Looking Back at 2011, What a See-Saw Year!

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It started off well enough, with regular price increases on all major grades of market pulp (NBSK, BEK, Acacia etc.), paper mills with full order books, containerboard mills struggling to stay up with their box plant customers and, best of all, commodity rayon grade dissolving pulp soaring on the spot market to a high of USD 3000/mt in April. As one might expect, those high prices set off a flurry of announced mill expansions and changes-over from paper grade pulp grades. Booming economies in countries all over the world caused UFS and CFS (uncoated and coated free sheet) paper companies to speed up their new paper machine construction programs to a point where today there are no fewer than 41 new paper machines under construction (28 in China, 18 in India, 2 in Viet Nam and 1 each in South Korea, Indonesia and Thailand but more about that later in this article).

And, it should come as no surprise that China is the main driver of this multi-grade expansion with its growing middle class being the engine. According to McKinsey Global Institute, by 2025 China will be adding 225 new cities each with a population of over one million compared with only 35 such cities in the whole of Europe at present. No other country in history has experienced this rapid move to urbanisation on such a broad scale. By 2015, China will be the world’s #2 consumer market after the U.S. In 2010 Yum! Brands opened 500 new restaurants including one new KFC store every day of the year! China now accounts for 27% of the global luxury market. It’s reported that 4 in 19 Chinese own a car. This growing (in size and affluence) group are the ones who use disposable products - nappies, facial and bath tissue, paper towels, home computers equipped with printers, subscribe to magazines, receive catalogs in the mail and read newspapers. P&G suggested that China’s middle class by the end of 2012 might number as high as 290 million but sales of their products which amounts to only USD 4/tp would suggest that it might be as small as 56 million. By contrast, US consumers buy USD 96/polyear of P&G’s products. The truth is that China’s middle class’s size might be somewhere in between. But we know it is growing rapidly with more and more earning power.

The McKinsey Quarterly Report stated that in 2005, 77.3% of the population were below the lower middle class income bracket but that by 2015, this “poor” group will drastically shrink to only 9.7% while 79.2% will have moved up to the lower and upper middle classes. This, no doubt, will mean a dramatic jump in domestic consumption.

Why are we bothering to go into such detail? It’s simply because, as we’ve already said, the middle class is a society’s consuming group and for this article we want to focus on pulp and paper products. If, indeed, there are 41 new paper machines under construction, who is going to use all this paper? After all, we’re just now emerging from a recession that saw the North American paper industry lose 7 million mt/year and the different research institutes believe 90% of this tonnage has been lost forever. Newspaper circulation is down in N.A. and Western Europe and there are fewer Sunday supplements. Magazines are losing circulation as well as ad pages. Book publishers are rapidly adopting e-readers and catalog mailings were severely impacted by consumers’ economic woes. CM (Coated Mechanical) tonnage is down 8.2% with Verso just announcing the permanent closure of 3 paper machines at their Bucksport, ME and Sartell, MN mills in the US. North America’s remaining 23 million annual tonnage is projected to decline 2-3% /year for 2011-2013. With this dramatic loss of domestic business, it will be necessary for N.A. mills to increase their exports to Latin America most likely but also possibly to Asia. With 41 new paper machines added to existing capacity, is there going to be a market in Asia for these N.A. exports? There will be if China’s and India’s middle class grow as expected and increase their per person paper consumption. And what about Europe and Japan? Why, they’re worse off than their N.A. cousins! UMP in October announced the permanent closure of 1.3 million mt/year of newsprint and LWC. It’s interesting to note that at one time, perhaps 20 years ago, Finland produced 17% of the world’s LWC (LightWeightCoated) and regularly exported almost one million mt/year to the US. But those days appear to be gone forever.

At the RISI Global Markets conference in San Diego, CA in September, it was said that LWC prices have increased 10% since 2005 (that’s the good news) but that cash costs have increased 25-35% (very bad news!). On a fully allocated basis, most CFS (coated free sheet) mills are losing money. How long can this continue?

As North American demand shrinks, the paper companies must either find export markets or shut down their older/slower/high cost paper machines.

Let’s turn our attention to Asia which paints an altogether different picture. The RISI Global Markets conference said annual demand was increasing by 2 million mt/year and that in the period 2011-13 would increase by a full 6 million mt.

Here’s how the capacity of those 41 paper machines break down: 4.4 million mt will be UFS (uncoated free sheet) which is used to produce A4 Copybond, commercial offset printing paper, envelopes, text books and novels, tablets and filer paper, carbonless paper and fancy text and cover papers. 1.7 million mt will be CFS (coated free sheet) and 800,000 million will be coated mechanical. RISI’s report went on to say that 1.5-2.0 million mt of Asian capacity must shut down or find off-shore markets. But going off shore is easier said than done since these Asia mills will find themselves competing with North American and European mills who face the same over capacity situation in their country. It’s very possible the rest of this decade will find each nation faced with a “survival of the fittest” situation. Which machines are the fastest, the newest, having the highest percent first quality, producing the most popular paper grades, being of a size that permits them to fully utilise each machine’s deckle (filling out
the width of the machine on a consistent basis), and being fairly close to their major markets to reduce transportation costs.

All paper mills today are faced with the same six cost centers. #1 is always fibre cost. In a fully integrated mill, this percentage if as low as 34% while in a non-integrated mill which must purchase market pulp on the outside, that cost can be as high as 54%. #2 today is energy, #3 is labor + fringe benefits, #4 is chemicals, #5 is maintenance and supplies (clothing which must be regularly replaced such as fourdrinier wires, wet felts, dryer felts, roll coverings, lubricating oils, etc. and #6-transportation - which can involve paying the freight on pulp and sorted office papers that now had to be brought from the Port as well as paying the freight on finished paper going to printers, publishers, envelope plants etc. Transportation costs are becoming a bigger and bigger burden for the average paper mill. In order to minimise fibre costs, many Asian mills sought to utilise as much recovered paper as possible - especially OCC (N.A. OCC is more highly regarded because it has a higher percentage of virgin softwood fibres whereas domestically produced OCC may have fibres that have already been across the paper machine 3 or 4 times each time getting shorter and shorter and picking up more headbox starch (to improve internal bond. It is often used at the recommended rate of 9 kg/tonne of fibre).

In 2010, 1 in 4 tonnes of all recovered paper in N.A. was shipped to China. 76% of all OCC recovered went to China, 5% to India and 4% to Taiwan. From January-July of this year, 5.4 million mt of OCC was shipped to China, which was 1.55 million tonnes more than 2010. This is a phenomenal increase! It reflects the huge expansion of Nine Dragons, Lee & Man and others.

Containerboard is one of the major paper grades that has remained relatively strong all through 2011. It includes linerboard (the outside of the corrugated container and must possess high strength to protect the carton’s contents), corrugated medium (the fluted inside of the carton - always made from 100% recycled fibre) and testliner (the inside of the carton - not requiring the same high strength as linerboard). These grades are always sold on a per square metre basis and never on a per tonne basis. Another packaging grade growing globally is CUK - which stands for Coated Unbleached Kraft - a grade used in beverage packaging. It must possess extra high strength but with a bright/white coating capable of producing high gloss images and outstanding graphics. We'll elaborate more about CUK later on.

In summary, while publication and book papers have suffered in the last half of 2011 while enjoying a healthy first half, containerboard grades remained strong all year. Their fourth quarter can always be counted on to be their busiest.

Moving on to Dissolving Pulp, especially the commodity rayon-grade DP, high cotton prices (topping out at USD 2.37/lb from a normal USD 1/lb) and middle-class demand caused the 92-95 Alpha DP grades to start the year at $1500/ admt and move quickly (on the global spot market) to USD 2000, then USD 2200, USD 2800 and finally touching $3000 briefly in late April. All good things must come to an end and when customers found their warehouses full they stopped buying. The pulp mills, however, felt certain the market would come back in the 4Q and refused to lower their spot prices below USD 2200/ admt. This showed an amazing amount of discipline!

Birla of India purchased two mills in eastern Canada and one in Sweden to assure themselves of adequate supplies for the long term. Fortress Paper (the old Thurso, NBHK mill on the Quebec/