

Effect of Sluggish Domestic Box Demand Clouds Prospects for 2008 Containerboard Outlook



By Harold Cody

Looking back, 2007 was a pretty good year for containerboard mills as prices gained ground, exports surged and domestic markets were in balance. However, prices didn't match the gains posted in 2006 and cost pressures, particularly for fiber, intensified and squeezed margin, while box cutups remained sluggish. The prospects for 2008 are generally good but will depend on whether a high level of exports and tight control of supply can continue to offset tepid domestic growth, and of course, avoiding an economic meltdown.

While change continues to be the norm for almost all manufacturing industries, including containerboard and box producers, 2007 was a much less frantic year for the containerboard sector than the prior two years. Linerboard, corrugating medium and box markets managed for the most part to avoid the large scale upheavals that occurred in recent years such as the huge wave of capacity closures in 2003-2005 or the rapid price run that occurred beginning in late 2005 and into mid-2006. The industry continued to consolidate, cut out a limited amount of high cost capacity and worked hard to be more efficient, but these changes occurred at a fairly modest pace.

There was one major new startup, as International Paper brought its new 500,000 tpy lightweight linerboard machine (converted from paper production) online in Sept. 2007 at the Cantonment mill in Florida. But IP also shut down the 200,000 tpy semi-chemical medium mill in Terre Haute, Indiana in October.

While the overall business climate steadied, with supply and demand generally in balance, the industry also worked through and around plenty of smaller bumps in the road including rising costs and sluggish demand. And the outlook for 2008 and beyond, while generally positive, appears more uncertain than what faced the industry at this time last year.

This heightened level of uncertainty centers on two major unknowns that essentially framed the market in 2007: the state of domestic demand and the direction of exports.

First, let's look at the U.S. corrugated box market, which at best can be described as lackluster. Through November 2007, containerboard shipments were weak and box volumes sluggish compared to 2006. Box volumes fell in November

by 1.1% year to year, and year to date volumes are off just under 1% (and even worse using an average week basis). This probably overstates the weakness a bit because the prior year was weak during this period as well. Nevertheless, corrugated box demand isn't growing right now.

In turn containerboard consumption was also weak, although it was stronger than box shipments, rising just 0.2% in November and 0.4% year to date. Total U.S. containerboard production through November is up 0.1% year to date. Thus, one concern is that box demand could weaken even further and undercut recent price gains and reduce what have been solid operating rates.

One continued positive note for containerboard producers is that inventory levels remain low—quite low in fact. Containerboard inventory at box plants and mills rose 19,000 tons in November to end the month at 2.211 million tons, according to FBA and American Forest and Paper Association (AF&PA) statistics. This would be 303,000 tons below the prior year level and only a bit higher than November 2005 levels, which are among the lowest levels seen since the early 1990s, and were right after hurricane Katrina. That's good news.

Export Surge Supports Overall Market

Exports continue to be a bright spot, with production for export in November of 278,000 tons, down 3.5% from year ago levels but up 10.8% for the year. North American containerboard exports have grown steadily recently rising in 2007 from just over 4.1 million tons in 2006 to nearly 4.4 million in 2007. It's likely similar gains can be posted this year and tonnage could rise to over 4.6 million tons. Of

course a major factor behind the increase is a favorable exchange rate. For example, the USD weakened versus the Euro in 2007, falling from about 83 cents to about 72 cents by the third quarter of 2007.

However, there is a limit to which exports to Europe can rise due to substantial growth in capacity in areas with closer proximity to the European market, such as mills in Eastern Europe. Mills in Brazil also have a favorable cost position on shipping to Europe.

The largest growth in U.S. exports has been for shipments to Latin America, which are estimated at about 1.4 million tonnes for 2007. In contrast, exports to Europe run at only about one-third of this level annually. Exports to supply the enormous appetite for packaging in Asia, which in the late 1990s reached 1.6 million tonnes annually, are also down to only about 600,000 tons annually, reflecting huge and continuing growth in Chinese containerboard capacity.

Put this all together and it appears that U.S. containerboard exports can continue to grow over the next two to three years on a global basis. Gains are unlikely to be major, but exports are already high and if they remain strong will certainly lend support to pricing if the domestic market falters (or continues to be weak). Kraft liner exports, if they continue to rise, would remain at or above the 2007 level of about 3.5 million tonnes, which is a whopping one million ton increase from what was considered the norm or average as recently as the 2003-2005 period.

Challenges for 2008

One problem facing producers is rising raw material and energy costs. The increase in energy costs has slowed—simply because they have already risen so much—while fiber costs, in particular recovered fiber costs, have risen out of

sight due to strong offshore demand, notably in Asia, for domestic wastepaper. However, it appears for now that producers have been able to offset much of the rise in costs, notably because of the full realization of a box price hike in the fourth quarter of 2007. As mentioned, coming off an unimpressive level of box cutups in 2007, the strength of domestic box demand in 2008 remains a big question. Box



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demand has been trending generally upwards over the last 3 years. However, late 2007 demand appeared to flatten out so we'll just have to wait and see. The bottom line is that as of early 2008, domestic box and containerboard demand remained tepid, but not bad enough to initiate any backsliding in prices. The biggest worry of course is the nagging concerns about the health of the U.S. economy, where a major downturn would certainly pull down box demand and make it difficult to maintain

pricing. In early 2008 the prospect of an economic downturn appeared to increase, but forecasting the economy continues to be a nearly impossible.

With cost pressures remaining, an additional price increase is something producers will certainly be pushing for during the first quarter, and unless the economy goes in the tank, they have a decent chance of enacting an additional increase. However, lackluster domestic demand will certainly have a dampening effect and put a lid on price gains.

So, on balance it appears that 2008 will be a good year, pending the direction of the U.S. economy. Producers will have to continue to do a good job of matching output to demand, controlling inventories and looking for opportunities to maintain prices and possibly push through an additional increase to offset rising costs. ■

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