

## Old Europe?

**Outlook study reveals: Europe generally not attractive - Germany and Poland most attractive ♦ energy costs and regulations considered hurdles for the future ♦ consolidation and sustainability focus enablers for future competitiveness ♦ positive expectations for the economy ♦ expectations for pulp and paper mixed ♦ pressure on margins to remain high ♦ company priorities on cost reduction, pricing, customers and innovation ♦ Mondi, UPM, SCA and IP considered most competitive**

### Results from the 2014 pulp and paper outlook and European competitiveness survey

Similar to previous years StepChange Consulting conducted a survey among industry leaders including the participants of the 16<sup>th</sup> Annual RISI European Conference. The results of this survey were compared to results of prior years to allow for a historical comparison.

The outcome of the survey provides an indication of the perception of current economic and market developments in the industry, and highlights which measures are currently being taken to address the issues.

#### Highlights of the survey

- Improved expectations: more than half of participants expect the economy in their region to strengthen within the next 12 months
- However, with regards to the expected development in the pulp & paper sector for 2014, participants are less optimistic: almost two thirds believe that the industry is either in a downward trend or in a trough. Opinions differ significantly between the different paper sectors
- On the cost side, more than half of participants expect higher energy costs for 2014 and over 40% expect transportation and raw material costs to increase
- On the sales side, the demand outlook improved: 40% of participants expect demand to increase. However one third expect selling prices to decrease. At the same time 36% of participants expect demand to decrease – results vary significantly between the single industry segments; the packaging segment has the most positive perspective

- Measures to address developments are focused mostly on cost reduction, pricing & margin management and on product development and innovation
- The area that gained the most importance vs. 2013 is customer acquisition and retention, increasing from 19% in 2013 to 43% in 2014. Respondents expect major challenges related to product substitution – creating and retaining a loyal and satisfied customer base is at the heart of many companies
- Initiatives to improve cash flow and working capital management are a priority again: almost 50% noted this as a current priority vs. less than one third in the previous year
- Restructuring efforts mentioned less frequently than in 2013 - considered a priority by one third of participants
- Talent acquisition and development has been consistently gaining importance over the last 3 years: 25% of participants will focus on this topic in 2014
- Workforce reduction is a priority for 20% of respondents. In comparison, in 2011 only 7% of respondents noted this as an area of focus

#### Europe considered not very attractive

- Overall Europe is not perceived as an attractive location for the pulp & paper industry. Only about 14% of participants consider Europe to be attractive
- The infrastructure and the qualified workforce are considered positive influencers with respect to Europe's attractiveness
- Limited market growth opportunities, high cost levels (labor, energy, raw materials) and an unfavorable regulatory environment are considered issues negatively impacting Europe's attractiveness
- Germany is considered to be the most attractive country for the pulp & paper industry in Europe, followed by Poland and Finland
- According to survey participants, Mondi, UPM, SCA and IP are considered to be the companies best positioned to face future challenges

#### Survey Demographics

Survey participants represent a wide spectrum of the industry including suppliers, manufacturers, converters, distributors and printers & publishers.

More than half of the survey respondents are from the paper or paperboard manufacturing sector (53%), 24% of respondents from printing & publishing and distribution and 10% from converting.

Within the group of participants from paper & paperboard manufacturing (multiple answers were allowed), 52% are employed in the packaging sector. Another 40%/24%, are from the coated/uncoated woodfree paper segment, respectively. 40% of respondents are from newsprint & uncoated/coated mechanical papers and 19% work in the specialty/engineered paper segment; 10% of respondents are from the tissue sector.

Overall, respondents expect a positive economic development in most European regions. Taking a closer look by sub regions, most of the optimism comes from Northern Europe incl. the UK, where 60% of participants expect the economy to accelerate, and only 7% foresee the economy to decline. Respondents from Eastern and South East Europe provide a mixed picture: 25% of the participants expect the economy to head up and 25% to head down. Western & Southern European participants are only marginally more optimistic (43% up, 29% down). Considering the relative strength of the economies at this point, this means that the overall sentiment leans toward a further widening of the economic performance gap between Northern & Central Europe compared to the Mediterranean region.

**Macroeconomic development**

Where do you see the economy in your region heading in the next twelve months? [%]

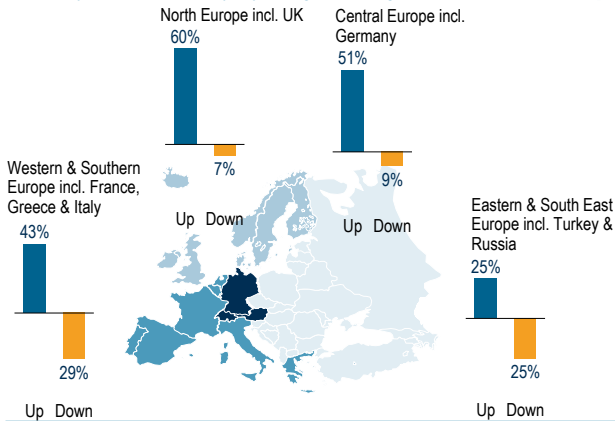


Figure 1 – Economy development expectations by European region

Respondents involved in paper & paperboard manufacturing are significantly more positive than the other respondents as 60% of

this group indicated that they expect the economy to move upwards and an additional 32% of the group expects the economy to move sideways. The most pessimistic group are the suppliers to the pulp & paper industry, 33% of them expect the economy to decline. This group is followed by the merchants and distributors, who also have a comparatively negative outlook. Around a quarter of participants from this group indicate that they expect the economy to decline.

Within the manufacturing group, packaging producers have the most positive view on the short-term economic development. Only few paper and paperboard manufacturers perceive the current economic situation to be in a downward trend.

**Economy development**

Where do you see the economy in your region heading in the next twelve months? [%]

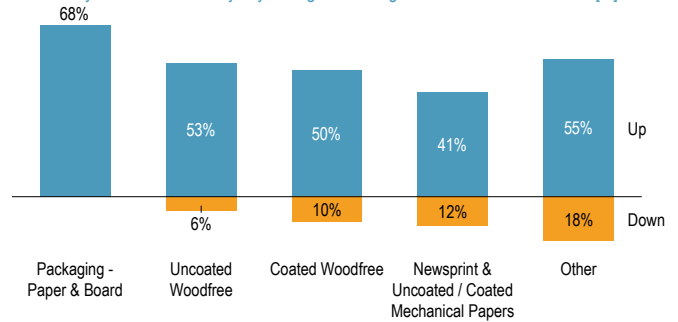


Figure 2 – Economy development expectations by sub-segment

The specific view on the paper industry remains negative in spite of a slight improvement over the last 3 years. 62% of respondents perceive their respective business segment to be in a downward trend or in a trough. In 2011, the responses indicated a confidence that the industry had reached a turning point (27% trough vs. 33% downward trend). However, the negative expectations from previous years remain.

**Industry development**

In your opinion, currently where is your area of the industry in the economic cycle? [%]

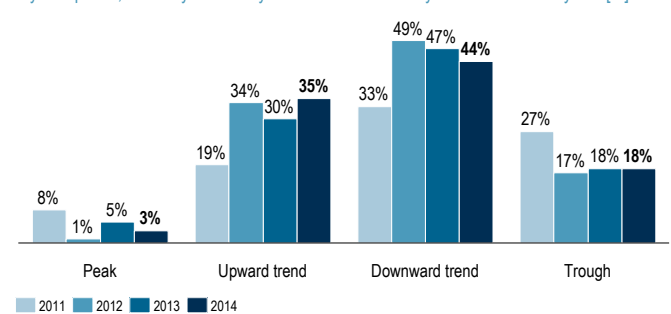


Figure 3 – Pulp & paper economic cycle position

With regard to their own industry segment, 42% of respondents from paper & paperboard manufacturing indicate a downward trend and 13% to be in a trough while 39% perceive an upward trend. Printers & publishers are more pessimistic: 80% state their industry is currently either on a downward or in a trough - so do two thirds of the pulp & paper suppliers.

#### Industry development

In your opinion, currently where is your area of the industry in the economic cycle? [%]

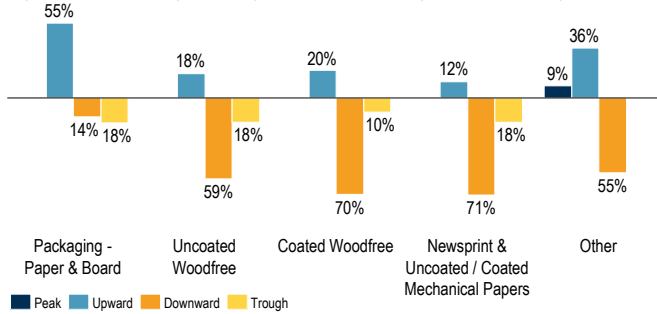


Figure 4 – Economic cycle position by sub-segment

Analyzing the manufacturers by sub-segments, respondents involved in packaging are by far the most optimistic group, whereas the printing and writing paper manufacturers perceive to be following a downward trend.

#### Margins continue to be under pressure

The survey inquired which trends respondents have identified and which priorities they have set to deal with business challenges.

The trends indicate continued pressure on the industry, both on the revenue and the cost side. In line with the overall economic and industry assessment, industry players increasingly expect market conditions to remain tough. Asked which trends they expect in 2014 versus 2013, 55% answered that they expect customer service level requirements to increase further.

Reflecting an optimistic view, 40% of participants expect customer demand to grow - the highest value for the last four years. Late payments and bad debts, on the other hand, are predicted to remain a challenge.

The perspectives on selling prices are diverging. 33% expect them to decrease while 26% foresee them to rise. Further investigation reveals that this is driven by the various industry segments: 44% of printing and writing paper respondents expect

price decreases (16% increases), whereas only 16% of packaging respondents expect decreases (32% increases).

Overall, the view on the sales side has improved slightly versus previous years, but remains less than enthusiastic.

#### Industry development

Sales side: What trends are you seeing in the market relative to last calendar year? [%]

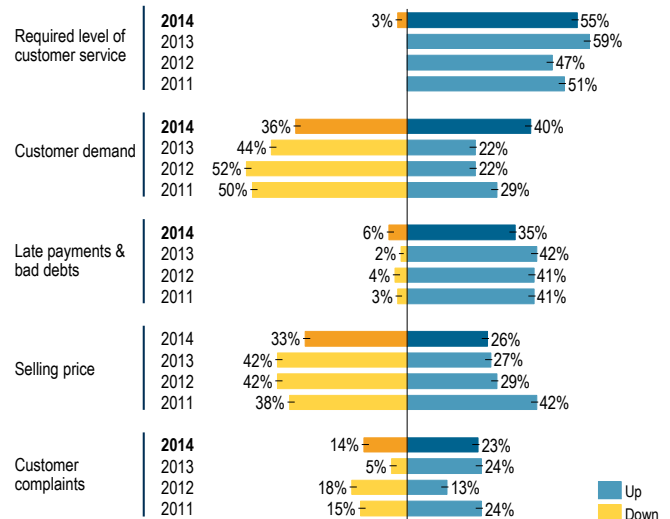


Figure 5 – Historical comparison of sales related trends

Combining the expectations related to price and demand with increasing customer service level requirements, cost competitiveness is a prerequisite for sustaining a reasonable level of profitability. This is especially true considering the anticipated continuation of input price increases. The cost driver expected to increase the most is energy – over 55% of participants expect energy costs to increase even further during 2014, while only 3% expect energy costs to decrease. Even though the share of respondents that expect transport costs to increase has shrunk compared to previous years, 45% of participants still foresee these costs to rise. A similar trend can be observed with regard to raw material costs (see figure 6).

**Industry development**

Cost side: What trends are you seeing in the market relative to last calendar year? [%]

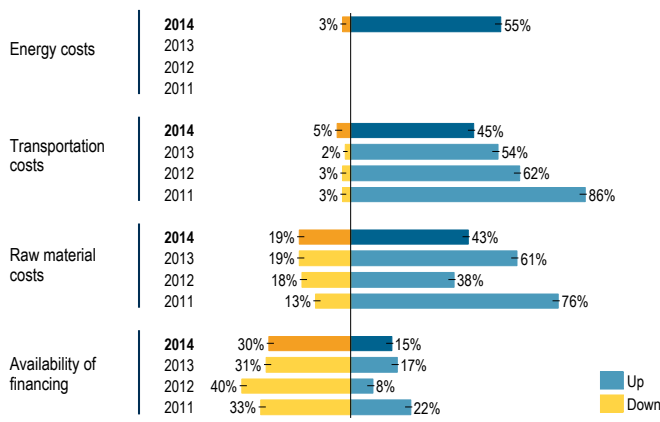


Figure 6 – Historical comparison of costs related trends

Companies take both internal and external measures in order to manage profitability – the main focus is on internal initiatives. Directly focusing on costs and margins remains the top priority. Cost reduction continues to be the single most important priority (71%) followed by pricing and margin management (66%) with the highest value since 2011. New product development and innovation is high on the business agenda in 2014 - 52% of participants state that this is a current priority for their company. Cash flow and working capital have moved up in priority again, after receding in 2013. Similarly, customer focused activities and supply chain development have moved up in the priority lists again.

**Industry development**

What are your company's current priorities? [%]

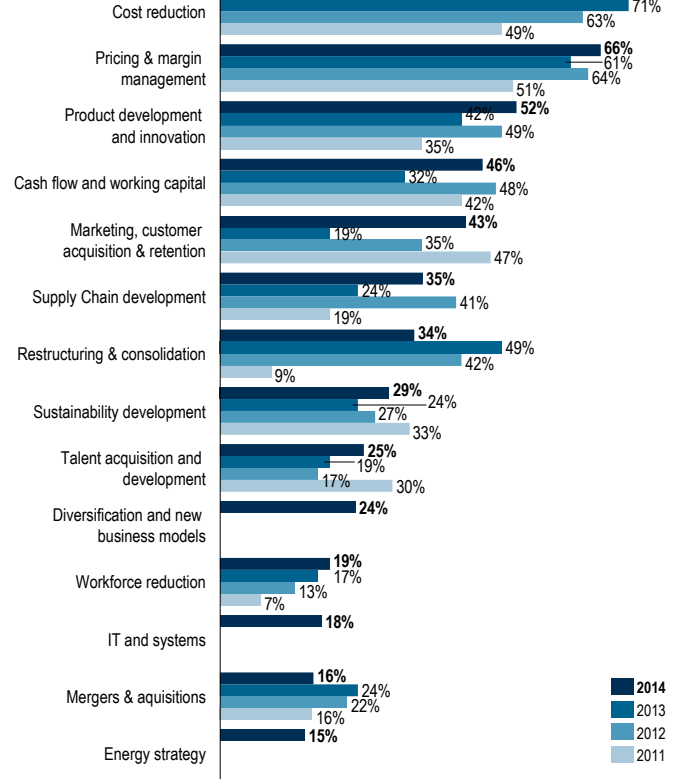


Figure 7: Historical comparison of current priorities

### Industry drivers - Outlook for the next five years

The industry continues to expect that capacity consolidation will have a positive influence on the industry (70%). Only 14% foresee a potential negative influence. To some degree surprising, environmental and sustainability requirements are regarded as the second most positive driver on the industry – 45% expect this factor to have a (very) positive impact on the industry.

Energy costs & regulations, electronic substitution, new capacities and margin pressure are expected to be the biggest negative influencers for the next five years for the industry.

#### Industry drivers

What influence do you expect the following drivers to have on the industry (next 5 years?)

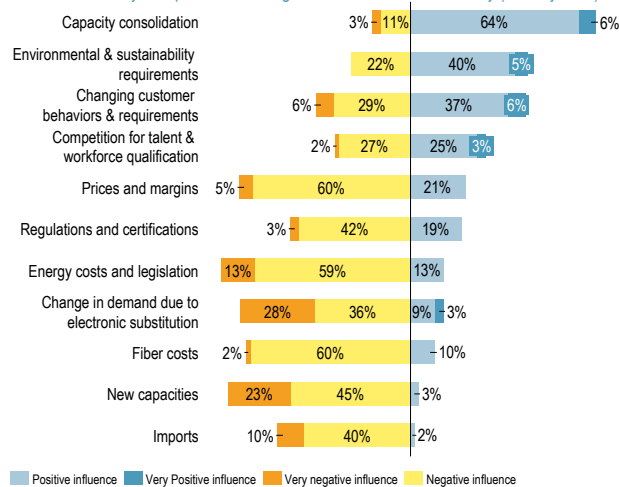


Figure 8 – Expected influence by external drivers

Companies seem to have aligned their priorities accordingly: costs and margin management, innovation and customer focus have a high priority as shown previously on figure 7.

### Poor European Attractiveness for Pulp and Paper

Overall, Europe is not perceived as a very attractive location for the pulp & paper industry. Only 2% of respondents see Europe as a highly attractive location; another 12% assess Europe as somewhat attractive. In contrast, 34% state that Europe is not attractive for the pulp & paper industry and for 6% Europe is considered not attractive at all.

The two main positive drivers for future competitiveness of Europe are a qualified workforce and the available infrastructure and (66% and 62%, respectively) followed by the availability of financing. However, in contrast to the perceived good qualification of the workforce, labor costs are considered to be either not attractive or not attractive at all by 55% of participants. High energy costs (80%) and high raw material costs (46%) combined with limited market growth opportunities (60%) add to the perceived unattractiveness of Europe as a location for the pulp & paper industry.

48% of participants state that imports will have no influence on the industry over the next five years. 43% perceive the competition for talents and qualified workforce to have no impact on the industry.

#### European attractiveness

How do you see Europe's attractiveness for the pulp & paper industry in terms of...

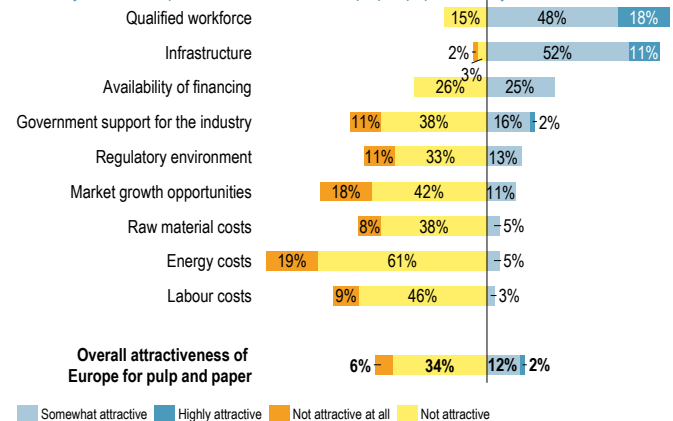


Figure 9 – Perspective on Europe as an industry location



### Germany and Poland win

Answering the question which European country is considered most attractive for the pulp & paper industry, 40% name Germany, followed by Poland (16%). The main reasons stated by respondents as a rationale for Germany's attractiveness are among others its market size, the central location and reasonable energy prices. The economy is perceived as solid and not overly regulated.

#### Europe's attractiveness

Which European country is most attractive for the pulp & paper industry? (open question)

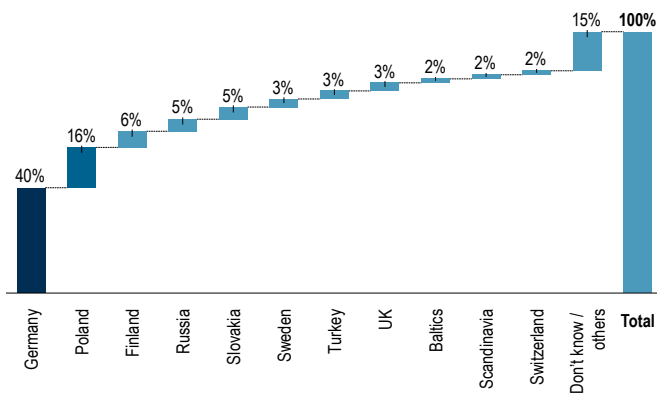


Figure 10 – European attractiveness by country

Original quotes regarding Germany's perceived attractiveness include: "Germany because of size [and] strong economy...", "Germany, due to its central location in regards to raw material supply and sales markets, best economic outlook", "Germany - due to cost to serve, infrastructure and knowledge".

Poland is perceived as the second most attractive country for the pulp & paper industry in Europe; some of the original quotes include: "Poland: improvements in infrastructure, relatively low level of regulations, overall market development --> however, capacities might increase too much", "Poland, due to its local growth and flexibility", "Poland - market size, access to CEE, Russia, policy, labor, energy etc.", "Poland - relatively low cost but good infrastructure and education level".

Finland is considered attractive due to the perceived availability of resources by 6%. Russia is considered attractive due to the perceived cost advantages combined with growth: "low labour costs, low raw material cost and growing market in many segments". Slovakia's legal environment as well as its industry friendly tax policies are positively perceived by 5%.

### Best perceived competitive position: And the winner is ...

According to the survey participants, Mondi is considered to be the company best positioned to face future challenges. 13% consider that Mondi has the best overall competitive position, followed by UPM, SCA and IP Europe.

Mondi's perceived competitive position is driven by the perceived growth in emerging markets (23%), its energy strategy (20%) and sustainability (17%).

UPM's perceived position is mostly driven by its perceived leadership in its energy strategy (33%) and for driving industry consolidation (27%).

SCA is considered the best positioned to face challenges in the area of talent attraction, human resources management and employee retention.

#### Industry development

Which company do you consider best positioned for the future challenges in terms of... [%]

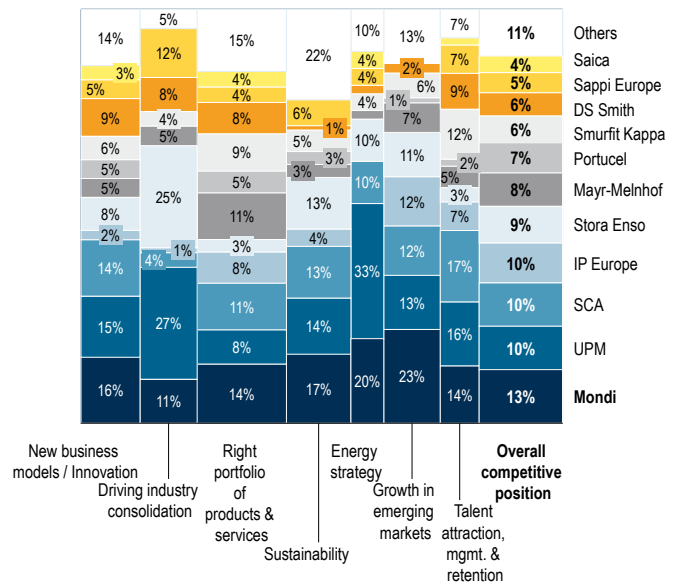


Figure 11 – Perceived competitive position Top 15 European Players

IP Europe is perceived by 12% to be leading in growth in emerging markets.

Stora Enso is considered by 25% as best positioned to face future challenges in terms of driving industry consolidation, followed by Sappi Europe (12%).

Mayr-Melnhof is perceived by 11% to have the best portfolio of products and services.

Portucel ranks well in its overall perceived competitive position, driven by the perceived right portfolio of services and products.

Smurfit Kappa is recognized as well positioned through its activities in the area of talent attraction, management & retention.

DS Smith's portfolio of products & services is considered to be well positioned. The company's efforts in new business models and innovation are also adding to its perceived competitive position.

Saica's best rating is in its perceived overall competitive position supported by its product and services portfolio.

Holmen efforts in the area of sustainability are perceived as a strength, followed by its energy strategy.

Prinzhorn Group is perceived as well positioned to face future challenges through its efforts in emerging growth markets.

BillerudKorsnäs' key perceived strengths are in the area of new business models and innovation; its portfolio of products & services is also considered to be good positioned.

Metsaliitto key perceived strength area is sustainability.

Further analysis related to the perception of the competitive position of each single company can be available upon request.

## Summary

Overall, survey respondents remain skeptical regarding future expectations for the industry. Even though the majority has a rather positive perspective on the economic outlook, the participants are skeptical about the development of the industry.

External influences such as raw material and energy costs are expected to maintain the pressure on margins. The threat of substitution by electronic media continues to concern parts of the industry. In addition, the regulatory environment is perceived to be less than helpful in mastering these challenges so that Europe overall is not considered very attractive.

In order to mitigate the manifold challenges, companies have defined their internal and external improvement priorities such as cost reduction, working capital management, price and margin management and customer acquisition and retention. Additionally the industry is addressing future challenges through an increased focus on sustainability development, talent management and a significant focus on innovation.

The path remains challenging, the outlook remains mixed and much homework remains to be done but the industry is aware of the challenges and seems to be addressing them with appropriate measures – a recipe and a framework for future success.



### About StepChange Consulting

StepChange is an industry focused and independent management consulting company with a proven track record in supporting clients to achieve sustainable value. StepChange provides support to top tier organizations in the industry from strategy development to implementation of operational improvements.

With an international team of industry experts StepChange can hit the ground running. StepChange provides innovative and yet pragmatic solutions, placing an emphasis on delivering measurable business results.

For further inquiries and comments regarding this Point of View please contact us at [leapfrog@stepchange.com](mailto:leapfrog@stepchange.com).

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