Durable Goods Orders

Plastics Mfrs: Prices Surging amid Middling Demand; China and Oil Only Partly to Blame

- *Cost Increases Bring Derisive New Meaning to Term 'Supply Management'*
- *Consumers Insulated, for Now, as Producers Absorb Higher Production Costs*
- *Demand for Plastic Materials from Automakers Unusually Strong for January*

By Gary Rosenberger

MIAMI BEACH (EconoPlay) Jan. 21 – The cost of making anything from plastic has been climbing for months, and it just got worse with the New Year – fueled by artificial scarcity rather than by growing demand for such products, industry officials suspect.

Overall demand remains lackluster – except for automotive components, where demand has been unusually strong for this time of year. Price increases for PVC (used in piping) remain moderate, reflecting stagnant new home construction.

Most of those added costs are being absorbed at the producer level for competitive reasons. So any shock to consumers is months away – if it comes at all, considering that a vast array of products, like toys and apparel, can be redesigned to maintain familiar price points.

Demand from China and higher oil and natural gas prices are only partly to blame. The bigger culprit seems to be "supply management" – which some have redefined as the art of keeping supplies artificially depressed to create a perception of scarcity.

Thus pricing power has shifted to producers, and it is hard to see why they would abrogate that newfound power by restoring capacity – especially in an economy that always seems to teeter into decline or stagnation.

"In general we're seeing severe upward price pressures for plastic raw materials," said Arch Van Meter, president of Mega Corporation in Schaumburg, Illinois, which produces plastic injection moldings for military applications and for off-road vehicles.

"But it's a very competitive business, and it's very difficult to pass on any price increases to customers," he added.

"Without being too specific, I would estimate that my raw material prices have gone up more than 10 percent since last year," he noted. "But it's now accelerating. The pressure is there and prices are moving higher. It's no secret. Everybody in the industry knows it."

He's not clear on what's causing the rapid increase. It's certainly not demand, which has been relatively flat. "But there is pressure on pricing whether it's China or the natural gas and petroleum components in the raw material," he said.

So far, he has absorbed most of the increases because why take the risk of losing customers?

Van Meter has the occasional opportunity to raise prices on new customers, but there aren't a lot out there. "I have a lot of colleagues in this business, and we're not seeing the business to be robust at present," he said.

"But we are beginning to see more inquires and are getting bids on new work they wish to release," he added.

'Not True Inflation'

"It's a game. It's not truly inflation," said Kelly Schwenk, general manager of Pyramid Plastics in Rockford, Illinois. "It's all about managing supply and demand."

While the price of plastic tends to track crude oil, the price increases are out proportion to historic norms – especially for plastics made from natural gas, where any increases have been relatively moderate.

Nor does Schwenk see China as a price mover anymore because it has built too much internal capacity to need to wade into global markets as it has in the past.

Prior to the recession, his industry was beleaguered with overcapacity, which kept prices down. "But in 2008 and 2009, a lot of guys went out of business and the people who didn't go out of business shut down some of their lineup because they couldn't make any money," he said.

All that spare capacity, which might or might not come back, has created artificial scarcity. "So when prices rise, it's manipulation, not truly inflation," Schwenk said.

Still, it's easier for some to pass on those costs than for others. "We run into price resistance every day, especially from the automotive industry, where we deal with Tier 1 and 2 suppliers," he said. "We try to pass on what we can. At a certain point it becomes counterproductive to deal with people who won't accept a price increase."

His volume sales are up "a little bit." But most of his customers are still "hand to mouth" in matching inventories to orders. "There's still a lot of skepticism about this recovery," Schwenk said.

Matt Davidson, president of Xten Industries in Kenosha, Wisconsin, an outsource manufacturer of a wide gamut of injection-molded plastic products, has seen his costs rise – and he pins it China and industry consolidation.

"The plastics companies have been buying each other up. Where there were 20 suppliers there are now just three or four big players," he said, citing the 2007 sale of GE Plastics to Saudi Basic Industries.

At the same time, global demand is growing "even if it's stagnant in the U.S. and Europe," he noted.

“Anyone who tells you China is not booming is lying. So they’re shipping it all to China, even if they’re making it in China now,” he said. “If you’re a global company with capital to deploy, why would you put it to use in an economy that’s stagnant or in decline?”

Meanwhile, U.S. producers seem intent on keeping production down to keep prices high. “You’ll hear that our cracking facility broke down. You hear every kind of excuse to limit supply,” Davidson said. “It’s the old monopoly/oligopoly thing all over again. They’re always testing the market to see what they can get away with.”

It’s also his view that the U.S. has turned into a “two-tier” economic system. “Yes, we’re out of a recession – if you happen to be a large public company with lots of cash and record earnings,” he said. “But if you’re a small or midsized company, you’re still struggling to get financing.”

Davidson’s own company grew by 20% last year and he expects to do the same in 2011. But none of that is a reflection of economic growth. “It was all getting business from other people,” he said. “We saw more transfer business last year than we’ve seen in years. None of it was new programs where we had to retool.”

The Auto Revival

“In our 20 years we never saw the start of the year be this busy,” said Dave Matthews, a partner at Creative Techniques in Auburn Hills, Michigan, which primarily makes custom-injection and structural foam molding for the material handling and packaging industries.

His main clients are automotive parts suppliers that run the gamut from engines to car seats.

Usually, January is a slow month of gradual ramp-ups. “But this January has been crazy, which is a wonderful thing for us,” he said. “In all our automotive segments, I think it’s pent-up demand and confidence that 2011 will be a better year.”

He has also seen the cost of his raw materials rise by around 17% in the last three weeks alone, and he expects more subdued increases in February and March because “there’s only so much of a hit that people can take.”

Higher costs for feedstock and natural gas are the main rationalizations his suppliers use to impose price increases. But Matthews believes the real accelerant comes from the capacity cutbacks of 2009. “Capacity is being metered back – but we’re still at a point where you have supply backlogs that gives them reason to raise prices,” he said.

TDL Plastics in Corpus Christi, Texas releases an informal State of the Market survey on a biweekly to monthly basis – and its latest issue is an eye-opener.

It noted price increases in January across the entire gamut of commodity and engineered plastics beginning with polyethylene (PE) – up 3 cents a pound on Dec. 1 and another 5 to 6 cent a pound on Jan. 1, after increases in October and November.

“There is a global tightness in ethylene right now because the Chinese government told ethylene producers to make more diesel to relieve the country’s shortage. This is not only hurting their domestic production of PE, but putting a lot of strain on U.S. supplies,” the newsletter said.

Polypropylene (PP) is a bigger story. Producers announced 3 to 4 cent increases on Dec. 1 but then “rocketed up” 10 cents a pound in January. There are supply issues here as well. But demand is up for textiles, automotive components, and other applications that contain PP.

Engineered plastics are galloping upwards from 3 cents a pound for polyvinyl chloride (homebuilding applications) to 19 cents a pound for polycarbonate, used for electronic components, construction materials, and the surface material for Chinese stealth aircraft.

The price of nylon also spiked up recently after Rhodia declared *force majeure* on its nylon products following an outage at a plant in France.

A Pattern of Increases

Doreen Michelini, president of China Mexico Solutions, a consultancy based near Chicago, just bought 3,000 pounds of PTE (used for such things as plastic bottles) for a client only to see prices increase yet again. “It’s always a couple pennies here and a couple pennies there. But when you buy 3,000 pounds, it adds up,” she said.

This time, though, the product (trademarked Dynaflex) rose 11 cents to $3.47 a pound. “In June, I paid $3.27 and in February, I paid $3.15 – as you can see there’s a pattern that it keeps going up,” she said.

GLS, the company that raised the price on her, cited tight supplies and escalating raw material costs that were incurred during the fourth quarter.

It also noted that due to higher costs for diesel fuel, it would increase freight charges by 3 cents a pound.

Mike Klein of U.S. Toy is seeing input costs rise for just almost anything that goes into a toy.

“We have three people in Hong Kong right now and they’re saying prices will be up a lot,” Klein said. “Cotton is raising the price of fabrics – and labor costs continue to rise due to demand and changes in China's labor laws on overtime and minimum wage.”

Higher plastic and metal costs are also raising the price of making “Hot Wheels.” In addition, incremental revaluations of the yuan should raise prices by another 5%. “When all is said and done, prices should rise close to 10 percent,” he said.

To combat this, his people are looking into design changes to protect popular price points – like using less material, size changes, or fewer pieces in sets “so that a 100-piece farm set could end up with 90 pieces.”

Klein also foresees changes in materials to cheaper ones – from hardwood to softwood and cheaper fabrics. "Designs will be simplified to use less labor, so doll clothes will have fewer frills," he said.

Importers might also opt for cheaper packaging that uses less space to save on shipping costs.

But some might do nothing at all. For instance, when it comes to a Barbie doll most of the cost is in marketing – TV ads – or other costs like packaging and testing and executive salaries.

The actual raw materials that constitute a Barbie represent "only a tiny share of where the real costs lie," Klein said.

The PPI/CPI Lag

For major appliances, there will be a very long lag before consumers feel the pinch that manufacturers are only beginning to feel now, opined an executive for a global manufacturer of home appliances.

"I would expect that plastic is going to move with things like oil and energy prices," he said. "But when raw material prices get more expensive for manufacturers, there's sort of a delay between the time when raw material prices go up and the time it starts to impact manufacturers."

That's because most of them have long-term contracts that protect them from price spikes. "But after a time, there is no escape," he added.

And even then, their ability to raise prices to retailers is subject to what competitors decide to do. Manufacturers might also choose to substitute materials where cost-saving opportunities arise.

In any event, if cost run-ups continue at this rate, he thinks it will be at least another six months before the consumer will feel it.

For now, in the first quarter, consumer demand for major appliances seems to be on the weak side. "I wouldn't be surprised to see demand fall off in the first quarter. December shipments numbers came out, and they weren't all that great," he said.

That's because this past holiday season, there was an enormous pull-ahead of sales to Black Friday – and November's gain was December's loss. "It leads me to think that dealers bought quite enough and won't be replenishing for a while," he said.

The Commerce Department is scheduled to release durable goods orders data for December on Thursday, Jan. 27 at 8:30 a.m. ET. The above outlook also provides an early reading into factory orders, industrial production, and ISM. It also applies to January inflation data.