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- [Press room](#)
- [PwC portal](#)
- [Publications](#)
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• [Industry sectors](#)

• [Today's challenges](#)

• [Our services](#)

• [Global Press Room](#)

• [News Releases](#)

• [BroadcastRoom](#)

• [Resources](#)

• [Contacts](#)

• [Fact Sheet](#)

• [Search](#)

## Forest and Paper Sector is Riding a Wave of Suboptimal Earnings and Many Challenges

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**Vancouver, 10 MAY 2007**— Although sales of the 100 largest forest and paper companies around the world have been creeping up, the 2006 Return on Capital Employed (ROCE) — a key industry metric of financial health — of 4.6% was still well short of the 10 to 12% target that is needed to be competitive in the capital markets. These were among the results released today by PricewaterhouseCoopers (PwC) at its 20th annual Global Forest and Paper Industry Conference in Vancouver, Canada.

Net earnings of the world's 100 largest forest and paper companies in 2006 increased 50% from 2005. These companies went from US\$9.1 billion to US\$15 billion largely due to increased paper prices, and a flurry of one-time, unusual items within North America such as countervailing duty refunds in Canada and International Paper's US\$5 billion gain on the sale of their forestlands.

"Things aren't improving and there still remain many challenges to overcome including chronic oversupply, low barriers to entry, high barriers to exit, fragmentation and much more," says Craig Campbell, leader of PwC's performance improvement practice for the global forest and paper industry.

The North America forest products sector is languishing due to old and inefficient mills that are shutting down and production is moving to the southern hemisphere where new modern mills provide better return on investment. Combined, Canada and the US have dropped to a 4.7% ROCE in 2006—significantly lower than the 11.8% in 2005.

Production capacity is moving to emerging markets, primarily South America and non-Japan Asia. These regions were at the top of the pack again this year with ROCE rising from 9.5% in 2005 to 12.6% this year. Campbell adds: "these returns are actually deceptively understated given the goldrush of new capital that has been invested in production capacity over the past decade, which negatively impacts the ROCE

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calculation. If we looked at cash flow, we would see emerging markets generating in the order of 40 to 50% cash on sales versus 6 to 8% for Europe and North America.” Elsewhere around the world, ROCE in 2006 ranged from 3.8% in Europe and 4.7% in Japan. Separated, ROCE in Canada was 0.5% and 4.2% in the US.

Areas that are currently effecting and will continue to affect the industry include pulp and lumber prices. Currently, pulp prices are at their highest level in US dollars since a peak in 1995. According to Campbell, the outlook is good for pulp over the short term but there is a wave of South American capacity that is due to crest next year. On the other hand in real terms, lumber prices are at their lowest levels in the last 25 years but prices are expected to improve modestly for the balance of the year.

Consolidation is accelerating in the industry with over 280 mergers and acquisitions (M&A) with a value of nearly US\$26 billion completed in the global forest, paper and fibre-based packaging sector in 2006. The largest single deal in the global industry last year was International Paper’s disposition of 3.8 million acres of forestlands pegged at US\$6.6 billion. North America remained at the forefront of forest, paper and packaging M&A activity, with a collective total of 67% of deal values in 2006. The second largest forest products company deal in 2006 occurred in Canada—Domtar Inc’s acquisition of Weyerhaeuser Co’s fine paper business and related assets for US\$3.3 billion.

Interestingly, there has been a noticeable move by non-traditional financial players who are becoming a big part of the M&A landscape. Their share of total deals has moved from approximately 30% in 2003 to 48% in 2006.

When looking ahead, according to PwC and many industry sources, one of the biggest challenges facing the future of the B.C. industry is the mountain pine beetle epidemic and it is no longer confined to just this Canadian province. The pine beetle infestation has crossed the border to Alberta and has even made appearances in Europe. Campbell challenges the industry to find alternative uses for the wood fibre residue. For example wood biomass, while a more expensive source of energy than hydroelectricity or coal, has the benefits of lower emissions and availability.

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