

## Stable outlook for pulp and paper industry

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We view the outlook of Indonesia's pulp and paper industry as stable in the near to medium term. The industry has been growing at a significant rate in the past two years, driven by domestic and international demand for tissue paper and paper-based packaging. Growing demand, combined with tight supply, has seen the pulp price increase significantly since 2016, and we expect it to remain high in the near term. Although the growth of paper for newsprint, printing, and writing, which is one of pulp's main derivatives, has slowed due to digitalization and remained stagnant in the past two years, we are of the view that the pulp and paper industry will keep growing in the near to medium term. Based on United Nations' Food and Agriculture Organization (FAO) data, the 10-year compound annual growth rates (CAGR) for the consumption of newsprint, printing and writing paper, household and sanitary paper, and wrapping, packaging paper and paper board for 2006-2016 were -4.6%, -1.2%, 2.8%, and 2.3%, respectively.

Indonesia is one of the largest producers of hardwood (short-fiber) pulp in the world in terms of capacity, mostly contributed by the Sinarmas Group. In 2017, with the operation of PT Oki Pulp and Paper Mills (OPPM), a Sinarmas Group company with annual pulp production capacity of 2.8 million tons, Indonesia's annual capacity increased to 10.7 million tons. OPPM has the lowest cash cost of hardwood pulp producers in the world due to the use of the latest production technology. We are of the view that the Sinarmas Group will progressively upgrade its companies' production technology to obtain lower cash costs, thus enabling the Group to offer a more competitive price in the export market. Based on FAO data, excluding Indonesia, the world's annual chemical pulp production capacity in 2017 increased by 3.1 million tons, 61.3% from Brazil. Even though the world's pulp production capacity increased in 2017, the pulp price kept growing due to stronger demand for pulp and its derivative products, especially tissue paper and paper-based packaging. According to Chinese Pulp Bleached Hardwood Kraft Pulp Price Index, pulp price has increased around 54.9% to USD753 per ton at the end of 2017 from USD486 per ton in third quarter of 2016.

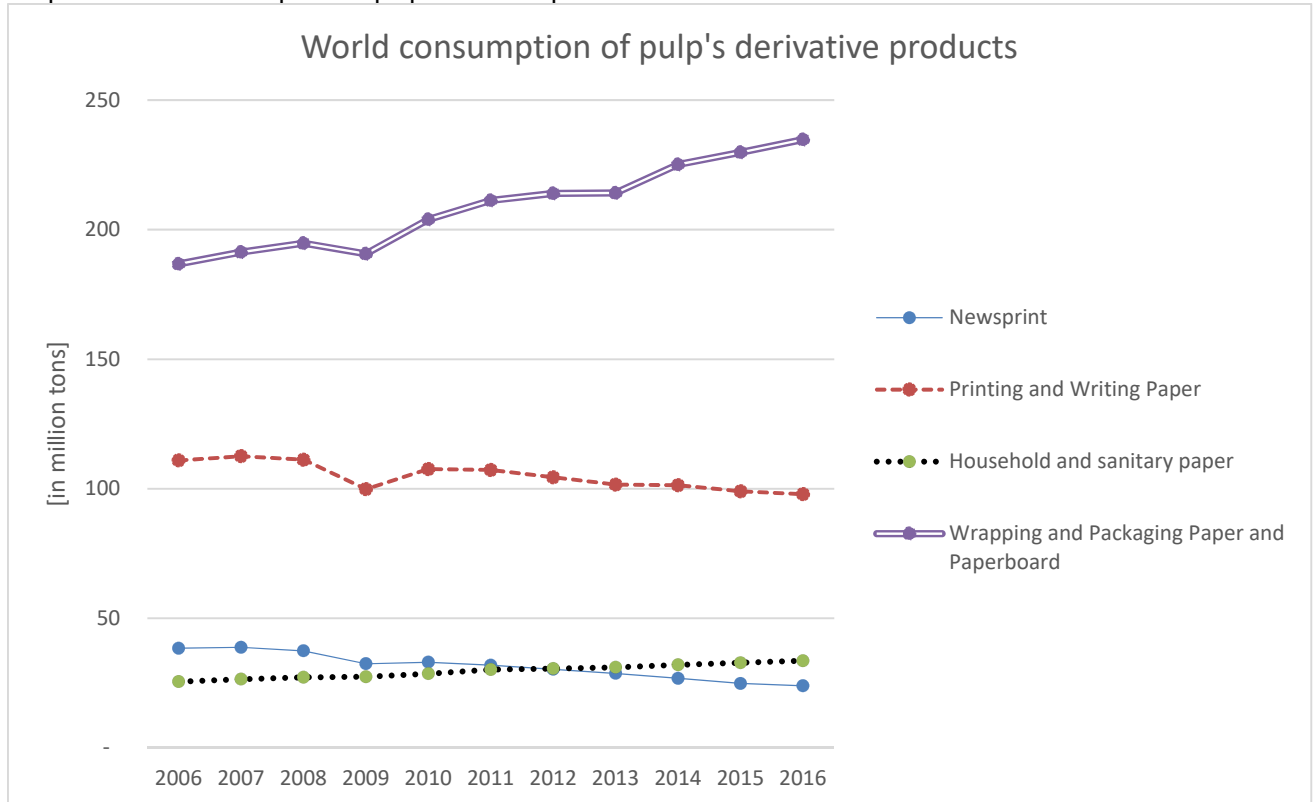
We are of the view that tissue paper demand will grow steadily in the long term. It is less sensitive to economic cycles because it is not easily replaceable by a substitute product, as it is low priced, easy to use, hygienic, and environmental friendly. Historically, demand has grown steadily, even during economic slowdowns. Going forward, we are of the view that the tissue paper industry will grow around 5% annually, and in the domestic market consumption will keep increasing in the long term. Indonesia's tissue paper consumption is still considerably lower than other ASEAN countries such as Malaysia, China, Hong Kong, and Japan. As Indonesia is an emerging country, demand will keep growing, given the high population with low consumption per capita and improving purchasing power. In the export market, we are of the view that demand in China, which is the world's largest tissue paper producer, will remain strong due to its low consumption of 6 kilograms per capita, compared to the US (22 kilograms per capita), Europe (11 kilograms), and Japan (14 kilograms). As China's economy continues to grow and Chinese consumer behavior is changing, we are of the view that tissue paper consumption there will keep growing in the near to medium term.

We are of the view that paper-based packaging demand will grow significantly in the domestic and international market, especially in China. Although digitalization has slowed the use of newsprint, printing and writing paper, it has created strong demand for paper-based packaging due to the emergence of e-commerce. For the last five years, e-commerce in Indonesia has increased significantly along with e-payment systems and logistics, which support e-commerce sales. Paper-based packaging materials, such as corrugated cardboard boxes, are largely used to pack the products sold by e-commerce companies. We are also of the view that pulp exports to China will grow rapidly due to the shortage of recycled paper and waste paper, as the Chinese government banned waste paper imports in 2017 to improve environmental issues. As waste paper, the raw material for paper-based packaging, is no longer available, the demand for pulp has increased significantly from Chinese paper mills. In 2016, China imported 27 million tons of waste paper, according to the Bureau of International Recycling. Paper-based packaging consumption in China (48 kilograms per capita) is low compared to the US (129 kilograms), Japan (90 kilograms), and

Europe (69 kilograms). Paper-based packaging demand growth is also supported by growth in the fast food industry (food grade paper-based packaging) and the manufacturing industry (high quality cardboard boxes).

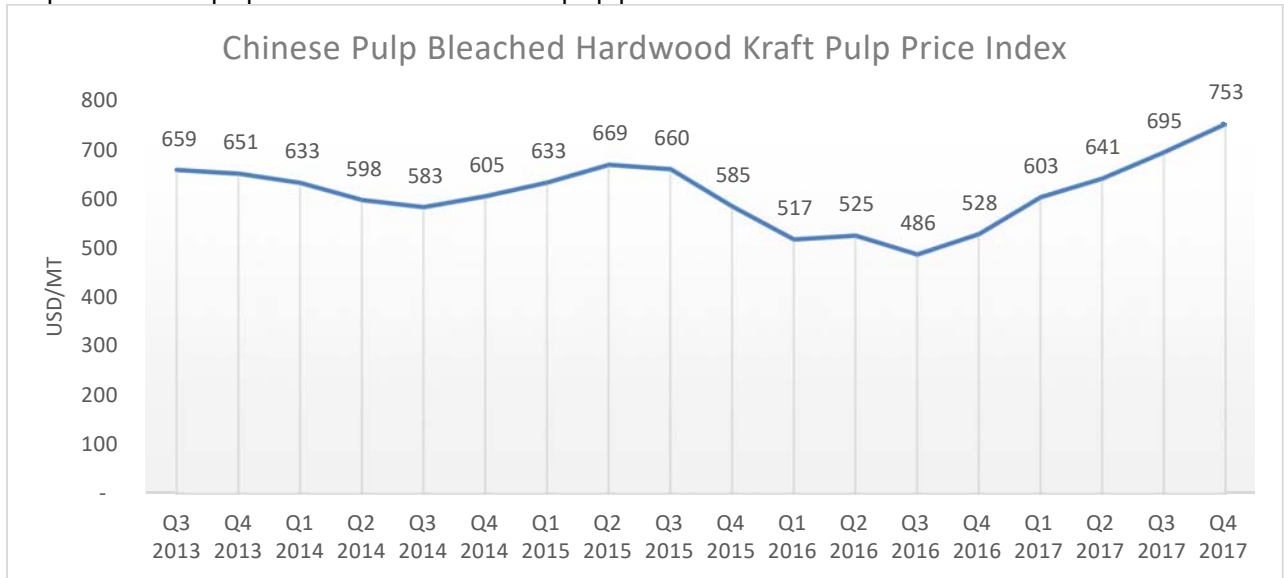
We have identified several challenges in the pulp and paper industry. All pulp and paper producers will be exposed to the volatility of product prices and raw material costs, which are highly related to global commodity prices. Although most raw material needs can be sourced domestically at low cost, there are risks that the supply may not be sustainable due to factors such as unfavorable weather conditions and environmental issues. Any increase in reliance on costlier external sources for raw material needs may diminish pulp and paper producer cost competitiveness and put pressure on their profit margins, especially when product prices weaken. We also consider the pulp and paper industry capital intensive, given the large capital expenditure needs for machinery and factory equipment, which are majorly financed by debt and, in turn, result in high financial leverage for the majority of Indonesian pulp and paper producers. Thus, producers are challenged to maintain good profitability and cash flow to service debt repayments, especially during unfavorable external factors such as sudden raw material shortages, increases in operating costs, lengthening receivables collection, decreases in pulp price, and others.

Graph 1. World consumption of pulp derivative products



Source: United Nations' Food and Agriculture Organization statistics on forest products, 2006-2016

Graph 2. Chinese pulp bleached hardwood kraft pulp price index



Source: Bloomberg

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