Morningstar.com

Is Paper Dead?

Friday September 12, 7:00 am ET

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A few months ago, we attended International Pulp Week, an annual gathering of pulp and paper industry players from around the globe. Jim Lopez, CEO of Tembec, a Canadian forest products company, delivered the event's keynote address. Like many who've seen their share of industry conferences, we had expected to hear a fairly standard keynote speech: an uplifting talk filled with industry promotion and pie-in-the-sky projections for the future.

Lopez's speech included none of this standard fare. Those hoping for the usual "rah-rah" boilerplate must have realized they were in for a disappointment by the time Lopez's first presentation slide hit the screen, bearing the title Forest Products: A Broken Model. The slides that followed read like a litany of failures: poor stock performance, feeble returns on capital, and general inability to post consistently positive margins. Reaching the end of his list and appearing somewhat exasperated, Lopez summed things up by saying, "The industry has destroyed value, and the equity markets have punished us for it." Take a look at a five- or 10-year stock chart for any of the major North American paper companies, and you'll see what Lopez was pointing out.

Appetite for Destruction

So what explains the industry's apparent appetite for value destruction? While there have been several culprits, we'd argue none has been more important than the recurring problem of overcapacity and attendant price wars. Historically, the trouble usually began on the supply side: A year or two of above-trend demand growth and rising prices would prompt a flurry of new builds, followed by a cyclical downturn in demand that would leave the industry with significant excess supply and force producers to slash prices to retain market share.

More recently, the problem has manifested on the demand side: overcapacity and resultant price wars caused not by supply additions but by demand destruction. As Morningstar equity analyst Matthew Coffina discussed in a recent article, electronic communications are mainly to blame. We won't bother rehashing the details of the narrative here, but suffice to say that the continued ascent of electronic media ultimately means paperboys will make fewer deliveries, office workers will make fewer trips to the copier, and retailers will flood your mailbox with fewer glossy catalogs (we can only hope!).

For many, the discussion ends there. Paper is a dying business. Investing in paper companies is a sucker's bet. Happily for investors in and employees of paper companies (not to mention the analysts who cover them), this is an oversimplification--one that doesn't have the virtue of being true. Even declining industries can generate respectable profits, given the appropriate industry structure. As Michael Porter noted in his seminal work, Competitive Strategy, "Industries differ markedly in the way competition responds to decline; some industries age gracefully, whereas others are characterized by bitter warfare, prolonged excess capacity, and heavy operating losses."

Can the Paper Industry Age Gracefully?

So how will the paper industry cope with decline? Will it continue to exhibit a troubling penchant for loss-making, or can it turn the page on its value-destroying past? Will the pattern of overcapacity and price wars persist, or will more rational competition prevail? While the macroeconomic narrative that entails the ascendance of ones- and zeros at the expense of paper and ink makes it tempting to consign paper stocks to the dustbin of history, we think the latest evidence points to a future much brighter than the recent past.

Over the past few years, we've witnessed a major overhaul of the paper industry's competitive landscape wrought by a flurry of mergers and acquisitions activity. This reworking of the industry structure has included two important developments: dramatic capacity consolidation in nearly all major paper categories and a narrowed focus by the big players on one or two major categories.

In 2007 alone, we witnessed the creation of a new and larger leader in each major paper category. North America's two largest manufacturers of newsprint, Abitibi and Bowater, came together as AbitibiBowater in a move that gathered nearly half of industry capacity under one roof. Domtar (NYSE:UFS - News) merged with Weyerhaeuser's (NYSE:WY - News) fine papers business, creating a firm that now controls one third of uncoated freesheet capacity. Private-equity-owned NewPage acquired Stora Enso's (Other OTC:SEOAY.PK - News) North American operations, boosting its share of the coated paper market beyond 35%. The end result of all the merger-and-acquisition activity is a paper industry that is much more concentrated than it was a decade ago.

What Consolidation Means for the Bottom Line

From a theoretical perspective, the case for consolidation is rather straightforward. Simply put, by gathering more capacity under fewer roofs, consolidation affords the remaining coterie of players greater control over the industry's output, thereby reducing the likelihood of overcapacity problems. Frequently, consolidation also carries the added benefits of reduced competitor diversity and the elimination of players with objectives that may differ from that of a "rational" competitor--for example, the family-owned mill that aims foremost for high operating rates rather than high profits or the "dead-man-walking" business unit buried within a sprawling conglomerate that, thanks to the financial support of its corporate parent, isn't forced to make tough choices. In the end, a more tightly controlled capacity managed by more rational players should keep supply and demand in better balance, thereby reducing the risk of mutually destructive price wars.

For a variety of reasons, the theoretical benefits of consolidation don't always materialize in practice--yet thus far, we've seen many signs that they have. Despite a significant recent demand drop-off--a development wrought by the unfortunate alignment of secular and cyclical weakness--we haven't seen the sort of price cuts that characterized previous downturns. Consider, for example, uncoated freesheet paper. In the economic downturn of 2001, uncoated freesheet demand fell 7%, sending prices plummeting from $890 per ton to $765 in a year--a 14% drop. This time around, we haven't seen prices suffer. On the contrary, while uncoated freesheet demand fell 4% in 2007 and then another 4% year-to-date through July, prices have actually increased 19% since the first quarter of 2007. A similar story has played out in coated freesheet paper (demand down 6% year-to-date, prices up 11%) and newsprint (demand down 9%, prices up 23%).

What explains this reversal of fortune? Some would point out that the price increases merely represent sellers passing along higher costs to buyers. While this is certainly true, we'd argue higher costs alone don't necessarily lead to higher selling prices. After all, buyers don't agree to higher prices out of the goodness of their hearts. Just ask struggling newspaper publishers how pleased they've been with eight consecutive monthly newsprint price hikes in 2008. No, a price hike goes through not because it's "needed," but because supply and demand dynamics make it possible. In the paper industry, producers have simply done a much better job managing supply in the face of depressed demand, whether through production downtime or outright closures. We consider this improvement to be a direct a consequence of the industry's recent consolidation. Indeed, much of the credit for the improved supply discipline goes to industry leaders like AbitibiBowater, NewPage, and Domtar, who have proactively slashed production in the face of weaker consumption.

It remains to be seen whether the paper industry can maintain its supply discipline over the long haul. Pitfalls abound, and it is not out of the question that the price wars of the past could be re-ignited, particularly in those portions of the industry characterized by steep or highly variable decline rates. Additionally, the industry's improved discipline doesn't necessarily make for attractive investment opportunities. Given that many paper companies are laboring under burdensome debt loads financed at double-digit interest rates, long-term survival will be challenging even under the most favorable of supply-and-demand circumstances. In the coming months, we'll delve deeper into the long-term supply-and-demand prospects for newsprint, coated paper, and uncoated paper. Using this framework, we'll discuss which industry segments we consider most attractive and the companies within those segments that have the best chance for success.