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Commentary on the Abitibi-Bowater Merger

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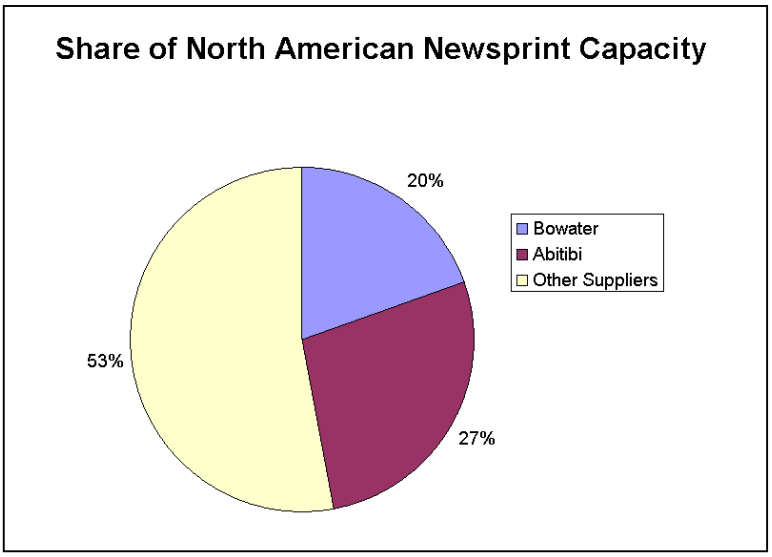
By Kevin Conley, Economist, Graphic Paper
and John Maine, Vice-President, Graphic Paper

North America's top two newsprint producers have decided to join forces. At a press conference January 29, Abitibi-Consolidated and Bowater announced plans to merge the two companies in an all-stock deal to form AbitibiBowater with headquarters based in Montreal. Pending shareholder and regulatory approval, the merger will create the third largest publicly traded paper and forest products company in North America and the eighth largest in the world.



The two companies expect the merger to be completed by the third quarter and generate annualized cost savings of approximately US$250 million through improved efficiencies in production, selling, general and administrative costs, distribution, and procurement. The companies stated that the merger and the predicted costs synergies are based on the continued operation of exiting assets without any further capacity closures.

Even with the peak in the newsprint price cycle in 2006, both Bowater and Abitibi-Consolidated continued to lose money, pressured by high production costs, a strong Canadian dollar, plummeting domestic newsprint demand and increased competitive pressure in the export markets. Their hope is that the union of the two companies and resulting cost reduction will restore profitability and create a more efficient and financially sound manufacturing platform.

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This union will lift the new company to the position of largest global producer of newsprint in terms of capacity with Norske Skog slipping to second place. AbitibiBowater will command 15% of global newsprint capacity and 47% of North American capacity. This jump in market share could present the first hurdle for the merger to overcome when the companies apply for the required regulatory approval.

Although the share of North American newsprint capacity is 47%, AbitibiBowater's share of domestic sales would be lower since both companies are major exporters of newsprint. Based on the 9.8 million tonnes of North American demand and 94% capacity utilization last year, Abitibi-Consolidated and Bowater commanded a 40% share of the domestic market in 2006 since approximately 30% of their production went to export markets. We could refine this calculation further by adding the tonnage from Boise Cascade's DeRidder mill sold through the Abitibi-Consolidated Sales Corporation and subtracting the joint-venture tonnage owned by several newspaper publishers. This would contribute another 1%, bringing Abitibi-Consolidated's and Bowater's combined domestic market share to 41% in 2006.

Given this share of domestic demand, the merger still has a substantial hurdle to overcome with anti-trust authorities, but not as severe as the 47% share of North American capacity might initially indicate. The last major merger proposal approved by the regulatory authorities, passed unaltered with the 32% market share resulting from the Domtar/Weyerhaeuser union. Therefore, it is conceivable that the competition authorities may require some alteration to the proposed AbitibiBowater merger, which would lower this 41% market share.

Since the beginning of this decade, 3.7 million tonnes of newsprint capacity have been removed from the North American market through permanent closures, shifts to lighter weight newsprint, or conversions to other paper grades. By 2006, Abitibi-Consolidated and Bowater combined have accounted for 77% of the reduction in North American capacity. The union of these two companies should lead to improved flexibility to quickly adapt to changing market conditions, forcing the new AbitibiBowater to remain the leader in balancing North American newsprint market through supply-side management. The long-term decline expected for North American newsprint demand will necessitate the eventual permanent closure of even more capacity, and AbitibiBowater will likely carryout the brunt of that burden.

However, this merger could limit the ability of Abitibi Consolidated and Bowater to improve the North American market balance through supply-side management in 2007. The proposed merger is based on the continued operation of existing assets with no further capacity closures, which will prevent Abitibi-Consolidated and Bowater from playing a leadership role in arresting the deteriorating supply/demand balance in 2007.

Although an acceleration in conversions to other paper grades in 2007 is an option, any significant rise in uncoated market share would likely raise concerns with regulatory commissions since Abitibi-Consolidated and Bowater combined already hold a 40% share of North American uncoated mechanical capacity. The lack of capacity reduction by North America's two largest producers increases the possibility that other producers' highest-cost newsprint mills that have benefited from Abitibi-Consolidated's and Bowater's past efforts to balance the market, will not survive the current downturn in prices.

Consolidation of the North American newsprint industry will prove to have a positive impact, creating a leaner, more-efficient manufacturing platform over the long term and the merger of Abitibi-Consolidated and Bowater is another step in that direction. However, any short-term benefits will remain unrealized as the North American market balance deteriorates and profitability for newsprint producers remains elusive in 2007.

RISI
4 Alfred Circle, Bedford, MA 01730 U.S.A.; phone 781.734.8934
326 Avenue Louise, Bte 22, 1050 Brussels, Belgium, phone +32.2.536.0748
email: info@risiinfo.com