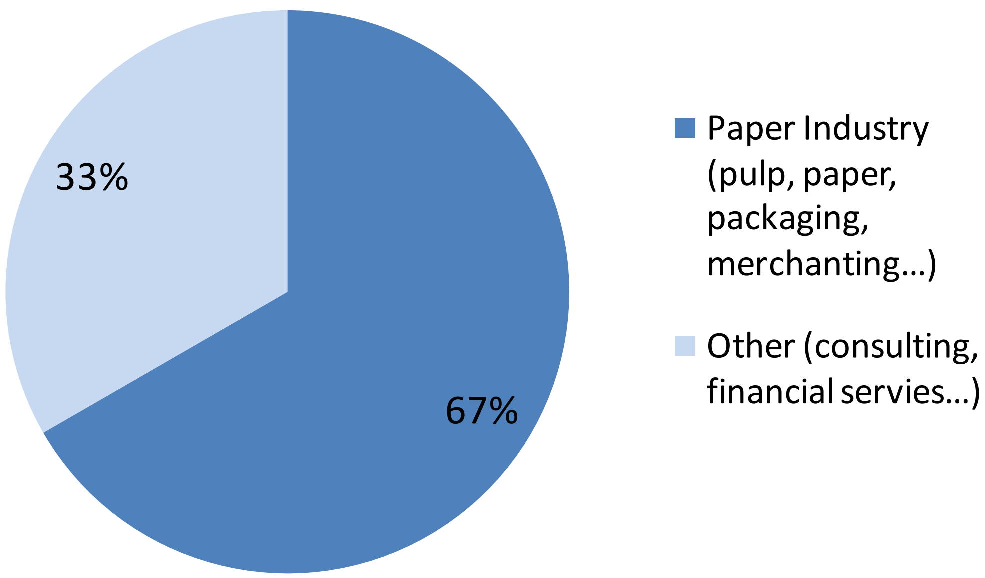
Return to Business as Usual?

Survey results: "Visibility and Control in Turbulent Times – 2010"

StepChange Consulting conducted a survey to obtain a view from industry stakeholders on the state of the industry and an assessment of the signs of recovery after the crisis. Results were compared to a survey conducted in early 2009. Based on the previous year confidence in the industry clearly shows an upward trend. However competitive pressure remains strong and the business climate is still challenging. Companies surveyed expect a long road to recovery. In summary the key findings and implications are:

- **Business environment is slowly improving.** Market demand is up or unchanged for most of the participants compared to last year. The majority expects a return to pre-crisis levels to last longer than 12 months.
- **Competitive pressure remains high.** While prices appear to pick up for about 1/3 of participants, almost half of respondents are confronted with falling sales prices.
- **Profitability improvement required.** Management resources continue to focus on margin management and cost-cutting. While last year's liquidity & cash flow improvement initiatives appear to be successfully implemented, customer retention and services climb up on the priority list.

Distribution industry sectors of companies surveyed



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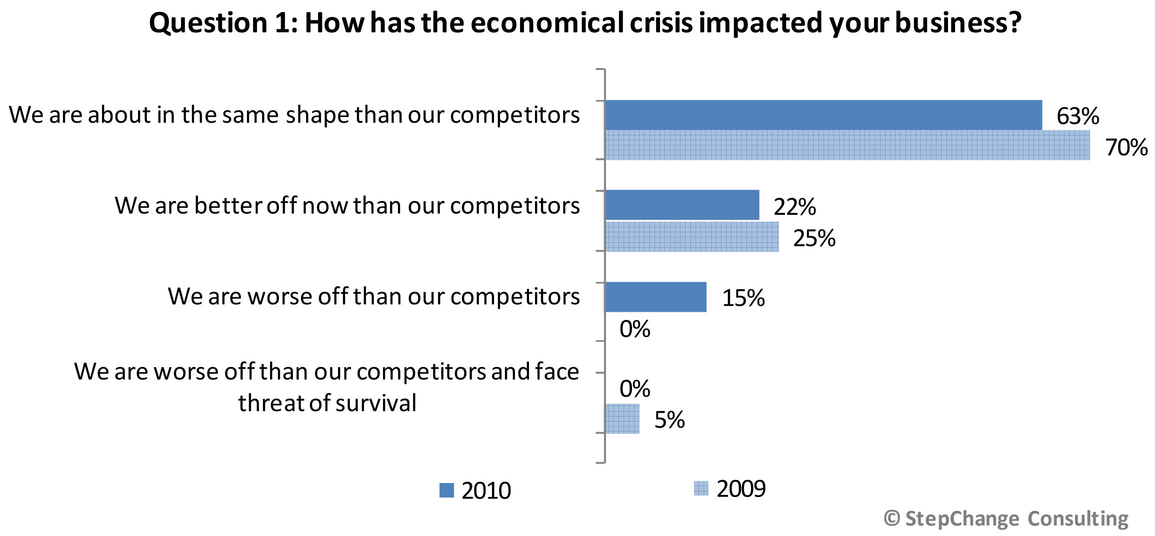
The respondents demographics show representation from a wide spectrum of the industry, including producers of containerboard, uncoated fine and craft, coated woodfree, coated mechanical, coated paper and coated board, newsprint, publication paper and coated groundwood, merchants and distributors. Management Consultants and respondents from Financial Services added an external perspective.

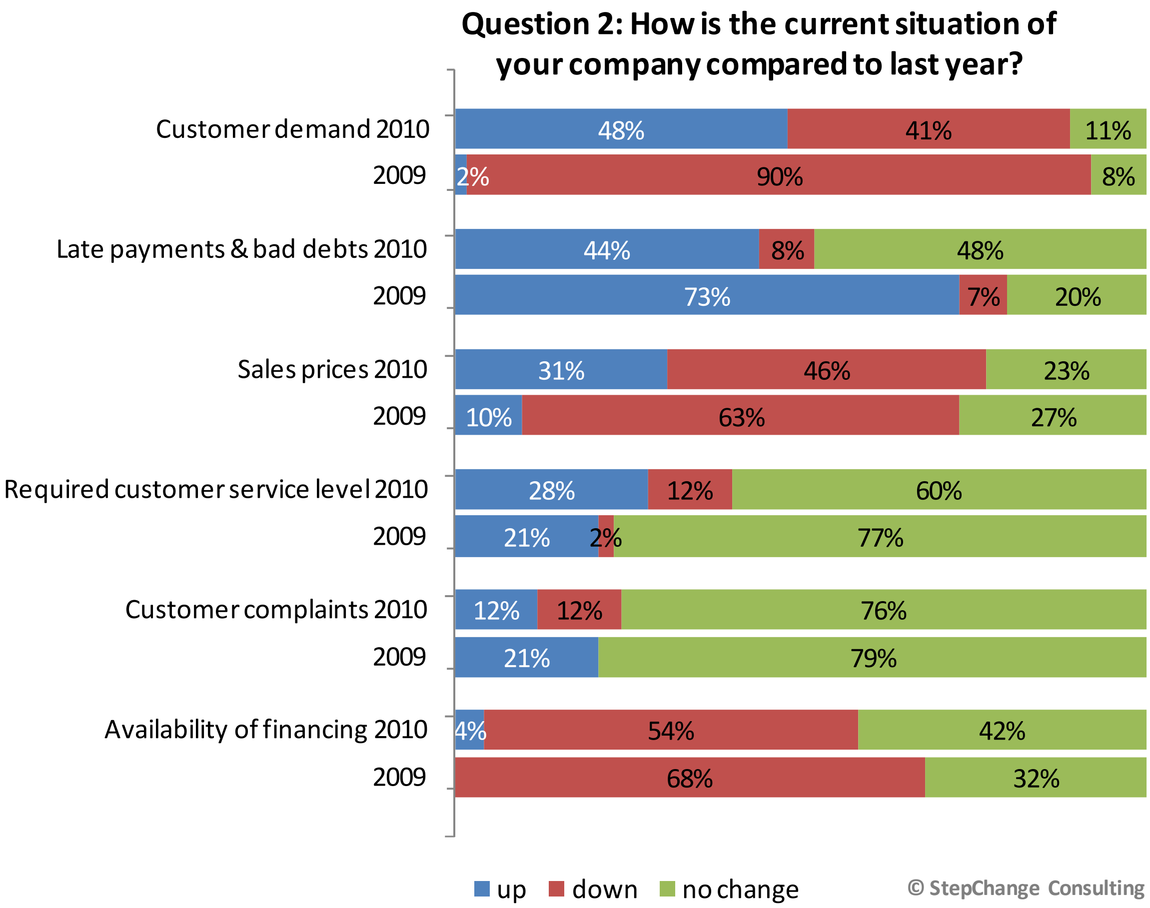


Profiting from the economic downturn?

Compared to the 2009 study the vast majority of respondents still believe their company is in the same shape as competitors. Roughly a quarter of respondents believe they are better off than their competitors.

While no respondent indicated to be worse off than their competitors in 2009, 15% of respondents now believe to have a competitive disadvantage. On the other hand no single respondent indicated that their company's survival is threatened, compared to 5% in 2009.

Overall the results show that the respondents believe to be in fairly good shape compared to the competition.



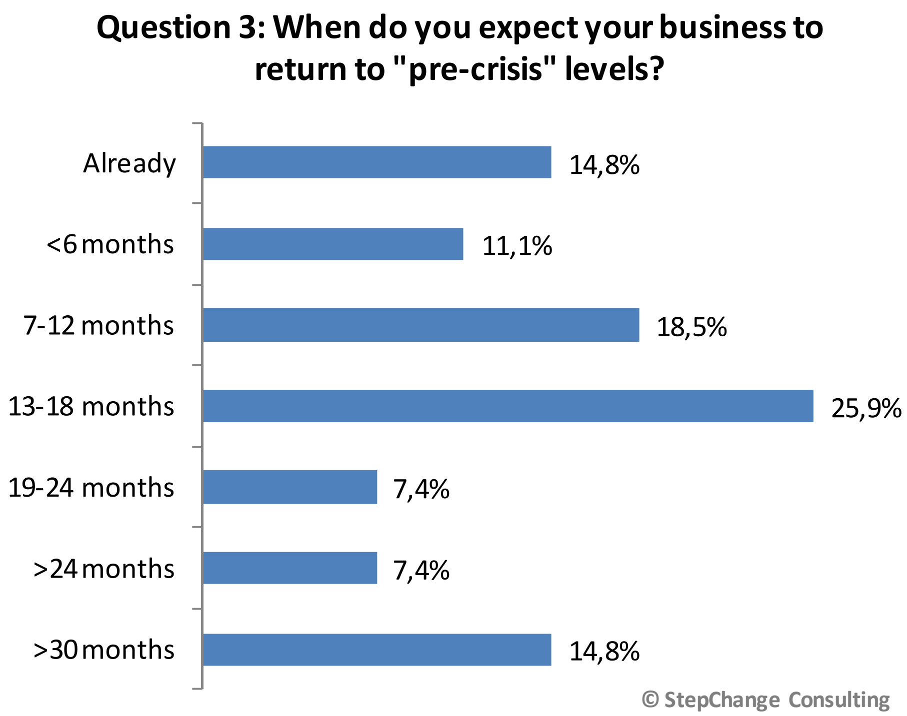
Has business activity returned to normal again?

Compared to 2009 customer demand shows clear signs of recovery, with 48% of participants reporting higher demand than in the previous period – however still not at pre-crisis levels *(see question 3)*.

Companies are already capitalizing on the positive trend of demand, but not to the same extent as volumes are returning: Although more than 30% report price increases, sales prices remain under pressure (decreasing or unchanged) for the majority of survey participants. Customer complaints seem to remain on similar levels compared to 2009. Only 12% of respondents report complaints to be up, offset by 12% of respondents who report that complaints are actually down.

44% of respondents still report that late payments and bad debt continue to increase (compared to 73% in 2009), 48% (20%) report no change and only 8% (7%) report that late payments are actually decreasing. This shows that financial pressure on the industry is still high and is in line with the increased insolvencies observed in 2009. The answers concerning "Availability of financing" point in a similar direction - only 4% reported that availability of financing has improved. The majority of 54% (68%) reported that availability of financing is actually down. For competitors in the paper industry only (excluding merchants, technical services etc.) the situation has improved overall, even much more compared to other industry segments. Only 33% of paper companies report deteriorating availability of financing versus 54% industry-wide.

As a consequence efforts to preserve liquidity continue to be high on management's agenda (see question 4: "priority areas"), while M&A activities are only relevant for 7% of participants.



Business outlook: Long road to recovery expected

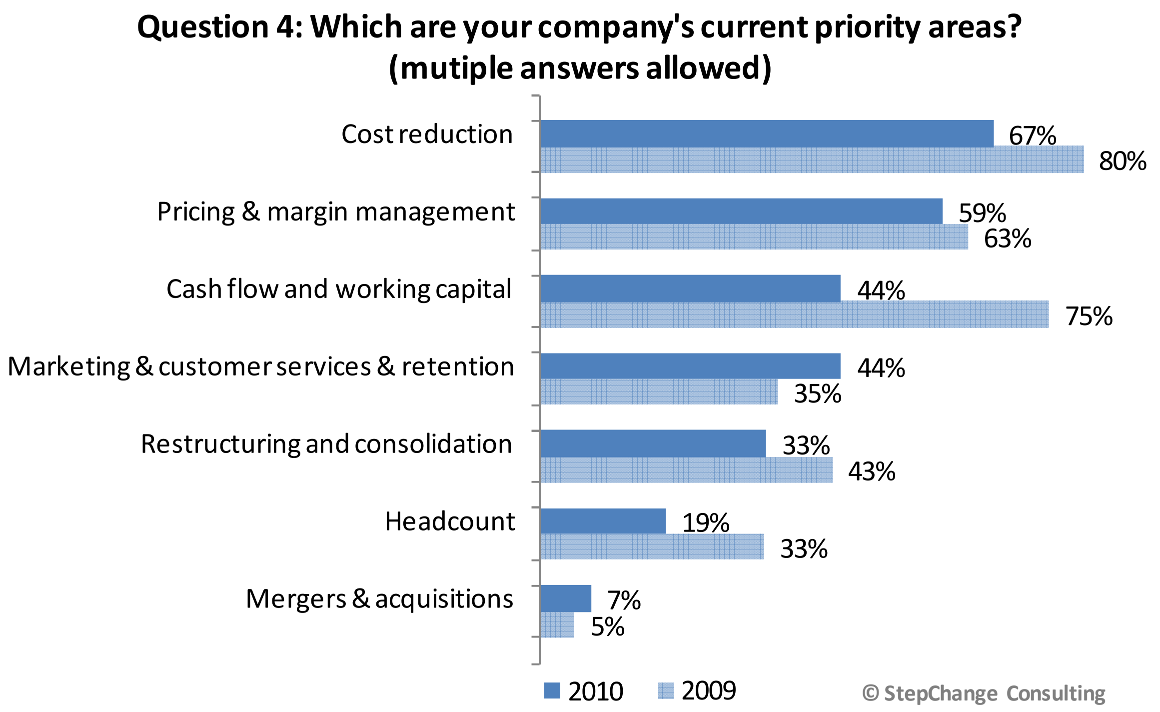
The majority (56%) of participants expect their business activities will not return to pre-crisis levels within the next 12 month. On the other hand a remarkable share of 15% report to have reached pre-crisis levels and an additional 29% expect to reach pre-crisis within the next 12 months.

In comparison 81% of participants of the 2009 study expected the downturn to end within 12-18 months. Apparently some participants now estimate the recovery to take longer than earlier assumed.

According to the IMF global growth is estimated at 4% which is stronger than anticipated in 2009. The recovery is proceeding at different speeds (strong growth in Asia, but only sluggish growth in Euro area). Advanced economies still depend on government support through public spending and monetary policy[1].

Overall economic and industry recovery remains fragile. Risk factors include momentum of industrial production growth, unemployment, the health of demand and price inflation at major input factors (raw materials, energy, chemicals, freight cost).

[1] Source: IMF World Economic Outlook, March 2010



Industry environment is improving – cost cutting still under way.

Improving results remains the top priority on management’s agenda. In order to improve profitability companies continue to focus on cost cutting, margin management and pricing.

As in 2009, cost reduction stays on top of the agenda also for 2010, followed by price & margin management and working capital management.

In comparison to the survey in 2009 cash flow and working capital management has a significantly lower priority (-31% points) in 2010. The explanation might be that almost all companies in the sector successfully improved in this area in 2009. Overall the topics mentioned in 2009 have declined in importance in 2010. However liquidity is still the 3rd most important topic as liquidity preservation is still a key issue for companies in the sector due to the increase of late payments and low availability of financing (see question 2).

Compared to 2009’s survey, marketing, customer service and customer retention has increased significantly in importance in 2010. This may be a sign for shifting priorities after many companies focused internally in 2009. Additionally price & margin management is a topic that remains on top of the agenda. This is not surprising as demand picks up and rising input costs are eating up margins quickly.

At the moment headcount reduction is a priority for only 19% of respondents (-14% points compared to last year’s result) – participants from the paper companies even indicated a much lower percentage - merely 8% consider personnel reduction. Also restructuring and consolidation has declined on the priority list by 10% points. While this is apparently a positive development, the question remains if efforts to consolidate capacity are being halted too early.

According to surveyed participants, M&A activities are still not a top priority although they seem to be gaining attention in some cases (increase by 2% points).

Prepare for recovery but remain cautious about a potential economic retraction

Survey participants indicate a modest recovery in the markets, even though slower than expected last year.

Price hikes are supported by rising demand, but a significant part of announced price hikes for this spring is absorbed by increasing input costs (e.g. energy, raw materials). While western European markets are predicted to recover slowly, institutions predict stronger growth for emerging markets.

In 2009 most companies were forced to react to the effects of the economic crisis – immediate measures to preserve liquidity were taken to ensure refinancing and debt reduction.

In 2010 management focus continues to be on preserving the financial health of the companies. As in 2009, cost cutting remains the top priority overall. While sustaining cash flow improvements is still on the agenda, margin management and profitability improvement are among the top priorities to support growth and reach profitability targets. Various paper companies have announced another round of cost cutting and restructuring programs such as rationalization of capacity and disposal of non-core business units and assets.

In 2010 almost 30% of survey participants observed increasing customer service level requirements (see question 2: “Current situation”). Therefore the financial focus has to be complemented by an increased focus on the customer: Supply chain integration, leveraging of core competencies across business units and customer service models need to be high on the agenda of top management.

Mid- and long term perspectives for the industry environment are still unclear. Announced price hikes for this spring are mainly a reaction to already higher input prices. Overcapacities still exist and demand remains on modest levels or is impacted by structural change in many industry segments. However, many economic factors are not in balance (e.g. corporate investments, government spending or unemployment). Therefore a retraction of the global economy is not unlikely. Companies may be cautiously optimistic but should still maintain readiness to revert to measures applied during the height of the crisis in 2008 and 2009.

About StepChange

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 our international team of industry experts we hit the ground running. We provide innovative and yet pragmatic solutions, placing an emphasis on delivering measurable business results.