

## Temporary relief or tipping point?

**Outlook study reveals: Demand stable ♦ prices and costs down ♦ financing up ♦ packaging up ♦ graphic papers down ♦ focus on price and margin management ♦ strategy is back ♦ Germany and Poland most attractive in Europe ♦ Mondi, DS Smith, UPM, Smurfit Kappa and SCA considered most competitive ♦ Hopeful for positive influence from capacity consolidation and customer requirements**

### Results from the 2015 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 17<sup>th</sup> Annual RISI European Conference. The results of this survey were compared to results of prior years to allow for a multi-year comparison.

The outcome of the survey provides an indication about the perception of current market and economical developments in the industry, and highlights what the priorities in the industry currently are.

#### Highlights of the survey

- 44% of participants expect the economy in their region to strengthen within the next 12 months. Almost the same percentage of the participants expect the economy to stagnate (move sideways).
- With regards to the expected development in the pulp & paper sector for 2015, participants have very diverse views even though the outlook for this year is more positive compared to last year: 46% of respondents believe their segment in the pulp and paper industry will increase or reach a peak.
- On the cost side, most participants foresee costs (transportation, raw materials, energy) to decrease with one quarter of respondents believing costs will go up
- On the sales side, the demand outlook remains somewhat unchanged: while still more than 50% expect an unchanged demand, similar to 2014 38% of participants expect demand to increase. Only 28% expect selling prices to increase. At the same time 37% of participants (up from 35% last year) expect late payments and bad debts to increase
- Results vary between the industry segments - While Packaging has a very positive outlook, Graphic and

publishing papers continue to be negative in their demand outlook

- Company priorities are focused mostly on cost reduction, pricing & margin management and on product development and innovation
- The area that gained the most importance in the priority list vs. 2014 is diversification/ new business models and M&A activity
- Initiatives to improve cash flow and working capital management decreased priority this year after a considerable increase last year: Only 36% (from 46% last year) noted this parameter as a current priority for this year. (Note of caution: The latest StepChange research reveals that Working Capital levels are the highest since the crisis)
- Restructuring efforts mentioned less frequently than in 2014 – only considered a priority by slightly more than a quarter of participants
- Workforce reduction is a priority for 12% of respondents compared to 19% last year.
- Talent acquisition and development has been consistently gaining importance over 3 years (2012-2014) but this year lost importance: Only 12% of participants highlight this area to be a priority in 2015

#### Europe considered not very attractive

- Overall European attractiveness remains rather weak with labor costs, the regulatory environment and energy costs being picked as the least attractive parameters for lack of attractiveness
- Qualified workforce, infrastructure and availability of financing are considered positive influencers with respect to Europe's attractiveness
- Germany is considered to be the most attractive country for the pulp & paper industry in Europe, followed by Poland and Scandinavian countries (Finland, Sweden)
- According to 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 DS Smith and UPM (11% and 9% respectively).

## Survey Demographics

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

45% of the survey respondents are from the paper or paperboard manufacturing sector, 13% from merchanting & distribution and 13% from printing & publishing. 7% of participants are from converting and 12% of participants are from either technical, consulting or financial services,

Within the group of participants from paper & paperboard manufacturing (multiple answers were allowed), 73% are from the packaging sector, 23% from Newsprint, coated & uncoated mechanical and 27% from uncoated woodfree. 17% mention to work in the specialty/engineered paper segment; 14% in the coated woodfree paper segment as well as 7% from tissue.

Overall, respondents have a mixed opinion on the economic development in Europe. Taking a closer look by sub regions, more optimism comes from Northern Europe incl. the UK, where 63% of participants expect the economy to grow, and only 6% foresee the economy to decline. Compared to last year, expectations for this region have remained the same with some slight differences (63% expected upwards development and 6% downwards development).

Respondents from Eastern and South East Europe provide the most conservative view compared to the other regions with 43% of the respondents expecting the economy to decline (compared to 25% last year). On the other side, the same amount of respondents (43%) expect the Eastern & South East European economy to increase compared to only 25% in 2015. Western & Southern European participants have a very fragmented viewpoint with 33% expecting the economy to increase, 17% expecting a decline and 50% expecting a sideways movement.

Considering the relative strength of the economies, this implies that the overall sentiment leans toward a further widening of the economic performance gap between Northern & Central Europe and the Mediterranean region.

### Macroeconomic development

Where do you see the economy in your region heading in the next 12 months? [%]

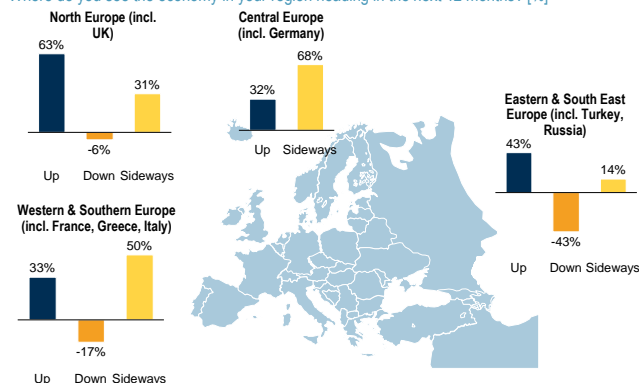


Figure 1 – Economy development expectations by European region

The specific view on the paper industry has improved slightly compared to last year.

48% of respondents believe their segment of the industry will increase or reach a peak. Only 43% of respondents perceive their respective business segment to be declining or reaching a trough compared to over 60% of respondents in 2015.

### Industry development

How will your sector of the pulp and paper industry develop in 2015? [%]

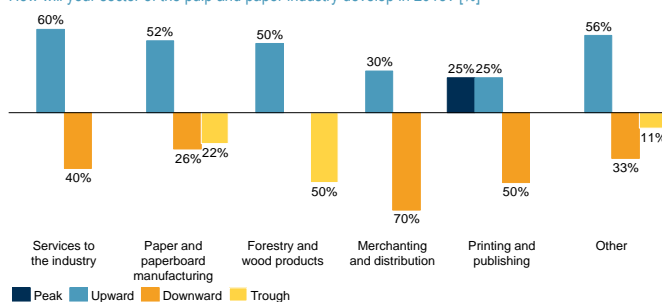


Figure 2 – Pulp & paper 2015 development by industry segment

By sector, paper and paperboard manufacturing, forestry & wood products and industry services are the most optimistic sectors with more than 50% of respondents believing their segment will develop upwards in 2015. A negative outlook can be observed in merchanting and printing and publishing where 70/50% of respondents have a gloomy outlook.

### Industry development

How will your sector of the pulp and paper industry develop in 2015? [%]

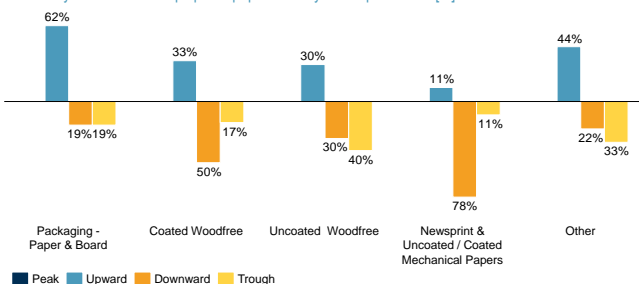


Figure 3 – Pulp & paper 2015 development by paper and paper board manufacturing sub-segments

Looking in more details at the paper and paperboard segment, respondents from packaging are the most optimistic group. 62% of respondents from packaging – paper and board subgroup expect their sector to increase during 2015 while 19% expect it to decrease or face a trough. Newsprint/uncoated/coated mechanical papers subgroup are more pessimistic: 85% state their segment will either decline or stay in a trough during 2015 which is very similar to 2014 expectations.

**Margins continue to be under pressure**

The survey covered questions inquiring how respondents see the development of market parameters and which priorities have been defined to deal with business challenges.

The trends indicate some pressure relief especially on the cost side with demand somewhat stable and prices slightly downward. Asked which trends are expected in 2015 versus 2014, almost 55% responded that customer service level requirements are expected to increase further.

Reflecting a slightly less optimistic view, 38% of participants expect customer demand to grow compared to last year's 40% of participants. Late payments and bad debts, on the other hand, are predicted to remain a challenge.

The perspectives on selling prices are diverging. 41% expect them to decrease while 28% foresee them to rise. Further investigation reveals that these results are driven by the various industry segments: 67% of printing & publishing respondents expect price decreases (0% increases), whereas paper and board producers 46% expecting a decrease and only 18% an increase. Pulp producers have a considerable more optimistic view with 0% of respondents expecting decreases but half of them expecting increases on selling prices (other half does not expect changes).

Overall, the view on the revenue side has deteriorated slightly compared to 2014.

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. Contrary to the previous years, pressure from raw material costs are rather expected to decrease in 2015. The share of respondents who expect raw material costs to increase has shrunk significantly compared to the previous three years (from a maximum of 61% to 29%), whereas the share of respondents who see a decrease in raw material costs almost doubled from the previous years (from 19% to 36%).

**Industry development**

Sales side: What trends do you see in your segment of the pulp and paper industry compared to 2014? [%]

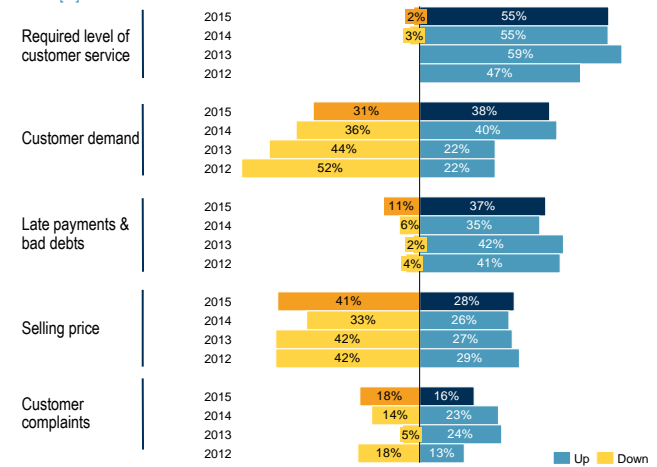


Figure 4 – Historical comparison of sales related trends

A very clear picture is portrayed in transport costs: 44% expect transport costs to decrease which is almost tenfold previous years. The same picture is true for energy costs where respondents indicate almost unanimously a decrease for 2015 compared to previous years. Availability of financing is equally in the best position compared to last three years.

**Industry development**

Cost side: What trends do you see in your segment of the pulp and paper industry compared to 2014? [%]

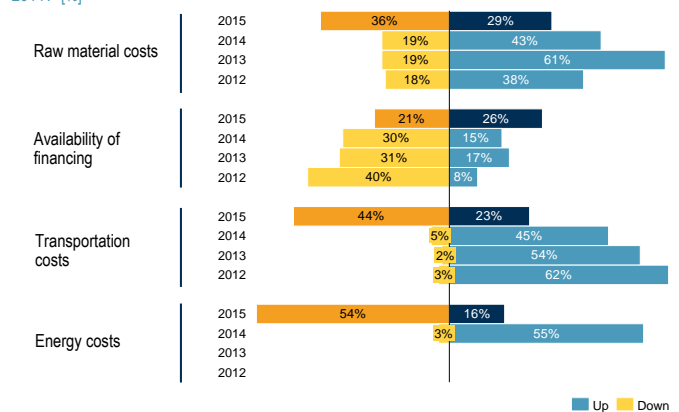


Figure 5 – Historical comparison of cost related trends

Companies take both internal and external measures in order to manage profitability. Directly focusing on costs and margins remains the top priority. Pricing and margin management continues to be the most important priority (61%) together with cost reduction initiatives (53%). New product development and innovation have dropped in importance compared to 2014 but still 44% highlight this area as their company's priority. Cash flow and working capital decreased in priority further; 36% 2015 vs. 46% in 2014. Diversification & new business

models, M&A and energy strategy have gained significant priority in 2015 (27%, 27% and 22% respectively).

#### Industry priorities

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

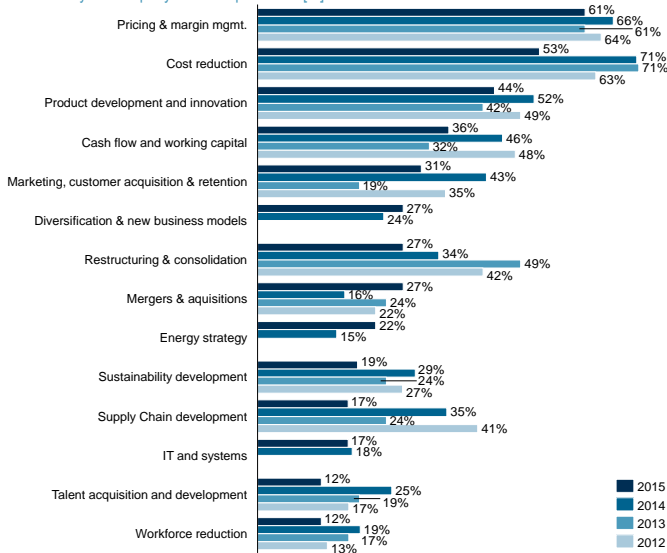


Figure 6: Historical comparison of current priorities

Participants were asked to answer freely in regard to the single most important driver that will impact their segment over the next 5 years. 28% of participants noted changes in customer demand as the main one, followed by availability & cost of inputs (21%) and in third place development of capacities and consolidation (19%). Macroeconomic factors (7%) are ranked 5<sup>th</sup> where among others drivers such as oil price and the development of the EU economy were mentioned.

#### Industry drivers

What is the single most important driver for change that will impact your area of the pulp and paper industry over the next 5 years? [%]

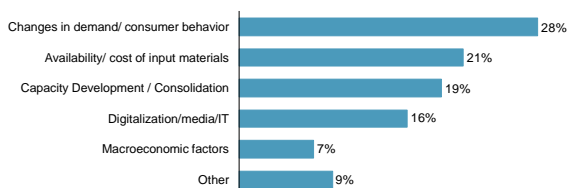


Figure 7: Single most important driver of business in next 5 years

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

The majority of the industry continues to expect a positive influence of capacity consolidation on the industry (65%) in the next 5 years. Changing customer behaviors and requirements are considered to have a positive influence (e.g. the trend towards sustainable packaging). On the other side the impact from digitalization is seen as a threat in other sectors of the industry. Environment and sustainability is considered by 29% to have an equally positive and negative impact on the industry in the next five years (ranked second in previous year).

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

#### Industry drivers

What influence do you expect the following drivers to have on the industry in the next 5 years? [%]

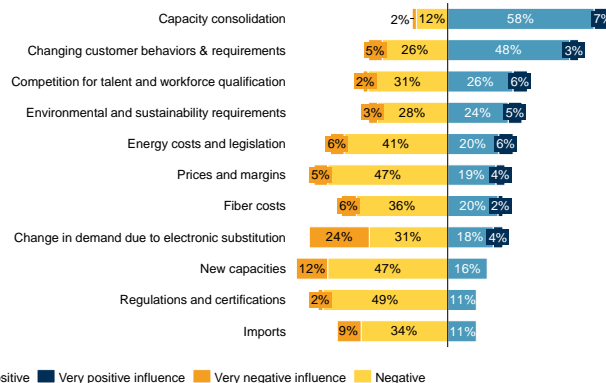


Figure 8 – Expected influence by external drivers

Companies seem to have aligned their priorities according to the influence of the most important industry drivers. Costs & margin management priorities together with customer focus have a high priority in 2015 as shown previously in figure 6. On the other side, drivers like capacity consolidation seem to have lost priority compared to 2014 despite the considerable influence of this parameter as an industry driver.

#### Poor European Attractiveness for Pulp and Paper

Overall, Europe is not perceived as a very attractive location for the pulp & paper industry. A qualified workforce, the quality of the infrastructure and availability of financing remain the only parameters this year where the majority of respondents believe Europe is more attractive than unattractive (74%, 70% and 46% respectively). When it comes to financing the picture is mixed. In opposition to the 46% of respondents who believe Europe is attractive regarding the availability of financing 29% of respondents believe this parameter contributes to Europe's lack of attractiveness. High labor costs (70%), difficult regulatory environment (64%) and high energy costs (60%) add to the perceived unattractiveness of Europe as a location for the pulp & paper industry. In summary 43% of respondents believe Europe is not attractive compared to only 18% who believe the opposite.



### Europe attractiveness

How do you see Europe's attractiveness for the pulp and paper industry in terms of... [%]

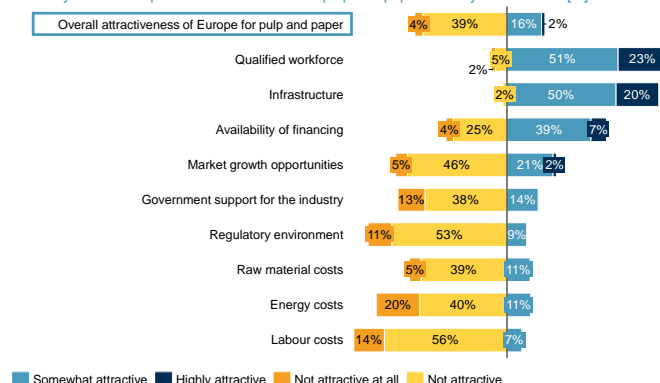


Figure 9 – Perspective on Europe as an industry location

### Germany and Poland win

Answering the question which European country is considered most attractive for the pulp & paper industry, 38% name Germany, followed by Poland (22%). The main reasons stated by respondents as a rationale for Germany's attractiveness are among others its market size, growth potential, competitive energy costs, and good infrastructure. Its economy is perceived as solid.

### European competitiveness

Which European country is most attractive for the pulp and paper industry and why? [%]

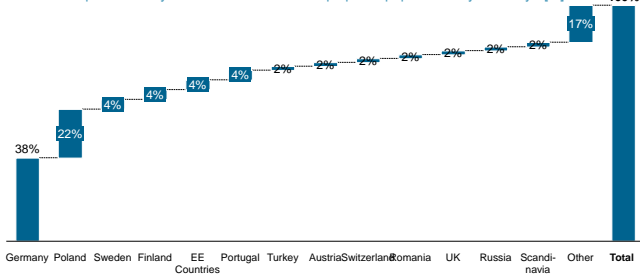


Figure 10 – European attractiveness by country

Original quotes regarding Germany's perceived attractiveness include: "Germany - solvent, reliable customer base, biggest market with growth potential for most its products due to high Efficiency/innovation", "Germany. Very good infrastructure, availability of raw materials, highly skilled work force, low logistic costs, competitive energy costs".

Poland is perceived as the second most attractive country for the pulp & paper industry in Europe; some of the original quotes include: "Poland: market demand, wood supply, labor cost", "In terms of growth Poland is more interesting than Germany".

Finland is considered attractive due to knowledge and wood resources. Portugal is considered attractive due to fiber availability, low costs and market demand. Turkey was as well a

country mentioned once as a first choice and twice as a second choice country with regards to attractiveness. Reasons mentioned for Turkey's competitiveness are current and future growth rates (despite volatility).

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

According to survey results, Mondi is considered to be the company best positioned to face future challenges of the 15 largest companies in Europe. 13% consider that Mondi has the best overall competitive position, followed by DS Smith, UPM, SCA and Smurfit Kappa.

The perceived competitive position of Mondi is driven by the talent attraction/management/retention (14%), perceived sustainability (13%), its portfolio of products and services (13%) and growth in emerging markets (13%).

DS Smith's perceived position is mostly impacted by its drive of industry consolidation (18%), new business models (11%) and talent attraction/management/retention (11%).

UPM's perceived position is mostly influenced by the perceived leadership in energy strategy (25%) and for driving industry consolidation (18%).

According to the survey, Mondi, Stora Enso and SCA are the companies positioned best with regards to talent attraction, management and retention. DS Smith and UPM are considered by far to be the industry leaders in driving industry consolidation. UPM is considered to have reached far beyond the other companies in energy strategy.

**European competitiveness**

Which of these top 15 (European) companies do you consider best positioned for the future in terms of ... (multiple answers allowed)

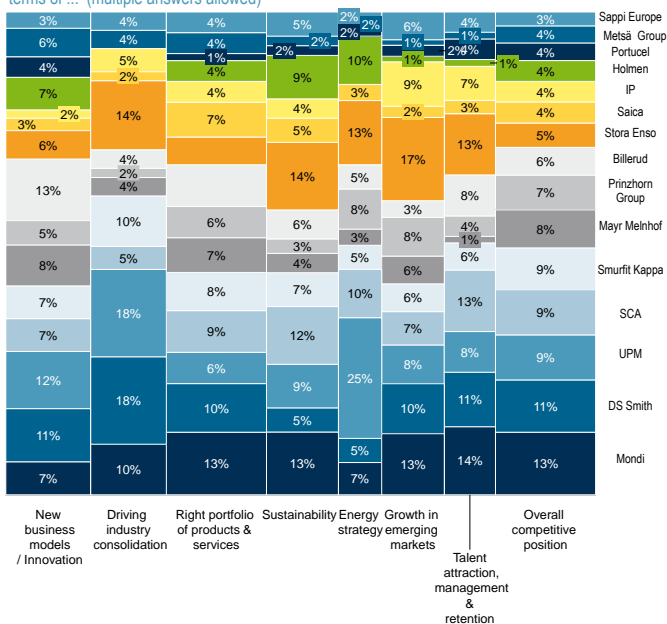


Figure 11 – Perceived competitive position Top 15 European Players

SCA is considered by 13% as best positioned in talent acquisition and in sustainability.

Smurfit Kappa is perceived to be best positioned in having the right portfolio of products and services (8%).

Mayr-Melnhof is perceived to be best in the portfolio of products and services and for new business models/innovation (8%).

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

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

Stora Enso ranks very well in most of the parameters, led by the growth in emerging markets, industry consolidation and sustainability. However, Stora Enso is perceived little competitive in new business models/innovation.

Saica's best rating is in the portfolio of products and services and sustainability (7% and 5% respectively).

IP is perceived to be best positioned in terms of talent attraction/retention and growth in emerging markets.

Holmen efforts in the area of energy strategy (10%) are perceived as a strength, followed by its sustainability (9%).

Portucel is perceived as most competitive in talent acquisition/attraction (4%) and in new business models (4%).

Metsä Group is perceived well positioned in new business models (6%), for driving industry consolidation (4%) and for having the right portfolio of products and services (4%).

Sappi's perceived competitive position is determined by growth in emerging markets (6%) and sustainability (7%).

**Summary and Conclusions**

Overall, survey respondents are carefully optimistic about prospective industry development. Even though the majority have a slightly positive perspective on the economic outlook, results vary depending on the segment of the industry.

Contrary to previous years most cost indicators point downwards mostly driven by decreasing energy costs. Demand is expected to remain high and prices fairly stable in the growth sectors of the industry such as packaging. For graphic papers especially newsprint, mechanical papers and coated woodfree the outlook is less than optimistic. The threat from substitution by electronic media continue to impact the development in these segments.

Overall European attractiveness remains rather weak with labor costs, regulatory environment and energy costs being the least attractive parameters. Within Europe, Poland and Germany are perceived to be the most attractive locations for the industry.

In order to mitigate the manifold challenges, companies have defined their internal and external priorities such as price and margin management, cost reduction, product development and innovation, working capital management, new business models and M&A. While remaining important, most internal measures such as cost reduction and working capital have dropped in importance.

The path remains challenging, the outlook remains mixed and much work remains to be done. After years of consolidation and cost reduction it is interesting to note that strategic measures such as new business model development and M&A are gaining in importance which is a healthy signal for and industry looking forward.



### 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.

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TO DELIVER RESULTS**

