

Containerboard – Early January Sees Light Activity and Flat Pricing for OCC as China Demand is Quiet

By Chip Dillon, Analyst, Vertical Research Partners

On January 5th, we learned from trade publisher RISI that the average price of recyclable old corrugated containers (OCC) across the USA remained flat at \$105/ton in the first three days of the year. No US region experienced any price changes from levels reported in early December. As a result, OCC in the export-heavy regions of Los Angeles and San Francisco held steady at \$120/ton and \$110/ton, respectively, while pricing in the key Southeast region remained at \$115/ton.

According to the RISI commentary, Chinese purchases were very light since the first batch of import permits (2.27 million metric tons) were issued by China’s Ministry of Environmental Protection in the days after Christmas (or just the week before this report). We also learned that additional licenses were granted the following week – just after New Year’s Day – with import license quotas so far reaching 2.61 million tonnes. These permits should suffice for over half of the country’s needs in the first quarter of 2018. Despite the official approval of import permits, buying of US-sourced OCC was light – perhaps due to the holiday season. Export OCC prices to China at the ports of New York and Los Angeles were in fact down \$5/ton each.

Chinese Buying Slow, but Uptick Expected

We note that there are perhaps other factors that could have caused the recent tepid pace of Chinese buying. First, there already appeared to be cargos with purchases from October-November (when US OCC pricing halted its rapid decline) that are scheduled to arrive this month. Second, these “early”



The Chinese authorities’ actions have not only resulted in higher domestic OCC prices but also significantly lower imported OCC prices

buyers in China were arguably taking a risk, though things have gone their way with the newly-issued license quotas. Thus, the early 2018 shortage may not be as severe as initially expected. Thirdly, the new “official” contamination level of 0.5% may have kept buyers sidelined, given the difficulty (if not impossibility) in finding such material in the US. That being said, OCC prices reported by RISI reflect activity taking place between January 2nd and January 4th. It appears that several OCC suppliers are already seeing a pick-up in export pricing by more than \$15/ton vs Jan. 5th reported level. Going forward, we believe that buying should accelerate.

Contamination Level Limit Lurks

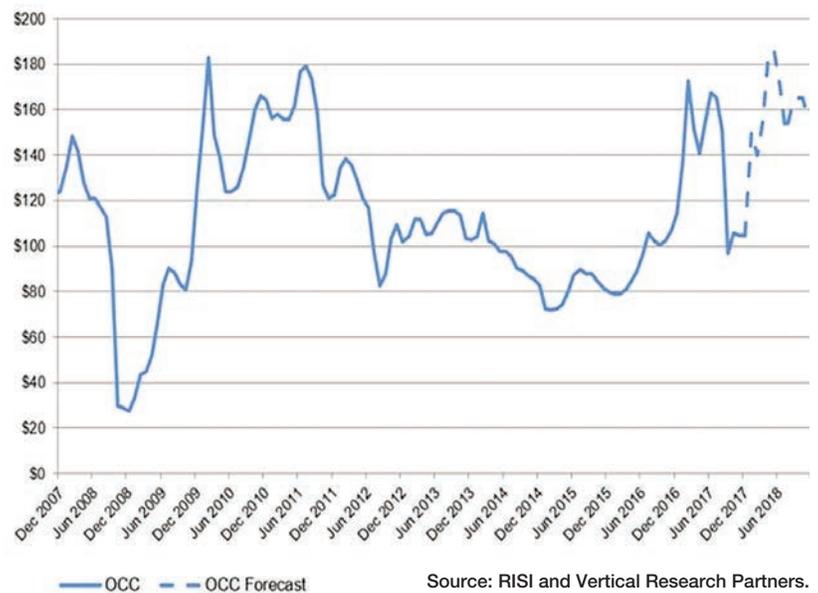
It is pretty clear to us that a blanket, sustained reduction

in OCC imports is not in the cards; such a thing would be unfathomable given the damage it would cause to China's economy (and possibly to its food distribution system). Even though import licenses will be issued later than usual – and the quota levels are still unknown – the most hotly contested rule at the moment is the 0.5% contamination limit for OCC imports after March 1st; we note that after setting a totally unrealistic level of 0.3% a few months ago, China reversed course recently, although the current level (0.5%) is significantly below the 1% level initially communicated. Industry sources have said that it is virtually impossible to collect and “clean” OCC with such a low contamination level. Chinese firms will likely have to import more expensive containerboard feedstock alternatives, such as double-sorted OCC (DS-OCC) and double-lined kraft corrugated cuttings (DLK). The former is simply a more thoroughly inspected form of OCC. The latter represents the trim waste generated by box plants in the US from the likes of International Paper and other box converters.

We believe such grades cannot suffice to cover China's substantial OCC demand. We expect US recycling/waste management firms to devote more time (and money) into cleaning OCC – thus increasing the supply of DS-OCC; yet Chinese mills will likely incur the financial burden of this development. If demand is very strong and the spread between DLK and OCC widens considerably, it is plausible to see US integrated box/board producers selling their trim waste to the market and replacing it in their own mills with regular OCC. Both of these changes (more thorough OCC inspections and market sales of DLK by integrated producers) are likely to happen (which could boost US companies' results), yet they are insufficient to cover Chinese demand. We highlight that with China's complete ban on mixed paper, its OCC deficit is even larger than it appears, as we believe that roughly one-third of mixed paper is OCC (not to mention that much of the remaining lower grade fibers are usually utilized by mills as furnish). We thus remain of the opinion that the country will have to eventually relax its proposed regulations even further.

Pricing Outlook

Having concluded 2017 – with the average OCC price across all US regions reaching \$138/ton vs \$92/ton in 2016 – we are refining our expectations for next year. We still expect US OCC prices to average \$160/ton in 2018 (our initial



Source: RISI and Vertical Research Partners.

forecast was introduced in October); however, we now believe that the price path will be somewhat smoother, as Chinese mills did get a change to import OCC in the past couple of months and the 0.5% contamination level rule going into effect in March will likely restrain purchases for a while starting in mid-February. We still expect an upward price trajectory, with a price peak of \$185/ton in May-June – at a time when we should have more clarity regarding the contamination level rule.

The US containerboard producers likely will see their “windfall” of super-low OCC costs in the fourth quarter of 2017 give way to some margin squeeze in the first half of 2018 – a period which is challenging anyway given winter weather and normal maintenance downtime that typically occurs late in the quarter. In what we expect to be substantially-higher recyclable fiber costs by sometime in the second quarter, we would not be surprised to see most/all major producers announce a US containerboard price increase sometime around late-February or early-March for an April 1st implementation. Box prices typically move up about 2-3 months after board prices move up. Remember – we believe the goal of most US companies is to maintain or slightly increase margins, not simply to seek to jack up prices indiscriminately.

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