doesn't negatively pressure prices. For example, the price of sanitary paper products continues to grow each year and accounts for a significant source of total industry revenue. This trend is expected to continue in both mature and emerging markets but at a much faster rate in emerging markets, thanks to increasing hygiene standards. IBISWorld forecasts world tissue consumption to rise 4.5% in 2013.

The building products segment includes products used in wood-frame construction and consists of lumber, oriented strand board, plywood and engineered wood products. Although not nearly as large as the packaging segment it is a key contributor to industry growth. The sustained recovery in the housing market is driving demand for wood products and consequently pricing and profitability have improved in this segment. Additionally, the value of timberland holdings has climbed due to improved construction activity, giving companies some additional financial flexibility. Supply, which was reduced by work shift cuts, suspended operations and permanent mill closures, is being brought back to meet improving customer demand for engineered wood products.

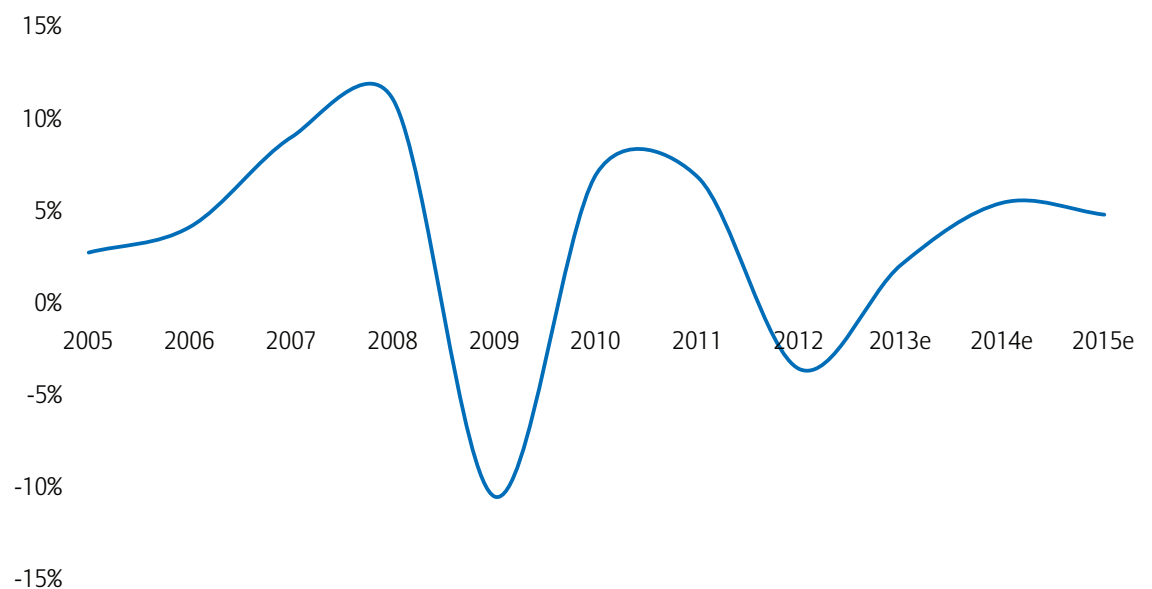
Despite signs of recovery from pre-recession levels, overall industry profit margins have only improved slightly since 2008. A major challenge of the industry is the increased usage of online communication. As consumers move to electronic devices, including smartphones and tablets, the demand for office stationery and newspapers has deteriorated significantly. Producers continue to reduce supply in response to the weakening demand. Typically, weaker demand without a reduction in production leads to supply overages and weaker pricing. However, as a result of capacity rationalization, average prices stayed relatively flat in 2012. These conditions have led to increased merger and acquisition activity as larger companies seek to improve market share, stabilize prices, and improve operating efficiency. The synergies from recent acquisitions are expected to improve operating income.



Outlook

As the U.S. economy slowly recovers, the outlook for the industry is improving and demand for paper products, especially packaging, should gain a firmer footing. Housing will continue to be a key driver in 2013 and accelerate demand for wood products. However, as consumer adoption of technology deepens, the percentage of services conducted online will only increase and paper consumption will continue to decline an estimated 5% annually. Despite this decline, pricing is improving as restructuring and merger and acquisition activity rationalize capacity, giving producers more pricing power.

Global Paper and Pulp Price Evolution



Source: IHS Global Insight, Euler Hermes

As operations are consolidated and production processes are improved, large companies will reduce their exposure to price fluctuations and transaction costs through vertical integration. Total paper and paperboard production will continue to grow in emerging markets with China and India amongst the fastest growing markets for paper, with 7-8% GDP growth. Finally, the President has announced a series of actions to address global climate change, largely aimed at reducing carbon pollution. One of the main ways carbon dioxide enters the atmosphere is through burning trees and wood products. Since there are no federal standards in place to reduce carbon pollution from power plants, the Environmental Protection Agency (EPA) has been tasked with establishing standards. Given the potential impact of these new standards, paper producers should prepare to spend more to assure environmentally sound processes.

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KEYS TO SYMBOLS

