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Paper & Packaging

Update: Are Inventory Reductions Starting to Ease?

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Industry Update

The last three months have been brutal across much of the paper & packaging sectors. A sharp drop-off in consumer spending coupled with an aggressive reduction in corporate inventories has yielded big domestic volume drops for many of our companies. The inventory reductions were very abrupt, but also somewhat different from past inventory cycles. Manufacturers & merchants appear to have been responding to fears about the pull-back by consumers as well as concerns about the health of the financial system and the ability to access capital. The upshot appears to have been an aggressive effort to convert working capital to cash by drawing down inventories.

Halloween come in November. Although Nov. volume numbers are not yet publicly available, they are apt to be very scary. How scary? Anecdotally, this sounds like it could be the weakest volume month in almost 30 years. A number of companies are reporting November volume comparisons in the range of -8% to -20% y/y. Looking at key indicators like the ISM's manufacturing survey (see page 2), these drops shouldn't be a real shock. For example, we think most firms will report corrugated box volume declines of 8-15% y/y for Nov. At the same time, it's hard to see some of the reported volume declines continuing for an extended period. 49% of corrugated boxes are sold to the food & beverage industry. Historically, volumes to these industries have been quite stable.

Inventory reductions may have reached a crescendo in November. In conversations with private & public companies over the past three days, we've been struck by the number of firms in various businesses reporting that vol's have stabilized over the past two weeks. A few examples: One paper company reported that its worst volume day in over a decade came on October 17th; just five weeks later, it saw a record order day on November 24th. A privately-held merchant reported volumes off 15-20% in November, but reported early Dec. vol's to be flat y/y. After big declines in October and November (especially weak), a number of box producers are reporting relatively flat y/y volumes since late Nov.

This may be a broader phenomenon. We were struck by similar comments out of NOVA Chemicals (NYSE: NCX) yesterday. Nova reported that polyethylene orders in the first 10 days of December exceed full month sales for Oct. and Nov. Interestingly, NOVA also noted that they resumed polyethylene exports to China in the second half of Nov. As we reported in a research note on Nov. 20th, our trade sources reported that Chinese buyers were slowly returning to the pulp market.

To be very clear, we are not calling a bottom in the economic cycle. We think that the next 12-18 months will be extremely difficult. The US economy is still contracting and the slowdown has now become global. In the US, a contracting economy will mean falling demand for many of the firms we cover. With offshore markets shrinking and the US\$ rising, we think the backdrop for our paper-based companies looks especially rough. And with credit still very tight, financial restructuring moves appear inevitable, from our perspective.

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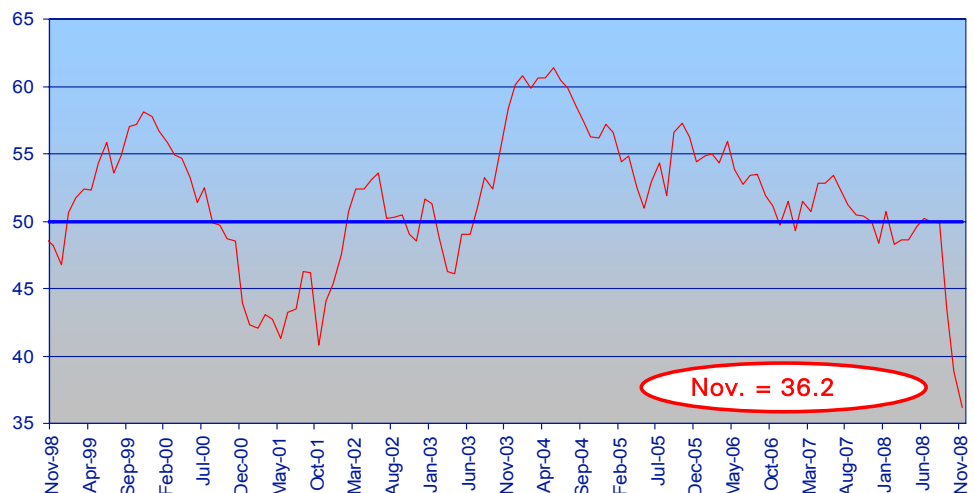
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Halloween came in November. Although November volume numbers are not yet publicly available, they are apt to be very scary. How scary? Anecdotally, this sounds like it could be the weakest volume month in almost 30 years. A number of public & private companies are reporting November volume comparisons in the range of -8% to -20% y/y. Looking at key indicators like the ISM's manufacturing survey (see below), these drops shouldn't be a real shock. For example, we think most firms will report corrugated box volume declines of 8-15% y/y for November. At the same time, it's hard to see some of the reported volume declines continuing for an extended period. 49% of corrugated boxes are sold to the food & beverage industry. Historically, volumes to these industries have been quite stable.

Figure 1: ISM Purchasing Manager's Index



Source: Institute for Supply Management, FactSet

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Appendix 1

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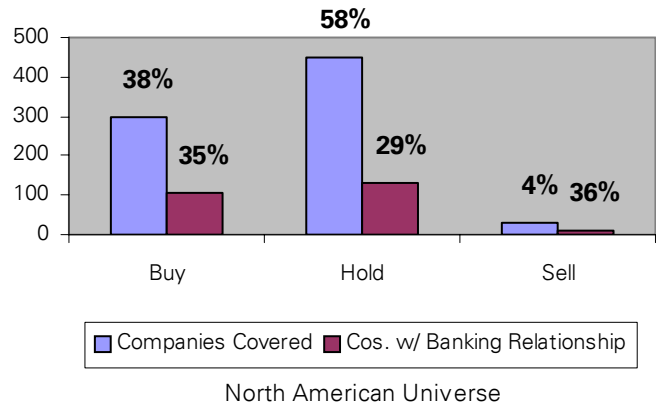
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