

Compass 2010 Global forest, paper, and packaging sector outlook

As the economy shows signs of recovery, the global forest, paper, and packaging (FP&P) sector players are asking themselves how to take advantage of new opportunities. Where will the sources of growth come from? What subsectors will recover first? How can mergers and acquisitions (M&A) be completed in this difficult financial environment?

An international panel of Deloitte member firm sector leaders examines these and other pressing questions. The participants included Luc Martin, FP&P sector leader, Deloitte Touche Tohmatsu (DTT) Global Manufacturing Industry, and member firm industry specialists John Dixon and Will Frame in the United States, Doug Wilkes in Canada, Daniel Alberto Lucca in Argentina, and Mikael Paul in Finland.

Q: How is market demand assessed at this point in the recovery?

North America, in particular the U.S. and Canada, has yet to hit the bottom in newsprint. As the economy emerges from the recession, there are fewer players remaining. Some have consolidated, others have filed for bankruptcy¹. In the uncoated and coated free-sheet export market, there are signs of optimism. Although U.S. dollar strength in North America creates a more challenging situation for importers, demand is on the rise for 2010². The lumber market has started to see a slight uptick in sales in 2010, with the construction industry anticipating a moderate increase in activity³. In the United States, the housing market is still suffering from mortgage foreclosures, keeping builders on the sidelines⁴. Until there is a fundamental shift in the strength of the U.S. housing market, there will be no meaningful demand increase in North America.



In Europe, demand for newsprint declined last year. While the decline was not as severe as in North America, it was still a significant decrease, and overcapacity in the segment⁵ is creating pricing challenges. As the economy is expected to improve in 2010, newsprint should fare better — at least in the short term. The paper market has shown positive signs so far in 2010⁶. A better balance and more disciplined approach to demand has resulted from plant closures, enabling the market to rationalize capacity and adjust prices. However, there is also a sense of uncertainty in Europe, due to concerns over budget deficits in Portugal, Ireland, Italy, Greece, and Spain⁷. This financial pressure may slow European recovery efforts and have a negative impact on the FP&P sector.

Recovery in South American markets began last year, mainly in Argentina, Brazil, Uruguay, and Chile. Moderate hikes in demand are projected for 2010, but it may be two more years before these markets return to pre-recessionary levels. The pulp segment is working at full capacity and recovering at a faster pace than paper. Due to the downturn, the paper segment experienced a 10 percent decline, although there have been slight increases over the last six months⁸.

If there is a source of strength in the sector, it is in the Asia-Pacific region, particularly China, where government stimulus has effectively mitigated the effects of the global recession. China's injection of US\$586 billion in stimulus⁹ spending had an indirect impact on the sector, and the demand for lumber and building materials is stronger now than it has ever been. Companies are questioning if they should be placing even bigger bets on China and the Asia-

1 Editor & Publisher: "White Birch Paper Co. files for bankruptcy protection in Canada, U.S.," February 25, 2010

2 ICIS.com: "Despite its forests, North America is not the paper maker it once was. But globally increased sustainability should lead to further growth," February 3, 2010

3 Wood markets: "U.S. softwood lumber demand and prices poised to rise slowly in 2010 but gaining momentum in 2011 as demand climbs - price surges to follow," November 11, 2009

4 CNNMoney.com: "Housing forecast for 2010," December 9, 2009

5 Mission of Finnish Forest Research Institute (Metla): "Finnish forest sector economic outlook 2009-2010," November 30, 2009

6 Mission of Finnish Forest Research Institute (Metla): "Finnish forest sector economic outlook 2009-2010," November 30, 2009

7 The Economic Times: "Is Spain the next Greece? Or Italy? Or Portugal?," March 5, 2010

8 RISI: "Outlook 2010 — A slow climb back," January 4, 2010

9 DTT Manufacturing Industry: "Deloitte says more is needed to revitalize ailing automotive industry," March 23, 2009

Pacific region. It is not surprising that China is leading the growth, while the North American and European markets remain weak.

Q: What are the opportunities and challenges for the FP&P sector globally?

Over the past two years in North America, consolidation by product line or subsegment has helped to stabilize commodity prices. In the newsprint segment, consolidations became necessary following sharp declines in demand. In 2010, further consolidation is expected to continue throughout the sector, but the availability of funding will influence the type and size of transaction. The diversity of the sector means that there are a number of small companies competing for market share. While these smaller players have found success in operating around the clock, the rapid pace of inventory added to the market is having an impact on commodity prices which may subsequently affect competitiveness.

South America is expecting an increase in market volume for both pulp and paper in 2010. With its size and accessibility to international financial markets, Brazil is leading the way. Although financially challenged, Argentina presents attractive investment opportunities because of its low production costs. Although risks are higher in Argentina because of current economic, political, and financial conditions, the country should be considered for future growth initiatives. Chile, while recovering from a devastating earthquake, has benefited from economic growth in the past and will devote the reconstruction efforts to support the economy and help modernize the infrastructure¹⁰.

Northern European players are evaluating the investment potential in South America, particularly Brazil, Argentina, and Uruguay, because of the improved local economic conditions and as export markets for building materials and pulp.

European and North American companies are investing in manufacturing biofuels from wood residues. The investment could improve operating margins and is closely linked to the core paper business since the sector is already the world's largest producer and user of bioenergy. There are a number of advantages to using bioenergy, including lower dependence on fossil fuels for producing energy internally. The improved market value of carbon credits is also driving increased use of biomass. Within the next two years, fully commercial-scale operations will launch¹¹ producing at least some volume of second-generation biofuels, from ethanol to synthesize gases and a spectrum

of further-processed motor fuels to biodiesel and a broad array of bioproducts. By 2020, the first commercial plants are scheduled to deploy¹². The scenario is similar to other parts of the world where fuel demand and escalating costs are pushing investments in alternative fuels to record levels.

China is another growth opportunity for the sector. Demand is increasing and conditions are suitable for growing trees (although not as ideal as in South America). However, doing business in China can be challenging due to regulatory and government mandates.

Q: Will more companies need to restructure to survive?

In 2010, consolidations are expected to continue with product lines such as container board. M&A transactions may occur, but much depends upon the financial health of the companies in the FP&P sector. Even companies that are currently stable are not in a position to participate in M&A due to the financial obligations required for a transaction. With the credit markets still under distress, acquisitions will require creative financing.

Restructuring through bankruptcy will still be prevalent in North America and Europe. Some small operators in North America may not survive. If those companies are not shuttered, the excess capacity will remain in the market and create pricing and competitive challenges.

Q: What role will private equity play in the sector?

It is anticipated that private equity will become increasingly involved in FP&P in the coming years. There are a few North American long-term private equity funds investigating opportunities in forestry in South America, mainly in Uruguay and Argentina. Although it is early in the investment process and only a few deals have been completed, private equity forestry deals will likely emerge in South America in the near future.

Funding from government and private sources will enable China to engage in private equity activity, allowing China to diversify its economy by investing overseas. Chinese investors are looking at forestry assets in the South Pacific, but also at manufacturing opportunities, with a focus on North America, and specifically, Western Canada.

Most of the equity injected into the sector has come through restructuring. There is a strong appetite among investors for paper-type assets that can provide a short-term attractive valuation, rather than assets which may require time to grow.

¹⁰ Forbes.com: "Chile's post-earthquake economic strength," March 4, 2010

¹¹ Renewable Energy World.com: "IEA's report on 1st- to 2nd generation biofuel technologies," March 9, 2009

¹² Renewable Energy World.com: "IEA's report on 1st- to 2nd generation biofuel technologies," March 9, 2009

Q: What impact will government regulation have on the sector?

Paper and packaging producers in the U.S. were certainly beneficiaries of government regulations. The black liquor tax credit enabled companies to earn alternative fuel credits to offset costs, pay down debt, and increase their bottom line. The credit gave companies the opportunity to produce inventory, even though demand was limited.

If proposed cap-and-trade regulations in the U.S. are passed, the laws will create an unlevel playing field for the paper and packaging market. Companies domiciled in countries where no such regulations exist will have a competitive price advantage.

Q: Are increased trade barriers and protectionism on the rise?

North America is fully entrenched behind both barriers and protectionism with respect to lumber, though it is unlikely to get any worse. The Softwood Lumber Agreement between the U.S. and Canada remains in effect until 2013, with the possibility for renewal¹³.

In Europe, a tariff was imposed by the Russians on Scandinavian hardwood¹⁴. The Europeans reacted by not purchasing wood from Russia, creating an overall negative impact on the industry. There have been indications this year that the Russian government will reconsider the tariff.

South America does not expect trade barriers or protectionism to increase. Within the Mercosur agreement, it aims to develop a free trade agreement among the unions of the South American Common Market of Brazil, Argentina, Paraguay, and Uruguay, creating an opportunity to link them politically, economically, and socially¹⁵. In addition, duties for imports from countries outside the pact are not expected to increase.

Q: What impact will environmental issues have on the sector?

In Europe, there are many European Union (EU) common directives that depend on the location of the facility — the closer it is to an urban center, the larger the challenge. This is an important issue and will have an increasing impact as the EU harmonizes regulations. The impact will also be seen in market barriers that companies will face if they do not make an effort to comply with environmental issues. Some markets will refuse products developed from companies — and even countries — that do not meet certain environmental concerns and as such could negatively impact future revenues returns.

Depending on how it is applied, the U.S. cap-and-trade policy could have a negative impact on many companies. It is expected that the proposed policy will generate US\$650 billion from 2012 to 2019 in revenues for the U.S. federal budget¹⁶. Such a costly policy, as currently outlined, will likely eliminate all profitability from companies in the United States. Without profits, there will be no investments for future growth opportunities. In New Zealand and Australia, cap-and-trade is also being viewed as a source of tax revenues.

In South America, regulators are not pushing companies to adopt new procedures or comply with environmental issues. Generally, no significant penalties or fines are being imposed. However, environmental issues are becoming more important in order to serve the global community. As a result, regulators may take a more active role.

Q: Are green products becoming a competitive advantage?

Not having green products creates a competitive disadvantage. Companies today are expected to carry green products in their portfolio and are no longer viewed as a unique offering. It is expected that in 2010, the industry will continue to focus on developing and promoting green products.

Despite common perceptions, over the last 30 years, the sector has been fairly environmentally friendly, exemplified by the Sustainable Forest Initiative (SFI)¹⁷. The perception issues may continue, however, given the sheer amount of water, energy, and raw materials the sector relies on to produce its products. The greening of products will depend heavily on the consumer and pressure from society.

¹³ CBC News: "Softwood lumber dispute," August 23, 2006

¹⁴ Forest2Market.com: "The effects of Russian timber tariffs on global wood supply," October 2008 newsletter

¹⁵ Spectrazine.com: "EU-Mercosur agreement," ©2001-2010

¹⁶ Scientific American: "Obama's draft budget projects cap-and-trade revenue," February 26, 2010

¹⁷ SFI: "Requirements for the SFI 2010-2014 program," January 2010

Conclusion

There are positive indicators that demand will strengthen in 2010¹⁸. There are challenges, however, as the sector struggles with overcapacity and price adjustments. Industry consolidation has helped to stabilize commodity prices. But M&A activity is likely to be slow as credit markets remain weak. It is expected that private equity will become involved in the sector in the coming years. In North America, in particular the U.S. and Canada, the sector is still challenged to keep businesses operating from the downturn and restructuring. China and South America are showing signs of a stronger recovery and all indications point to a more globalized industry. And yet, there are very specific concerns, the environment first among them. While green products are almost commonplace in most portfolios, local regulations around carbon emissions will have a more immediate impact on the business models of many companies. There will undoubtedly be opportunities for companies that weather the crisis, but the best prospects will go to those companies who emerge with a better understanding of the new sector landscape.

¹⁸ ICIS.com: "Despite its forests, North America is not the paper maker it once was. But globally, increased sustainability should lead to further growth," February 3, 2010

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