Global competitiveness: the view from Asia

CEPI Annual Meeting
November 2006

Overview

- Oversupply, mature or contracting markets, and rising costs result in capacity rationalisation on an unprecedented level in both Europe and North America.
  - Six million t/y P&W capacity closes 2004-2007

- China’s P&B capacity grows by ~30MT/y from 1995 to 2008
  - China grows at the expense of other Asia

- The speed of restructuring depends on factors largely outside the control of industry leaders and policy makers in Europe
  - Rate of demand growth in Asia and other emerging markets
  - Exchange rates: euro/dollar, renminbi, yen, won and others
  - Trade rules i.e. import tariffs, export incentives, other forms of state aid, particularly in China
Asia is not a single market

- Non-Japan East Asia
- Korea, China, Taiwan, Hong Kong, Thailand, Malaysia, Singapore, Indonesia, Vietnam, Philippines
- Economically, politically, demographically, ethnically diverse region
- India is not (yet) important in the international market. No fibre resources, lack of infrastructure hinders development of P&B industry

GDP per capita; regional disparities

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**China - the country**

- Area 9.6 million sq k
  - (Russia 17.1, USA 9.2, Canada 9.9)
- 31 provinces
- 656 cities
- 48,000 districts
- 56 recognised ethnic groups
- 7-10 groups of languages/dialects - 80 spoken tongues
- No ‘national’ market - consumers too dispersed, too inaccessible, too different

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**Household income in China**

Unequally distributed

- 78% of households have an annual income of less than $5000
- Just 6% of households (28 million in all) have an income greater than $10,000/year
- This 6% of households account for 28% of total income

Total of 363 million households in 2004
## China: Official statistics...

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Newsprint</td>
<td>1,730</td>
<td>3,000</td>
<td>3,600</td>
<td>20.0%</td>
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<td>115</td>
<td>3,715</td>
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<td>Printings</td>
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<td>10,200</td>
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<td>7.8%</td>
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<td>n/a</td>
<td></td>
<td></td>
<td>n/a</td>
<td>n/a</td>
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<tr>
<td>Writing</td>
<td>1,400</td>
<td>n/a</td>
<td>n/a</td>
<td></td>
<td></td>
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<td>Coated</td>
<td>1,300</td>
<td>3,000</td>
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<td>20.0%</td>
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<td></td>
<td></td>
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<td>Tissue</td>
<td>2,700</td>
<td>3,840</td>
<td>4,000</td>
<td>4.2%</td>
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<td>-65</td>
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<td>Packaging</td>
<td>4,000</td>
<td>4,700</td>
<td>4,700</td>
<td>0.0%</td>
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<td>465</td>
<td>5,165</td>
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<tr>
<td>Cartonboard</td>
<td>3,000</td>
<td>6,700</td>
<td>7,300</td>
<td>9.0%</td>
<td></td>
<td>780</td>
<td>8,080</td>
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<td>Duplex</td>
<td>2,500</td>
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<td>n/a</td>
<td></td>
<td></td>
<td>n/a</td>
<td>n/a</td>
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<tr>
<td>Linerboard</td>
<td>4,600</td>
<td>8,300</td>
<td>9,000</td>
<td>8.4%</td>
<td></td>
<td>1,300</td>
<td>10,300</td>
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<tr>
<td>Medium</td>
<td>6,000</td>
<td>8,100</td>
<td>8,800</td>
<td>8.6%</td>
<td></td>
<td>590</td>
<td>9,390</td>
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<td>Specialities</td>
<td>670</td>
<td>1,660</td>
<td>1,800</td>
<td>8.4%</td>
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<td>40</td>
<td>1,840</td>
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<td>TOTAL</td>
<td>32,000</td>
<td>49,500</td>
<td>53,800</td>
<td>8.7%</td>
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<td>3,255</td>
<td>57,055</td>
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</table>

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## Paper Industry structure – Hawkins Wright

- **The New China industry**
  - Capacity >50,000 t/y using imported fibre (woodpulp & wastepaper)
  - Some smaller mills producing woodfree papers
  - Mills built since 1996

- **The Old China industry**
  - Mills using predominantly non-wood fibres and domestic wastepaper
  - Mills built before 1996
  - We cannot define 'Old China' with any confidence, but it doesn’t matter as grades not comparable to international qualities

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### New China / Old China

<table>
<thead>
<tr>
<th>Year</th>
<th>&quot;New&quot; China</th>
<th>&quot;Old&quot; China</th>
<th>Total</th>
<th>Recycled fibre</th>
<th>Wood pulp</th>
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<tr>
<td></td>
<td>thousand tonnes</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>1995</td>
<td>1,750</td>
<td>14,350</td>
<td>16,100</td>
<td>906</td>
<td>751</td>
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<tr>
<td>1996</td>
<td>2,900</td>
<td>15,400</td>
<td>18,300</td>
<td>1,372</td>
<td>1,393</td>
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<td>1997</td>
<td>3,200</td>
<td>15,950</td>
<td>19,150</td>
<td>1,620</td>
<td>1,427</td>
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<tr>
<td>1998</td>
<td>4,200</td>
<td>15,400</td>
<td>19,600</td>
<td>1,913</td>
<td>2,054</td>
</tr>
<tr>
<td>1999</td>
<td>5,750</td>
<td>15,150</td>
<td>20,900</td>
<td>2,515</td>
<td>2,942</td>
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<tr>
<td>2000</td>
<td>6,700</td>
<td>16,000</td>
<td>22,700</td>
<td>3,712</td>
<td>2,823</td>
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<tr>
<td>2001</td>
<td>10,700</td>
<td>16,000</td>
<td>26,700</td>
<td>6,418</td>
<td>4,739</td>
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<tr>
<td>2002</td>
<td>11,250</td>
<td>16,450</td>
<td>27,700</td>
<td>6,873</td>
<td>5,021</td>
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<tr>
<td>2003</td>
<td>13,750</td>
<td>16,890</td>
<td>30,640</td>
<td>9,162</td>
<td>5,720</td>
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<tr>
<td>2004</td>
<td>16,000</td>
<td>17,330</td>
<td>33,330</td>
<td>12,300</td>
<td>6,860</td>
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<tr>
<td>2005</td>
<td>19,500</td>
<td>18,065</td>
<td>37,565</td>
<td>17,040</td>
<td>7,180</td>
</tr>
<tr>
<td>1998-2005</td>
<td>15,300</td>
<td>2,665</td>
<td>17,965</td>
<td>15,127</td>
<td>5,126</td>
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</table>

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### Over 80% of “New China” production in four provinces

*Industry is concentrated in the coastal provinces near to the export manufacturing zones*
New China apparent consumption, 2005

<table>
<thead>
<tr>
<th></th>
<th>Production</th>
<th>Import</th>
<th>Export</th>
<th>Apparent consumption</th>
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<tbody>
<tr>
<td>Newsprint</td>
<td>1,955</td>
<td>135</td>
<td>20</td>
<td>2,070</td>
</tr>
<tr>
<td>Printings</td>
<td>0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Coated</td>
<td>2,440</td>
<td>730</td>
<td>790</td>
<td>2,380</td>
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<tr>
<td>Uncoated</td>
<td>1,950</td>
<td>435</td>
<td>340</td>
<td>2,045</td>
</tr>
<tr>
<td>Tissue &amp; Specialities</td>
<td>1,425</td>
<td>50</td>
<td>100</td>
<td>1,375</td>
</tr>
<tr>
<td>Cartonboard</td>
<td>3,710</td>
<td>970</td>
<td>190</td>
<td>4,490</td>
</tr>
<tr>
<td>Liner</td>
<td>6,770</td>
<td>1,775</td>
<td>85</td>
<td>8,460</td>
</tr>
<tr>
<td>Other Packaging</td>
<td>1,250</td>
<td>720</td>
<td>35</td>
<td>1,935</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>19,500</strong></td>
<td><strong>4,815</strong></td>
<td><strong>1,560</strong></td>
<td><strong>22,755</strong></td>
</tr>
</tbody>
</table>

- But up to 50% of printing papers and 65% of Packaging grades could be exported in converted form
- Chinese domestic consumption < 15 million t; high savings rate and low growth in domestic consumption.

Imports are falling...

- Imports are being displaced
- It is difficult to displace imports for conversion and re-export
- Import tariffs have fallen but anti-dumping duties are in place on newsprint and CWF

Source: Chinese customs
Exports are rising...

- Exports are rising rapidly... particularly in coated woodfree...
- ...but also in uncoated, newsprint, and cartonboard
- Export subsidies phased out, meaning lower returns
- High proportion of exports are accounted for by a handful of companies
- Does NOT include converted products - tissue, stationery, books and magazines

Source: Chinese customs

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China strengths

- Key advantage has been low cost of capital
  - Originally from state banks
- In China, government relies mainly on administrative measures to curb investment
  - Small increases in interest rates are more effective
  - Excess liquidity; China's foreign exchange reserves are $1 trillion!!
  - Need to stop saving and investing and start spending
- Several Chinese companies have raised money on Shanghai stock exchange, or have private sources of finance
  - IFC, and other paper companies (Sappi, International Paper, Moorim)

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Asian Strengths

- Labour – a relatively small cost component in papermaking
- Scale advantage (China, Indonesia, Korea, Thailand)
- Producers and consumers are flexible and open to substitution
- Vertical corporate structure leads to fast decision making, willingness to take risks
  - Relationships are key - Even within Asia the playing field is not level

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Asian weaknesses - fibre

- China, Japan, Korea and Taiwan are net importers of pulp wood, market pulp, and recycled fibre
- Market pulp prices have increased by 30-45% ($120-220/t) in 12 months
- Historically a “spot” market and very exposed to volatile fibre markets
- Recycled fibre imports to China have increased from 4 million tonnes in 2000 to 20 million tonnes in 2006
  - Availability is a major concern
  - Local collection systems remain unsophisticated by international standards
  - High straw content degrades quality

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**Other Asian weaknesses**

- Asia is on a par with, or at a disadvantage to, Europe in terms of energy, chemicals, and other input costs
- Lack of reliable statistical information adds to volatility, and makes planning difficult
  - Herd mentality
- The growing environmental agenda presents extra challenge/cost for Asian companies
  - Especially for those with ambitions to export
  - Forestry practice is changing in Asia as companies start to engage with NGOs
  - In poorest countries, economic development takes precedence over environment

**How sustainable is China’s growth?**

- Profitability within China a subject of great debate, with experts from World Bank and private financiers in dispute
  - Quality of statistics is poor/unreliable and Stock markets a poor indicator
  - Profits wasted or re-invested?
  - Capital from cash-flow or from state??
- This debate is key to whether the growth is sustainable, or a boom waiting to bust
  - Answer probably lies somewhere in the middle
  - But new assets usually run 100%, regardless of ownership
- Some things we do know
  - Profits vary, and risks and rewards are high. Nine Dragons owner is richest lady in the world
  - Cash is king! Ability to open letter of credit is crucial
Conclusions

• Business conditions are tough in Asia
  ➢ Margins also diminishing
  ➢ On an operating basis, Asian advantages are not clear

• Despite WTO membership, China is long way from reaching free market status
  ➢ Most of the Publishing industry remains state controlled and closed
  ➢ Special economic zones, licenses for import and export
  ➢ VAT rebates on exports
  ➢ Other tax breaks, soft loans and debt forgiveness, etc.

• Any of these can change almost overnight
  ➢ In practice, “where one door closes, another opens”

Conclusions

• European exports to Asia will decline in volume and profitability, especially if euro retains its level against US dollar
  ➢ Niche market opportunities remain

• Asians are relatively new to export markets
  ➢ Will find it hard to compete with integrated mills

• Multi-nationals investing in China
  ➢ Norske Skog, Stora Enso, UPM-Kymmene, Arjo-Wiggins, SAPPI ?
  ➢ JVs are very difficult to work in practice as Chinese work to different business model
The playing field will never be level

Thank you