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Graphic-paper producers: Boosting resilience amid the COVID-19 crisis

Four proven actions can help graphic-paper producers rebound despite the market declines that have been accelerated by the COVID-19 pandemic.

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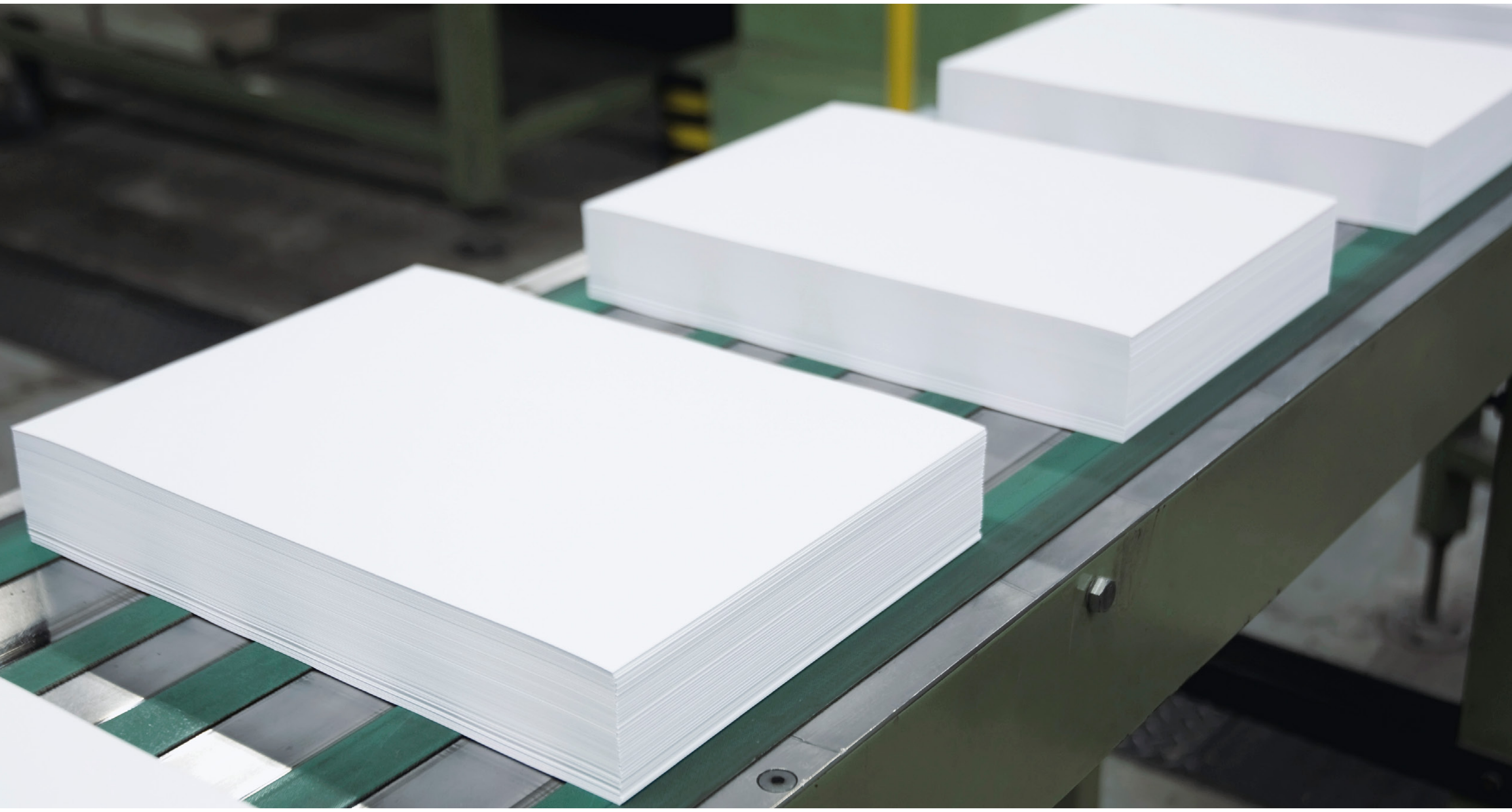

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Global graphic-paper markets have been declining significantly over the past decade. Developed countries have experienced the strongest decline, at approximately 5 to 6 percent per year (Exhibit 1). Developing countries' graphic-paper consumption surpassed demand from developed countries in 2014. However, consumption there, too, had started to wane in 2013, albeit at the slower pace of approximately 1 to 2 percent a year.

The decline in demand for graphic paper has been especially noticeable in developed countries, where there has been a clear correlation between reducing paper consumption and economic advancement, driven by digitization. The similar effects we are now seeing in developing countries can be explained in part by the relatively larger share of digitally savvy younger people in such markets. Generation Z (born 1995–2010) comprises true digital natives and already makes up 20 percent of Brazil's population today,[1] for instance.

The COVID-19 crisis has accelerated the decline of graphic-paper demand

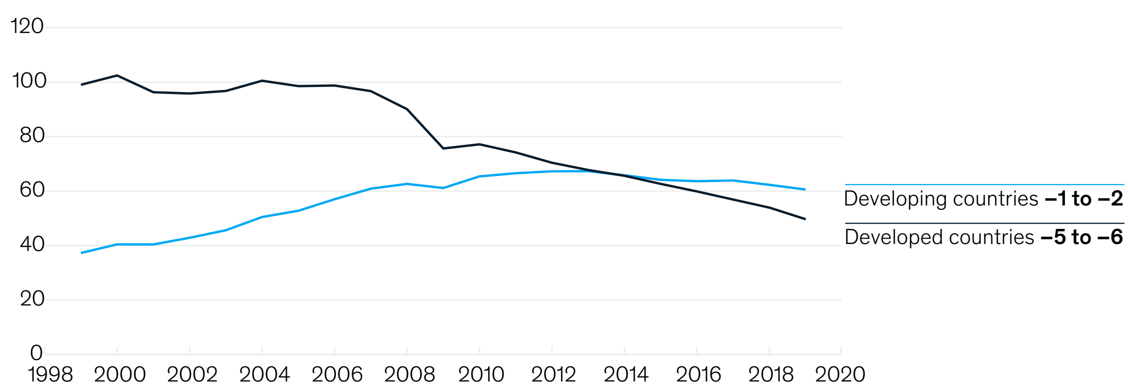
The COVID-19 crisis has been a mixed bag for paper and packaging players. On the one hand, some (packaging-paper companies) have benefited from an increase in grocery shopping and pantry loading of essentials, such as toilet paper. On the other hand, graphic-paper producers have suffered significant volume drops. For instance, US players faced declines as large as 40 percent for mechanical graphic paper during May 2020.

Such declines are driven by the fact that the pandemic has introduced new factors but also accelerated some of the previously existing trends that were already reducing demand for graphic paper:

— *Office printing.* There has been a decline in office printing because of the rise in remote working.[2] The associated absence of corporate-grade printers and the switch to digital meetings have drastically reduced office-paper

Exhibit 1

Global graphic-paper demand has been declining for a decade—and even longer in developed economies.



[1]Compound annual growth rate.
Source: RISI

[1] Tracy Francis and Fernanda Hoefel, "'True Gen': Generation Z and its implications for companies," November 12, 2018, McKinsey.com.
[2] Andrea Alexander, Aaron De Smet, and Mihir Mysore, "Reimagining the postpandemic workforce," *McKinsey Quarterly*, July 7, 2020, McKinsey.com.

consumption. That has been compounded by a tight grip kept on nonessential spending items (including stationery and office supplies) among organizations that are reopening offices.

— *Advertising.* There has been an absolute reduction in advertising (because of lower discretionary spending or tight spending control by companies) and a significant shift to online advertising with more targeted audience communication.

— *Media consumption.* A shift to digital and online consumption of media (newspapers, magazines, and books) has been accompanied by an accelerated increase in the availability and consumption of e-books, podcasts, and audiobooks.

— *Mail volume and forms.* The rise of e-communication, a further acceleration of e-invoicing, and a switch to e-forms driven by the closure of offices and retail outlets (manifested in, for example, the rise of online-only bank accounts) have led to a decline in mail volumes and forms. The decline of transactional paper uses has also been driven by governmental efforts to advance digital adoption. In that context, we should note front-runners such as Dubai, which aspires to become paper free by the end of 2021, and Denmark and Estonia, which have digitized almost all public services, with many other countries following.[3]

— *Digital learning.* The expansion of digital learning, with many schools and universities moving toward online courses, has been accelerated by the pandemic-driven rollout of digital solutions, which have become lifelines for the continuation of learning.[4]

There is, nevertheless, some light at the end of the tunnel for graphic-paper producers in the potential recovery of discretionary spending after lockdown. That could increase businesses' willingness to spend on print advertisements, reduce their freezes on office-material use, and see individuals turning back to printouts in business contexts, as well as paper-based media consumption.

Two big challenges remain for the industry, however. The first is that the COVID-19 crisis is accelerating structural changes that are "sticky" (for example, readers who have switched to digital magazines seldom return to print copies). Second, trends (such as working from home and digital-first education) that were once forecast to happen over a timeline of five to ten years have been condensed into a period of months—and they will probably be sustained.

A shift to digital media (newspapers, magazines, and books) has been accompanied by an accelerated increase in the availability and consumption of e-books, podcasts, and audiobooks.

[3] Matthias Daub, Axel Domeyer, Abdulkader Lamaa, and Frauke Renz, "Digital public services: How to achieve fast transformation at scale," July 15, 2020, McKinsey.com.
[4] Jake Bryant, Felipe Child, Emma Dorn, and Stephen Hall, "New global data reveal education technology's impact on learning," June 12, 2020, McKinsey.com.

Exhibit 2

Graphic-paper players can act upon strategic, cost, and commercial levers while also exploring diversification opportunities.

Strategic review	Relentless focus on costs and cash	Commercial excellence	Diversification opportunities
• Footprint consolidation • Segment participation • Level of value-chain integration	• Furnish and chemicals sourcing • Spares • Utilities • Overtime • Contractors • Staffing • Indirect costs	• Product-mix improvement • Domestic vs exports mix • Pricing opportunities	• New-product development
Estimates vary	8–10% cost savings in near term	10–15% volume increase in near term	+1–2% margin

Source: McKinsey analysis

How graphic-paper companies can weather the storm: Four proven actions

We can already see the effects of lockdown on graphic-paper demand by looking at market indicators. US demand for graphic-paper grades plummeted 25 to 40 percent, year on year, from April 2020 to June 2020; prices for wood-free paper in Europe fell 2 to 8 percent in July 2020 compared with December 2019.

Further, we are seeing players react to the dampened market outlook by taking drastic steps in both the short and the medium terms. Over the short term, there has been a suspension of global graphic-paper production capacity of more than 10 percent, while major conversions and closures are still being announced.

To weather the current storm, we anticipate that graphic-paper companies will need to consider four actions. Strategically reviewing their asset portfolios and market exposure, relentlessly focusing on costs and cash, driving commercial excellence, and exploring diversification opportunities is an approach that could allow players to improve their resilience (Exhibit 2).

1. Strategic review

Under the current circumstances, graphic-paper companies will need to review their strategies from three angles. Consideration of footprint consolidation (in case of multiple assets), end-customer-segment participation, and level of value-chain participation is a good first step in determining the best strategy moving forward.

Footprint consolidation is a relevant strategic choice for players with multiple assets in the same graphic-paper grade. Adjusting capacity in light of falling demand may help the competitiveness of the remaining assets and secure financial stability.

Segment-participation review (for example, of involvement in packaging, paperboard, containerboard, envelopes, and so on) will be critical to maintain sufficient volume stability during headwinds. In past years, numerous mills around the world have been converted from graphic-paper production to other grades, such as food packaging, coated free sheet, and containerboard—and that trend is set to stay. Some of the conversions will require significant capital investment, and they may require footprint rationalization for funding.

Depending on company size, various options for upstream and downstream integration could also prove beneficial (Exhibit 3). Many integrated mills could "forward integrate" into the tissue step of the value chain or further strengthen participation in the dried-pulp step. Alternatively, companies could choose to rely more on externally purchased pulp instead of internally produced pulp.

2. Relentless focus on costs and cash

The majority of graphic-paper companies have weathered the storm considerably well so far by reducing budgets, decreasing capital expenditures, and implementing zero-based approaches to indirect spending and organizational size. Furthermore, establishing strict spending-control towers and launching competitive sourcing for large cost items (such as furnish, chemicals, packaging, and so on) are key. Using analytical tools to drive process controls and asset performance has been proved to elevate operational performance and reduce costs further.

We have seen multiple instances in which digital and analytical tools have improved process parameters (yields, material consumption, and output) within kraft mills (digester and bleach assets) while also reducing overall downtime and improving yields across all production lines. That approach could deliver an added benefit of 5 to 10 percent throughput uplift across a mill and reduce conversion costs by 8 to 10 percent within three

Exhibit 3

Successful strategies will differ according to the size of the graphic-paper company.

Segment	Small	Medium	Large	Very large
Winning strategy	Focus on single niche in a specialty grade Obtain exclusive/ long-term contracts with printers/end users	Focus on 1 or 2 niche products with commonalities in manufacturing	Focus on 1 large-volume product segment Identify 1–3 additional smaller-volume product segments as backup	Create dedicated facilities, focusing on 1 high-volume product Integrate vertically to improve costs and margins
Main levers	Specialized product portfolio (eg, laminating paper, release paper) Partnerships with users (eg, magazine printers, personal-care companies)	Minimized costs (eg, in-house mainte-nance, controlled spare consumption) Manufacturing flexibility to produce variants to counter market volatility (eg, graphic paper, envelopes, inkjet printing)	Minimized costs (eg, controlled expenditures, optimized staffing, competitive sourcing) Logistics advantage with close-by customers Manufacturing flexibility across portfolio (eg, small-volume envelopes, large-volume kraft bags, copier paper)	Minimized costs (eg, lower changeovers, longer runs, higher overall equipment effectiveness) Specialized manufac-turing (eg, dedicated plants for specific printing products) Forward integration to capture synergies (eg, point-of-sale paper and machines/distributors)

Source: McKinsey analysis

to five months. An important cost-improvement enabler is the ability to access specific benchmarks around critical operational parameters. We are working to address this issue through an industry-wide benchmarking tool.[5]

3. Commercial excellence to create value for customers

To ensure strict controls on margin leakage while maintaining appropriate loading of paper assets, companies need to shore up their governance on commercial decisions. In the short term, that means focusing on optimizing the product and customer mix to maximize profitability and enforcing pricing discipline to maximize average price.

As markets remain volatile, graphic-paper players also need to remain active in searching for opportunities for geographic and product-portfolio expansion opportunities. It is important that mills keep close tabs on their average prices achievable via exports versus domestic customers. As home markets dry up, stimulating volume and pricing competition, mills might consider strengthening their relationships with distributors and brokers to access international markets and protect their order books—and to be able to cover fixed costs.

4. Exploration of adjacent value pockets to find market niches, conversions, and specialties

Product diversification presents another avenue for graphic-paper companies to consider as they seek a more lasting solution to protecting their businesses. For instance, they can explore adjacent product niches to utilize existing assets with little or no investment. As an example, offset-roll makers might explore opportunities in inkjet and release papers. Additionally, with a minor capital infusion, companies can participate in adjacent niches, such as envelopes, paperboards, and so on. That will help bridge order-book gaps over the near term until the market recovers.

We believe that graphic-paper companies can rebound amid the COVID-19 crisis. Despite the trend of declining demand, accelerated by the crisis, they can thrive by carefully executing the plan outlined in this article, thus creating value for shareholders. The power of the strategy has been demonstrated by a paper mill that used it to achieve an improvement in EBIT[6] margin of 6 to 10 percent.

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[5] McKinsey's basic-materials group is convening industry players to build a benchmarking tool to identify, size, and capture improvement opportunities in paper, pulp, and forestry operations.
[6] Earnings before interest and taxes.

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