Fastmarkets
FOREST PRODUCTS

The future of China pulp futures

The next generation

Market Insights

Quarter 2, 2021

Foreword

Matt Graves
Senior Vice President
Fastmarkets

Matt Graves leads the Fastmarkets Forest Products, Fastmarkets FOEX and Random Lengths price reporting businesses, including market reporting and price assessments. Matt has worked for over 20 years at Fastmarkets Forest Products with a focus on the global pulp and paper industry.

Just over a year ago, we put together a Market Insights piece about the rising tide of pulp futures. At the time, we were marvelling about the 400 million tonnes of pulp futures transactions in the previous 12 months of trading on the Shanghai Futures Exchange (SHFE). In 2021, volumes eclipsed that number in the first three months of trading! Like it or not, pulp futures trading is a thing now. As we saw in the unprecedented run-up of prices in the first quarter of 2021, it has become clear that the global physical and financial markets for pulp are inextricably linked.

So, what does this mean for buyers and sellers of pulp?

This is one of the key questions we will examine in this new Market Insights piece about the future of China pulp futures. As buyers scramble to deal with the whiplash of several rapid price increases of more than $100/tonne, sellers are trying to get their heads around how this will play out in the future. In short, now is the time to figure out how to factor in this new variable as you chart out your strategy for the future.

Opportunity or threat?

Both! If you ignore it, the financial market will certainly rear its ugly head in ways you didn’t expect. If you take the time to understand it and make it part of your strategy, however, there are plenty of opportunities to use it to your advantage.

So let’s get stuck-in and get our heads around this massive new elephant in the room that we can no longer ignore!

Matt Graves
Senior Vice President
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Timing is everything!

Executive summary

Global pulp markets experienced an unprecedented rally in early 2021 driven by China

The China pulp market experienced one of its fastest and steepest rallies ever in the first few months of 2021, surpassing even that seen in the second half of 2017. This has had a knock-on effect on pulp prices around the globe, with Europe and the US also seeing unprecedented price hikes.

Futures trading contributed to the rally

Both supply-side and demand-side fundamentals were strong going into 2021, but soaring futures prices on the Shanghai Futures Exchange drove prices up further and faster than expected. They created additional buying interest from traders, who could afford to pay higher prices in the local import and resale markets as they could sell on the exchange and still make a sizable profit.

High price volatility makes planning difficult

High price volatility creates a challenge for companies when it comes to managing their margins and costs. This is true for both buyers and sellers of pulp.

Pulp futures are here to stay

The incredible success of the Shanghai Futures Exchange softwood pulp contract has proven the use case for futures in the pulp market. Moving forward, this contract and new offshore contracts focused on industrial players will become an increasingly important part of the global market pulp landscape.

Global pulp market trends and price drivers in 2021

David Fortin
Vice President, International Fiber
Fastmarkets Forest Products

David Fortin has been with Fastmarkets Forest Products since 2005. He spent his first seven years as a member of the Fiber Economic Analysis team, where he was responsible for specialty pulp coverage and assisting with the World Pulp Monthly, the 5- and 15-year World Pulp and Recovered Paper Forecast and Dissolving Pulp Monitor. During his time on the Fiber team, he was the author of the World Fluff Pulp Study and multiple single-client and mill risk studies.

In the first few months of 2021, the global pulp market saw an historical price run that outstripped even the run-up experienced in the second half of 2017. Most indicators pointed to improving market fundamentals at the close of 2020, which set the stage for pulp prices to finally move higher after an extended stretch when they hovered at low levels near the cash costs of high-cost producers. Synchronized growth in the global industrial markets took hold toward the end of the third quarter, with the worst of the economic devastation brought on by the pandemic seemingly behind us. Producer inventories were back in balance, supported by strong shipments and supply-side disruptions. Pulp demand showed signs of both seasonal and cyclical improvement as the nascent economic recovery began to take shape, while delayed and extended maintenance outages piled up and constrained supply.

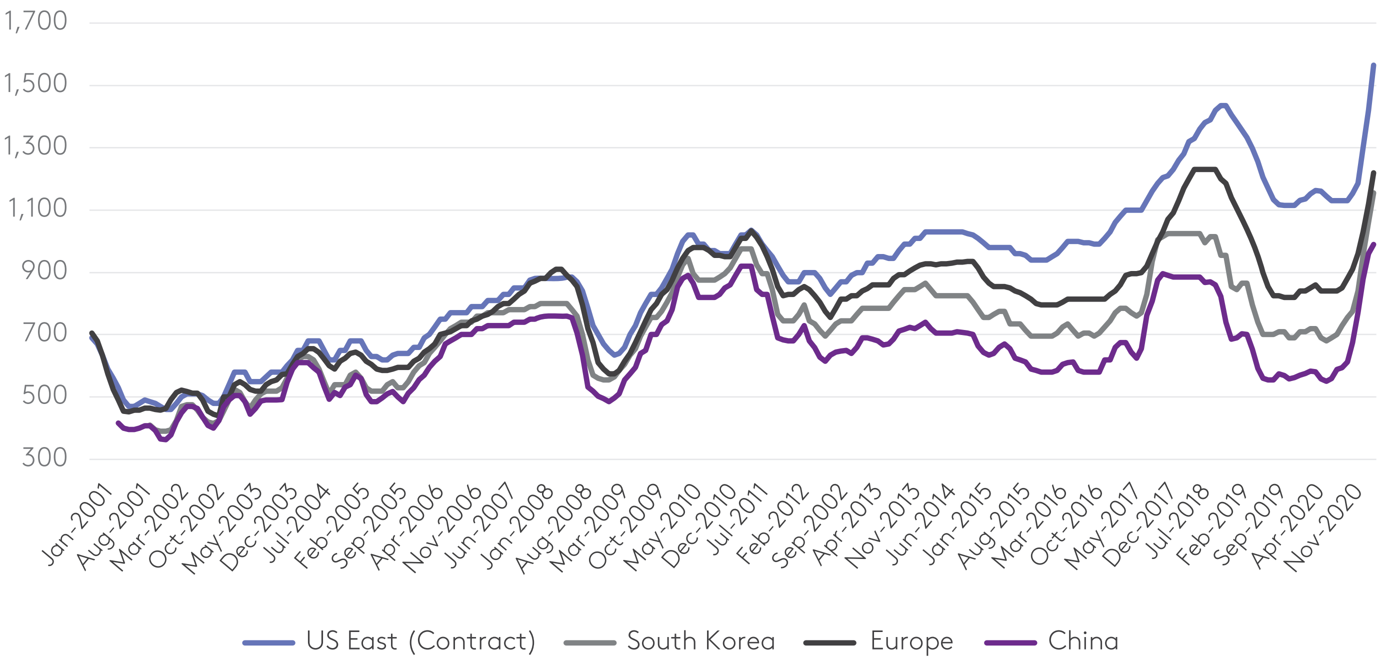
While these factors were supportive of an increase in pulp prices, the pace and magnitude of the increases seemed to go well beyond them. This raises the question of whether market fundamentals fully supported the rapid increase in prices or if prices had overshot and would tumble lower to realign with market fundamentals.

The upward pressure on pulp prices from the improvement in underlying market fundamentals was magnified by a number of factors. On the supply side, producer inventories were already at levels considered balanced to tight, and additional unexpected production outages and the growing logistics challenges from a lack of available containers constrained supply further, pulled producer inventories lower and pushed delivery costs higher. This had a disparate impact on pulp consumers in China. While larger end users in China were reportedly holding up to six months or more of pulp supply and could delay ordering as prices catapulted higher, smaller end users were operating more on a hand-to-mouth basis and were forced to continue ordering and chase prices higher, placing additional strain on their margins.

At the same time, pulp demand improved thanks to robust tissue and ivory board consumption. The reacceleration of the spread of the virus bolstered at-home tissue usage and demand for paper packaging for pharmaceuticals. Additionally, ivory board demand was strengthened by increased usage of paper packaging as a replacement for single-use plastics and a more constructive consensus outlook for the macroeconomy in the second half of the year.

The resultant price gains were reinforced by the continued appreciation of the renminbi against the US dollar. The stronger renminbi engendered end users' initial acceptance of rising pulp prices as a pillar of support for raising domestic

Comparison of global NBSK prices, 2001-2021
($/tonne)



Source: Fastmarkets Forest Products.

paper and board prices, but end users' margins were squeezed as they struggled to raise product prices in line with the unrelenting rise in pulp prices.

Pulp prices were pushed even higher by speculation in pulp futures contracts on the Shanghai Futures Exchange. The March pulp futures contract raced upward, supported by the general rise in global commodity prices and anticipation of stronger pulp demand as the recovered paper import ban was fully implemented in China. The price of the March futures contract plateaued at $600/tonne through early November, after a $50/tonne increase in late August. Since then, however, the futures contract has skyrocketed, increasing $50/tonne in November, $100/tonne in December and another $150/tonne in January to $895/tonne, up a total of $345/tonne from mid-2020.

The pace of the increase in the pulp futures contract was both unanticipated and breathtaking and has pulled domestic resale and net import prices markedly higher. The rate of change has resulted in disequilibrium across grades and regions, with the NBSK premium to BEK reaching more than $250/tonne and the net NBSK price delivered to China exceeding $150/tonne above estimated net delivered prices to Europe and North America. Net delivered pulp prices outside of China chased net import prices in China, while net import prices in China chased resale and futures prices. The March futures contract hit a high of RMB 7,444/tonne in early March, which was close to $1,000/tonne after removing VAT and logistics. Resale prices were at a similar level, and net import prices were between $930/tonne and $1,000/tonne depending on the brand. The pace of the increase in resale prices in China in November 2020 to March 2021 surpassed that seen in the second half of 2017, with prices up $350-400/tonne, and if you include the $50/tonne increase achieved in August before the price plateaued through October, the total gain from trough to peak was $400-450/tonne or nearly 70%. The main difference this time is that prices started $85/tonne lower at the trough. The exceptionally strong back-to-back increases have encouraged pulp producers to redirect spot volumes to China, dig deeper into their inventories and push for higher prices with contract customers.

While we had anticipated a rebound in prices this year, the rate of change greatly surpassed expectations. Heading into 2021, the continued economic recovery, stronger pulp demand, balanced-to-tight producer inventory levels, stronger renminbi and a lack of meaningful capacity expansion until the end of the year set up a market environment that is supportive of higher prices. However, a combination of exogenous factors, including a lack of container availability, speculative trading on the Shanghai Futures Exchange and additional unexpected supply-side outages, sent prices higher at a breakneck pace. ■

Understanding the SHFE and its impact on physical markets

Nick Chang
Managing Editor Asia
Fastmarkets Forest Products

Nick Chang manages the PPI Asia editorial team and reports on the Asian pulp and recovered paper markets. He has been with Fastmarkets Forest Products for nearly 20 years. He speaks Mandarin Chinese, the Chinese dialect Hokkien and English and reads Japanese.

The now established pulp futures trading on the Shanghai Futures Exchange clearly played its part in the spectacular rally seen in the global pulp markets in late 2020 and early 2021.

On March 15, the Ilim Group announced a hike of $100/tonne for bleached softwood kraft pulp (BSK) imports for April shipments in China, taking the grade's prices to $1,000/tonne, an historical high. The Russian powerhouse indicated the decision was made based mainly on BSK futures prices on the Shanghai Futures Exchange (SHFE).

Ilim sells more than a million tonnes per year of pulp, chiefly BSK, to China. The announcement set a precedent for BSK pricing past the mark of $1,000/tonne, and Chinese buyers braced themselves for other suppliers to follow suit.

Canadian producers were the first to peg softwood pricing to BSK futures and even began redirecting spot volumes away from other regions to capitalize on the high prices they could achieve in China. In early March, a major Chinese end user already had to fork out $1,000/tonne for northern BSK (NBSK) pre-sold by a Canadian producer for May shipments. The buyer explained the tonnage would feed a new cartonboard machine scheduled to come on line in the second half of the year.

The rises clearly show that the surge in BSK futures prices have made their impact on the industry felt, with buyers constantly bidding up levels for pulp imports and suppliers pre-selling them. Besides papermakers and traders, financial institutions not related to the industry are also involved in BSK futures investments.

When BSK futures prices surged, traders pounced on arbitrage opportunities, which were cracked open when the gap between prices for futures and

The Shanghai pulp futures were the 50th set of commodities futures contract to be launched in China. They offer local traders the opportunity to buy and sell bleached softwood kraft pulp for delivery in the next 12 months, either for procurement purposes or as a hedging tool. The contract is physically settled, meaning that those left with an open sell position when the contract expires are obliged to deliver pulp corresponding to one of the 12 brands recognized to a storage delivery designated by the exchange. The recognized brands include pulp produced by five Canadian suppliers (Canfor, Catalyst, Mercer, Cariboo and Nanaimo), two Nordic producers (UPM and Södra), two Chilean suppliers (Arauco and Pacifico) and Russia's Ilim.

resale/imports widened. There were several times when prices in physical trade soared to points where buyers and even sellers felt they were unsustainable as they had deviated from the fundamentals too much. But the futures price run continued unabated.

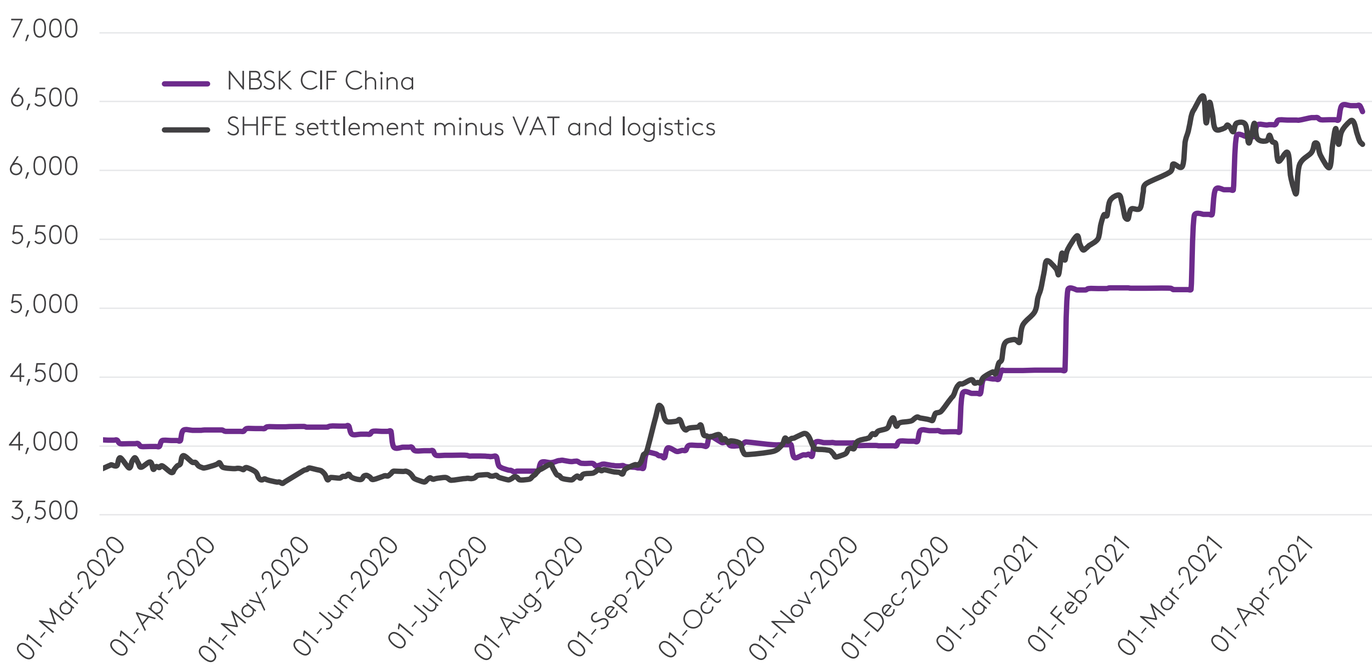
Most Canadian sellers and some Nordic suppliers have accommodated the development, changing sales plans from selling NBSK following monthly negotiations with buyers and giving contracted clients discounts to selling and pre-selling spot tonnage at net levels, with no discounts given.

The impact has not been limited to the BSK segment. Prices for other pulp grades have been driven up across the board.

Chinese customers have used their stocks of bleached hardwood kraft pulp and even bleached chemi-thermomechanical pulp as collateral to arbitrage on the Shanghai bourse. In the face of soaring costs, they have no choice but to adapt, cutting purchasing volumes when pulp grows more expensive, while reducing their inventories of finished products.

In the meantime, mills have sought to pass the extra costs on to downstream clients by raising paper and board prices in the domestic market. In the end, all the hikes will reach consumers. ■

Fastmarkets Forest Products NBSK CIF China vs SHFE pulp futures
(RMB/tonne)



Source: Fastmarkets Forest Products, SHFE.

Introduction to NOREXECO's new China Pulp Futures

Anita Skjong
Market Director
NOREXECO - The Pulp and Paper Exchange

Anita Skjong, Market Director with NOREXECO ASA, The Pulp and Paper Exchange, has been working in the commodity and financial service industry for more than 20 years. She has extensive experience with risk management, hedging strategies, derivatives and trading. Previously, Anita worked in companies such as Norsk Hydro, Orkla Finance Commodity Trading (a hedge fund) and Norsk Gjenvinning.

Anita holds a bachelor's degree in international marketing from ICADE, Madrid, and has an Executive Master of Management course from the Norwegian Business School.

Using financial instruments to increase strategic capacity or manage price risk or volatility is common for most commodities, and over the last several years these tools have been made available to the pulp and paper industry. The increasing volume in futures contracts traded, especially in China, and its significant impact on price discovery, prove the importance of making these contracts available to the international pulp and paper market.

On June 1, 2021, NOREXECO will launch two new China futures contracts tailor-made for the international pulp and paper industry with exposure to China pulp price volatility. These contracts are also available for Asian market participants seeking to reduce risk and/or exploit opportunities:

- NBSK CIF China Net – financially settled against Fastmarkets Forest Products's NBSK CIF China[1]
- BHKP China Net – financially settled against Fastmarkets FOEX's BHKP China[1]

*1. For product specifications please visit: **https://www.norexeco.com/pulp**.*

Below are examples on how to use these new financial settled pulp futures.

NBSK producer Canada – hedging production

A pulp producer wants to use the futures market to hedge against price decline and secure revenues of their production.

Futures and physical market @ time of hedging, March 21:

NBSK CIF China:	$939/tonne
Futures market (2Q21):	$980/tonne
Volume:	50,000 tonnes per month
Period:	Three months (2Q21)
Futures:	Sell - NBSK CIF China 2Q21 Contract[1]
Physical pulp:	High quality, normally they receive a $20/tonne premium to the NBSK CIF China

1. Selling futures creates a profit on futures contracts if the price decreases (short position).

Scenario: By the end of 2Q21, the pulp price has **decreased** and the average NBSK CIF China price for the hedging period is now **$900/tonne**. Let's see how this will affect the producer:

Settlement financial hedge, profit: ($980 - $900) * 150,000 tonnes	= $ 12,000,000
Physical average pulp sold during Q2 (including $20 premium): $900 + $20 * 150,000 tonnes	= $138,000,000
Total revenue on pulp production during Q2 ($1,000/tonne)	= $150,000,000

Conclusion: Independent of market direction, the pulp producer will receive $1,000/tonne. Had the producer not hedged, they would have received $920/tonne.

Paper mill China – hedging NBSK cost

In order to offset risk arising from fluctuations in pulp prices, the paper mill wants to use futures to hedge.

Futures and physical market @ time of hedging, April 2021:

NBSK CIF China:	$980/tonne
Futures market (2H21):	$950/tonne
Volume:	10,000 tonnes per month
Period:	Six months (2H21)
Futures:	Buy – NBSK CIF China 2H21 Contract[1]

1. Buying futures creates a profit on futures contracts if price increases (long position).

Scenario: By the end of 2H21, the pulp price has **increased** and the average NBSK CIF China price for the hedging period is **$980/tonne**. Let's see how this will affect the paper mill:

Settlement financial hedge, profit: ($980 - $950) * 60,000 tonnes	= $ 1,800,000
Physical average pulp bought during second half 2021: $980 * 60,000 tonnes	= $ 58,800,000
Total pulp cost during 2H21 ($950/tonne)	= $ 57,000,000

Conclusion: Independent of market direction, the paper mill will pay $950/tonne, eliminating the risk of increased prices, thus the desired predictability of cost is secured. Had the paper mill not hedged, they would have paid $980/tonne.

BHKP producer – flexible pricing customer

The producer wants to increase customer service by offering flexible pricing on commercial contracts to customers by giving them the opportunity to fix the price when the market is favorable.

In January 2021, the pulp producer gets a request from a large customer regarding a fixed price for pulp delivered in 2Q21; they expect prices to increase as demand is improving. The producer agrees to fix the price, but due to improving market fundamentals, they want to remain exposed to pulp prices by using futures.

Futures and physical market @ time of hedging, January 2021:

BHKP PIX China:	$537/tonne
Futures market (2Q21):	$600/tonne
Volume:	50,000 tonnes per month
Period:	Three months (2Q21)
Fixed price customer:	$600/tonne
Futures:	Buy – BHKP PIX China Q2 2021 Contract

Scenario: By the end of 2Q21, the pulp price has **increased** and the average BHKP PIX China of the hedging period is **$750/tonne**. Let's see how that affects the producer:

Physical contract:	Expected revenue without fixed price: $750 * 50,000 tonnes	= $ 37,500,000
	Payment from customer fixed price: $600 * 50,000 tonnes	= $ 30,000,000
	Lost revenue due to fixed price	- $ 7,500,000
Financial contract:	Long futures contracts 2Q21: $600 * 50,000 tonnes	= $ 30,000,000
	Settlement futures contracts: $750 * 50,000 tonnes	= $ 37,500,000
	Profit financial futures	+ $ 7,500,000

Conclusion: The customer fixed the pulp price in January, thus is not exposed to any price volatility. The producer used the futures market to remain exposed to pulp prices, which allowed them to increase customer service and benefit from higher prices.

Trading opportunities - example

The futures market doesn't always move in tandem with the physical market—sometimes, it can "overshoot" or "undershoot." Companies can take advantage of these moves. During 1Q21, the futures market rallied strongly, and some traders (industrial/professional investors) may believe the futures market has detached from the underlying fundamentals, supply and demand.

Futures and physical market @ time of hedging, April 15, 2021:

BHKP PIX China:	$780/tonne
Futures market (June 2021):	$950/tonne
Sell/short 20,000 tonnes June 2021:	$950/tonne

Scenario:

1. The trader can at any time until settlement buy back the futures position, either to take profit or loss depending on the futures market price movement
2. The trader can hold the position until financial settlement (average BHKP PIX China June 2021), no physical delivery involved. The BKHP PIX China reflects the price of physical transactions done during the period (June 2021) = the futures market will converge with the physical market at the time of settlement

Example 1:

On May 18, 2021, the June futures contract is trading at $880/tonne and the trader decides to close the position:

April 15, 2021 sold 20,000 tonnes * $950/tonne	$ 19,000,000
May 18, 2021 bought 20,000 tonnes * $880/tonne	$ 17,600,000
Position closed, total **profit**	+$ 1,400,000

Example 2:

On June 1, 2021, the June futures contract is trading at $1,000/tonne, and the trader decides to close the position due to changed market fundamentals:

April 15, 2021 sold 20,000 tonnes * $950/tonne	$ 19,000,000
June 1, 2021 bought 20,000 tonnes * $1,000/tonne	$ 20,000,000
Position closed, total **loss**	-$ 1,000,000

Example 3:

Trader decides to hold the position until final settlement, and position will be closed out based on average China BHKP PIX June 2021:

April 15, 2021 sold 20,000 tonnes * $950/tonne	$ 19,000,000
Settlement BHKP PIX China $850/tonne * 20,000 tonnes	$ 17,000,000
Position closed, total **profit**	+$ 2.000,000

Fastmarkets NBSK CIF China and PIX BHKP China Benchmarks

Sharon Levrez
Price Assessment Manager
Fastmarkets Forest Products

Sharon Levrez joined Fastmarkets Forest Products in 2017. She works closely with Fastmarkets Forest Products's SVP of Indices, Matt Graves, to improve the reliability of our price assessments and develop new ways of assessing prices.

To contact Sharon or a member of the price reporting team, email **prices.risi@fastmarkets.com**.

NOREXECO plans to launch two new cash-settled pulp futures contracts in June 2021. These will be a softwood contract, based on Fastmarkets Forest Products's NBSK CIF China assessment, and a hardwood contract, based on Fastmarkets FOEX's PIX BHKP China index. Both prices are net.

Fastmarkets prices are already used in some physical and financial contracts. They are rooted in a robust pricing methodology and based on transactions concluded in the offshore cargo market.

where required, and outliers are removed. Our integrated peer review system ensures that all data is verified by at least two reporters and an editor or senior reporter to ensure quality control and compliance.

Both our NBSK CIF China assessment and PIX BHKP China index show strong correlations with the domestic resale market for that grade in China, as well as with prices for the same grade in East Asia. In addition, PIX NBSK CIF China also correlates well with other softwood grades,

Fastmarkets has a strong history in providing benchmark prices for the industries we serve.

Fastmarkets has a strong history in providing benchmark prices for the industries we serve. We apply strict polices and processes, developed in accordance with the IOSCO principles for Price Reporting Agencies (PRAs), the gold standard for all price reporters.

Our pricing process starts with our trained reporters completing a broad, representative survey of participants from across the supply chain. The data we gather is entered into our proprietary pricing database, where it is analyzed, normalized

such as radiata pine and Russian BSK. This means they can be used to hedge exposure in other locations, and for other softwood grades.

The new NOREXECO futures should provide physical market players with a more appropriate tool to manage their exposure to price volatility going forward. Moreover, they will allow companies to cash in on the arbitrage between China's offshore and domestic markets, as well as the differential between hardwood and softwood prices. ■

Meet the Fastmarkets pulp team

Bryan Smith
North America
Pulp Editor

Steve Sachoff
Europe
Pulp Editor

Nick Chang
Asia
Pulp Editor

Lizzie Yu
China
Pulp Analyst

Marina Faleiros
Latin America
Pulp Editor

Lars Halen
Director of Pulp
Fastmarkets FOEX

Producing the most robust price requires a coordinated global team

Fastmarkets pulp assessments provide robust and transparent benchmarks for softwood and hardwood pulp imported to China. They are compiled by our team of experienced reporters located around the globe in Singapore, Shanghai, Helsinki, San Francisco, São Paolo and Brussels.

Our reporters are chosen for their knowledge and experience. Each is assigned a specific beat and works in close cooperation with a team of colleagues. To contact the team, please email pricing.risi@fastmarkets.com or info@foex.com. ■

Lina Liu
Head of FIS Shanghai

Lina Liu joined FIS from its London office and was relocated to Shanghai in 2016. In addition to managing the FIS office in Shanghai, she also helps to develop new derivative products and has been focused on a pulp derivatives contract in China. She has several years of experience in commodity derivatives and has an MSc in quantitative finance from CASS and LSE.

The broker's view

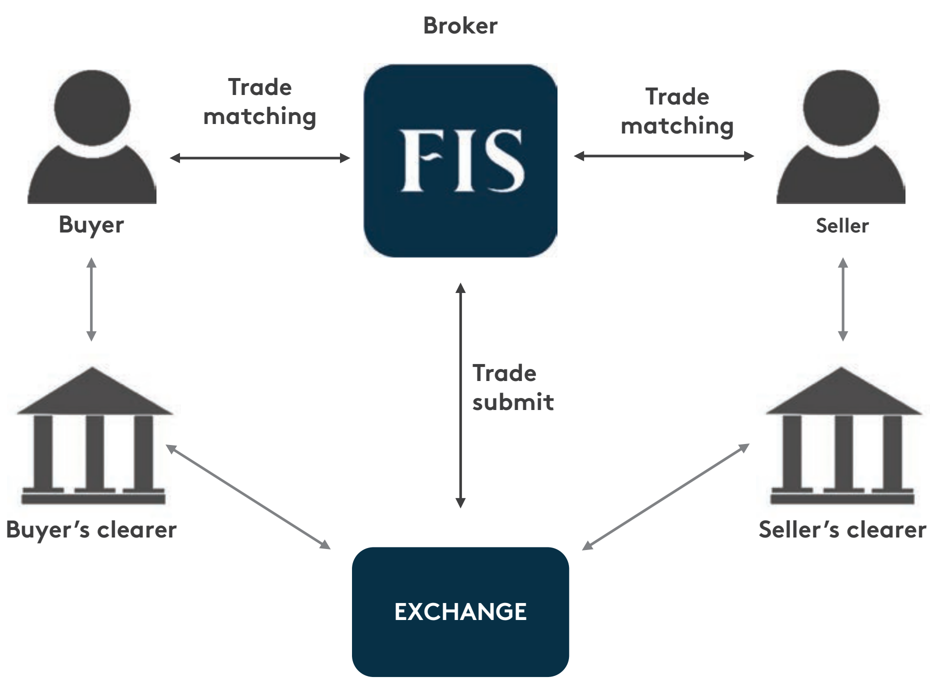
Since the launch of pulp futures by the Shanghai Futures Exchange, the pulp derivatives market has gradually attracted the attention of pulp industry players and investors and pushed the further development of offshore pulp futures products. As a leading shipping and commodity derivatives broker, FIS (Freight Investor Services) has been actively participating in the promotion of pulp futures.

Unlike contracts traded in the traditional OTC swaps market, the pulp futures offered by the NOREXECO pulp and paper exchange are standardized, cleared cash-settled contracts. Margin is required and managed by clearing banks—which helps to limit counterparty risk—and trades can be matched by brokers such as FIS. Chinese companies may need to use brokers like FIS to trade NOREXECO pulp futures. The trading process is outlined in the graphic below.

We have seen growing volumes and volatility in the market. In 2020, the trading volume of SHFE softwood pulp futures was nearly 350 million tonnes, and over 515 million tonnes have changed hands to date in 2021. Volatility has risen from 31% in 2020 to 35% so far in 2021.

The high correlation of global commodities, the systematic risk uncertainty and the

OTC clearing process



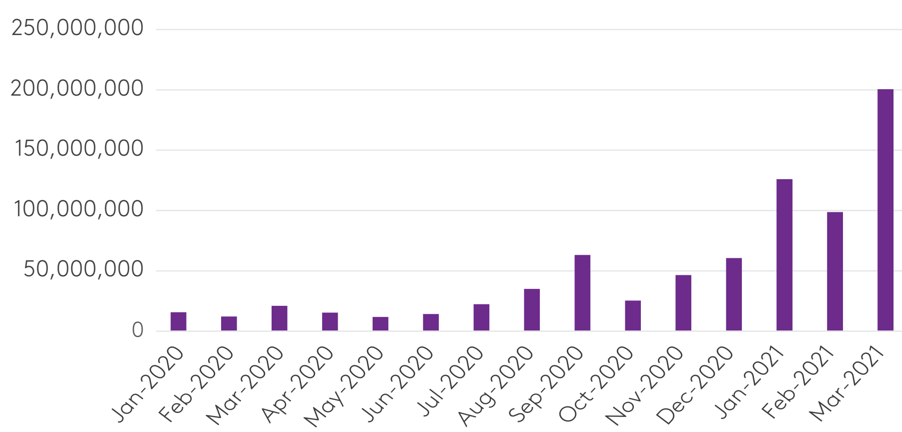
booming demand for pulp after China's plastic and RCP bans has driven the volatility of the pulp market. Combined with the instability of the US dollar, market participants are facing significant pulp and paper price risk exposure.

From FIS's network of customers in the global pulp and paper market, we understand that market participants have a great demand for US dollar pulp contracts and look forward to the launch of the additional China NBSK and BHKP contracts. These contracts are more suited to hedging Chinese imported pulp price risk. The US dollar pulp index is closely linked with the physical import price and can be compared with the SHFE renminbi pulp futures. Players can choose between contracts based on the price and create arbitrage opportunities.

Pulp future contracts can be traded by month, quarter and calendar year. Contracts with different expiry dates meet market participants' need to choose the right hedging period with corresponding purchase/sales cycle and realize the demand of conversion between floating and fixed prices for different players in the industrial chain. If the physical trade is also index linked, players can avoid repeated monthly price negotiations and use the index to reflect the monthly market price directly. Meanwhile, cash-settled contracts using the same index can minimize the basis risk and achieve a better hedging result.

We believe that the pulp market development pattern is similar to that in iron ore, with the emergence of onshore and offshore futures contracts improving the current market system and providing more flexible trading solutions. We hope the market can go from strength to strength, and we will be supporting it all the way. ■

Monthly SHFE futures volumes
(tonnes)



Source: SHFE.

Stephen Blyth
VP & Chief Financial Officer
Sappi Europe

Stephen Blyth is VP & Chief Financial Officer of Sappi Europe, based in Brussels, where he is responsible for all finance- and IT-related matters in Sappi's European operations. Stephen joined Sappi in 2005 at its Johannesburg head office, before being transferred to the European headquarters in Brussels where has held various senior financial management roles in finance, treasury and tax. Prior to Sappi, he worked at KPMG for nine years split between the Johannesburg and London offices and across various functions in accounting, auditing and tax consulting.

Stephen recently chaired the industry working group for CEPI's 2050 Roadmap and continues to support CEPI's initiatives looking into alternatives to fund the investment needed to transform the European Paper industry toward 2050. Stephen is a Chartered Accountant and has a B.Com Honours from the University of Kwazulu Natal in Durban as well as a Higher Diploma in Tax Law from the University of Johannesburg.

The buyer's view – Sappi

It's not about second-guessing or timing the market, that would be speculative, it's all about certainty...of margins and cash flows.

Those responsible for risk management, as far at it relates to raw material price movements, are well accustomed to being the "whipping boys" in times of price turbulence. If one has hedged or fixed a position in times of declining prices, one hears "Why did you do that, we could have been so much better off had we floated with the market." Conversely, "Why did you not lock in the prices" is often heard when a buyer's raw material price is floating with the market as prices are rising. A conundrum indeed!

Many companies address this raw material price risk as part of their risk management strategy, which may or may not include a hedging component. For global pulp markets, despite their size, a buyer's access to the pulp derivative market has been possible, but limited to mainly OTC trades with financial brokers and more recently via the pulp futures offered by the NOREXECO pulp and paper exchange. Liquidity in both these markets has been constrained.

This lack of ability to hedge the price of a critical raw material raises fundamental issues for buyers, especially in recent times of such rapid pulp price increases and particularly for those who are unintegrated paper producers. Although absolutely necessary, it is not always possible to immediately pass these increases on to a buyer's own customer, either due to fixed contract pricing, credit issues or the destruction of end consumer demand. The alternative for an end user of commodity paper is not another printer or publisher that can source paper at a lower price, but a different (often digital) means of communication. Once gone, these markets don't come back.

With approximately 40% of global pulp demand emanating from China, a liquid pulp futures market in the form of the Shanghai Futures Exchange and the new NOREXECO China futures contracts, have European buyers' derivative liquidity concerns been addressed? Partly. It is most definitely an additional arrow in the quiver of a European buyer trying to manage raw material price risk.

We are getting closer and many questions should be answered as the understanding of the pulp futures volatility on the SHFE improves. Liquidity in a derivative futures markets can only be a good thing, right? ■

High pulp prices set to linger

Liu Zhi Tao
General Manager
Xiamen ITG Paper

Liu Zhitao joined Xiamen ITG Paper in 2003. He has almost 20 years of management experience in the forestry industry, with a focus on marketing and sales management in wood, recovered paper, pulp, paper and board. He graduated from Xiamen University with a major in economics and business.

An interview with Liu Zhitao of Xiamen ITG Paper

When prices for northern bleached softwood kraft (NBSK) pulp imports to China soared from around $600/tonne in November last year to a record high of $1,000/tonne in March, sellers and buyers ascribed the jump to a surge in pulp futures prices on the Shanghai Futures Exchange.

The sharp increase of $400/tonne (67%) in just five months was unprecedented and would have been unthinkable before the Shanghai bourse launched its bleached softwood kraft (BSK) pulp futures contracts in November 2018. The BSK futures spike during the period unleashed the pent-up potential of NSBK price rises in physical trading. Consequently, price hikes accelerated, with demand outstripping supply.

Liu Zhitao, general manager of Xiamen ITG Paper, sees the process as the price discovery function of the BSK futures market. “Although there has been no softwood manufacturing capacity expansion in the global market, NBSK prices had been kept low for one and half years prior to late 2020, despite growing demand in China due to a wave of new paper and board machines coming on line in the country,” he said.

Besides price discovery, hedging and shifting pricing dominance to China are the other major impacts that the SHFE has had. “My company participates in the BSK futures market,” Liu says. “Our parent firm, Xiamen ITG Trade, is involved in futures activities for other commodities, such as iron ore, steel and chemicals. But most Chinese papermakers have kept their distance from futures investments, as they are not familiar with how they work.

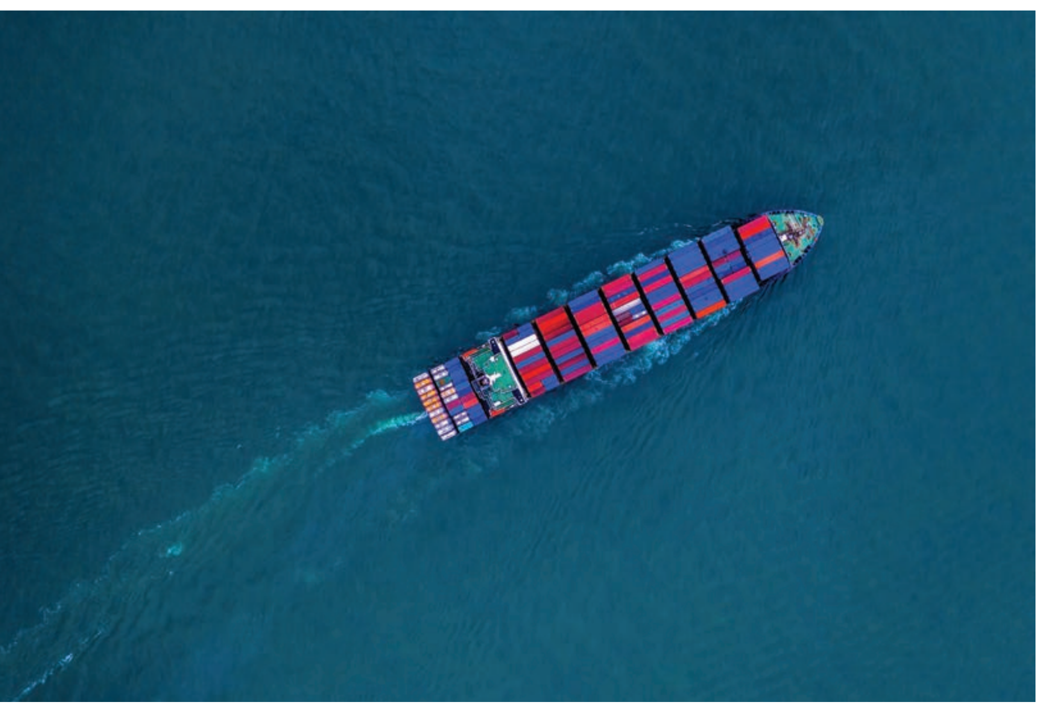
“As for pricing dominance, soaring prices in both BSK futures and physical trade have led to a number of suppliers breaking away from the traditional pattern of sellers and buyers negotiating NBSK prices on a monthly basis,” he says.

With investor buyers constantly bidding up prices, many Canadian and Nordic producers have cut tonnage allocated to contract customers and increased their spot sales, with multiple hikes implemented within a month for the same month’s allotments or for presales. And while BSK futures levels ostensibly peaked in late March and have been heading south (with fluctuations), NSBK imports have not seen prices dropping proportionately.

Liu projected that current high NBSK levels in the offshore cargo market will linger for the next few months. He pointed out that following several months of robust purchases of pulp imports, suppliers have little stock pressure and are therefore unwilling to cut prices, despite the fall in futures and absence of arbitrage buying.

"As for pricing dominance, soaring prices in both BSK futures and physical trade have led to a number of suppliers breaking away from the traditional pattern of sellers and buyers negotiating NBSK prices on a monthly basis."

Meanwhile, the ongoing international shipping logjam has hit deliveries of pulp cargoes to China. Liu indicated that a big portion of pulp that Chinese buyers ordered over the past month is likely to be shipped from June onward. "Pulp prices are likely to be under downward pressure in July and August amid the summer paper and board lull in the Chinese market," he said.



The BSK uptick has led to price increases for other pulp grades in China, notably bleached hardwood kraft (BHK) pulp. And the futures-driven pulp hikes have also persuaded global suppliers to send more volumes to China, while pushing for rises in other markets to close their gaps with China.

NOREXECO attraction

On October 16 last year, Oslo-based NOREXECO launched the listing of its Shanghai pulp futures. The offshore cash-settled contract is based on the monthly final delivery settlement prices of the BSK futures on the SHFE, with the NOREXECO contract being a "mirror contract" to the SHFE contract, converted from renminbi to US dollars with the Chinese VAT of 13% deducted.

The team-up allows cross-market hedging and arbitraging between the Norwegian bourse and SHFE, aiming to attract futures investors. Liu said the offshore pulp contract settled in US dollars is attractive to Chinese companies, but unfortunately, most Chinese investors are not familiar with how NOREXECO operates in China. That is something NOREXECO will be working on in the coming months, particularly with the planned launch of two additional China pulp contracts settled against Fastmarkets Forest Products's prices this summer. NOREXECO is also ensuring that Chinese companies can participate in trade via brokers and clearing houses by providing an easy access route. ■

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