Paradigm of maximum capacity utilisation has to go!

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When we examine the performance of the pulp and paper industry during the past few years, we may all agree with the view that the pulp and paper industry has not been able to defend its price levels, even though regional industry concentration metrics would suggest otherwise. It appears that the pulp and paper industry lacks true price leadership which would be effective in reaching a consensus on pricing without collusion in violation of antitrust laws.

True, there is no reason to expect any differences in price behaviour between competitive and concentrated industries as long as the leading producers cannot affect the price significantly by varying their output or inventory levels. If the price leader is not followed by the rest of the market, the leader is at risk of losing market share. In other words, short-term private interests seem to have overrun long-term industry interests.

Cost cutting does not guarantee profitability

Since late-2000, vigorous cost cutting programmes have improved the efficiency of pulp and paper operations in the key production regions. Good news so far. But: at the same time, paper prices have declined 3-6% per year in real terms leading to weakening profitability (Fig. 1).

Not only papermakers but also printing and converting industries have been suffering from low profitability. Bluntly saying, no one in paper, print and converting has been highly profitable, not even in a peak with full order books. The benefits of lower production costs have been passed on to the end users. Ironically, paper, print and converting have also been unable to pass on increases

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Nr. 11 / 2007
Code 2/07-10

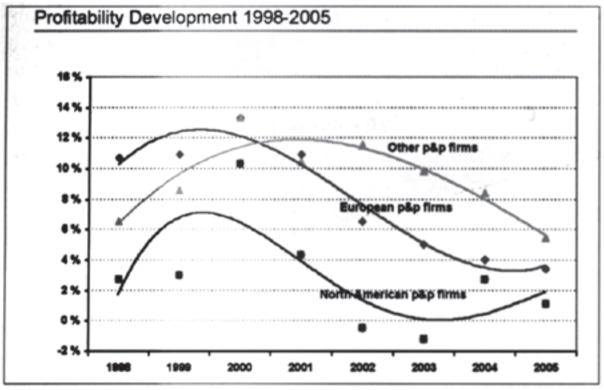


Fig. 1

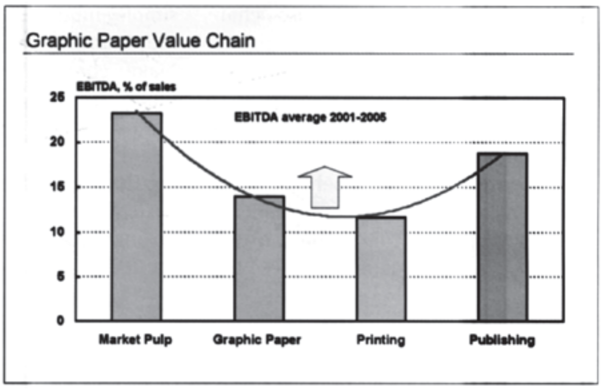


Fig. 2

in costs while revenues at the end of the chain have been growing, and no efforts are made by the papermakers and -users to capture and increase their share of these revenues (Fig. 2).

Throw away the over-capacity paradigm!

The only good thing in this embarrassment is that it does not need to be so. However, the industry mindset – volume before value – needs to be changed first. Producers should be aware of the need not to expand their production to the point where the supply is large enough to result in a reduction of price. Papermakers eagerly refer to industry overcapacity being the reason for lousy revenues. Surprise: Former GE chairman Jack Welch claimed that "there is excess capacity in almost every industry". Excess capacity in steel has been as high as 20% while in automotive industries it has been even higher than that, at around 30%. The paper industry starts selling cheap when the capacity utilisation rate sinks below 90%. With all respect, the paradigm of maximum capacity utilisation in the paper industry has got to go! In other oligopolistic markets, excess capacity is maintained as a strategic device. It is good to have spare capacity in case of demand peaks. Some level of unused capacity can even be considered an efficient entry deterrent in process industries.

Final consumers do not care about paper price

Final consumers would not even know if paper prices increased or decreased. Even if large paper price increases were passed forward in the supply chain, the final price of and thus the demand for magazines or packed goods would not change. The main reason for this is that paper costs play a minor part of the total costs of products they are related to. For example, magazine paper accounts for only about 6% of total magazine production costs (Fig. 3). The cost of paper-based packaging out of the total cost of the packed product is in most cases negligible. This is what economists call inelastic demand, meaning that large reductions in paper and paperboard prices do not yield significant increases in demand. And vice versa: Price increases do not result in significantly reduced demand.

Although it is not possible to equate industry concentration directly with market power, it is, however, quite logical to assume that pricing power increases with the decreasing number of competing firms. Has the paper industry reached the critical concentration level where the firms could already exercise some control over their prices and hereby influence the markets' behaviour? Based on the US antitrust authority's guidelines – deliberately applied to the Western European markets – one could come to the conclusion that the Western European paper industry is either concentrated or moderately concentrated, and therefore, in much better pricing position than pure price-takers in a perfectly competitive market (Fig. 4). Under the assumption of Nash-Cournot equilibrium it is

Fig. 3

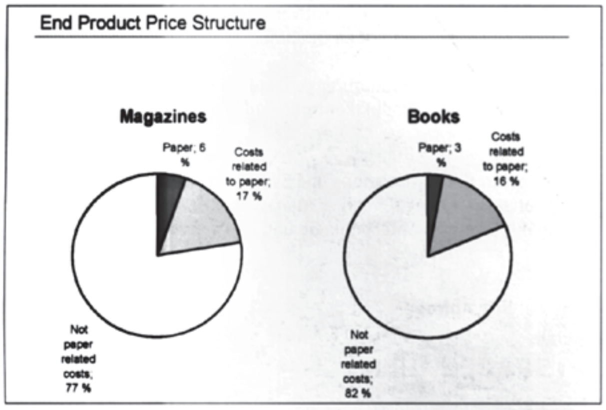
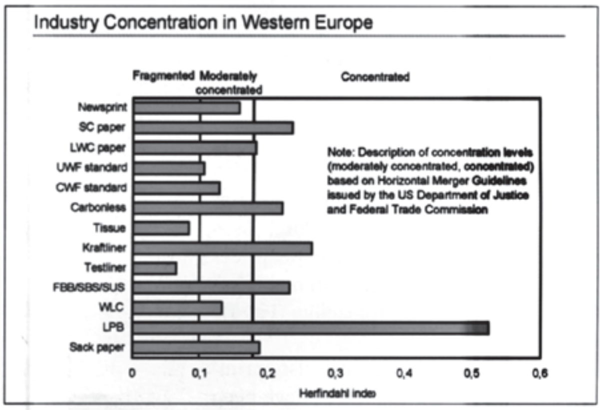


Fig. 4



easy to see that the profit margin and consequently the mark-up are directly proportional to seller concentration and inversely related to the absolute value of price elasticity of demand.

Has the paper industry recognised the implications of a relatively concentrated market and low price elasticity of demand? Such circumstances suggest that higher than present price-cost margins (read: reasonable profitability) for the industry would be possible.

Start your "revenues up" programme

Instead of "following up" what is going to happen on the pricing front, the pulp and paper industry should take immediate action and tackle a myriad of issues that tend to hamper the industry's well-being today and in the future. For starters: Change the industry/company mindset and paradigm; acknowledge your market power and strengths of your products; discard the eternal concept of excess capacity; fight for the image of printed/fibre-based products. Plan and implement – as necessary – needed supply restrictions in the phase of cyclical slow-downs; fit up your capacity management toolkit for quick supply decisions. Develop your sales organisation and sales skills within; merit and reward value in lieu of volume; fit up your sales manager's toolkit to support pricing decisions; optimise your sales channels; acquire in-depth knowledge of your consumers and possibilities to earn acceptable returns. Establish new pricing models for your products; performance pricing vs. cost plus; pricing based on relevant properties that are meaningful to the decision makers at the end of the value chain. Identify growth segments; develop value propositions for target segments; search for new products and niches that may fit your assets and natural market sphere; sell more value by integrating further down the value chain. Simplify your product portfolio; lower your customers' operational expenses through simplified product offering for mutual benefit. Seek new revenue streams from the product; patented systems; new product attributes and industry standards.

Pöyry's mission is "to create a prosperous and sustainable future together" with our clients. In line with this mission statement, we are in the business of improving our clients' performance through professional commitment and excellence, and would be very interested in supporting the paper industry's actions for improved pricing and increased revenues. ■