

INVESTING IN THE FUTURE OF YOUR MILL

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MAKING SENSE WITH CAPITAL DOLLARS

RECENTLY IMPROVED SALES AND PROFITS IN THE pulp and paper industry almost inevitably will cause some companies to dust off the expansion plans they shelved a few years ago, or to think about capital improvements for the sake of volume and quality.

The industry has been in recovery for well over a year. Prices and profits have improved nicely, rising in 1999 to the highest levels since 1995 and indications are that they will continue to rise at moderate, sustainable rates. Economic expansion (with periodic hiccups, of course) is continuing in the United States and Canada and good economic news is coming from Asia and Europe. Economic improvements naturally prompt thoughts of business expansion.

It is not likely that the industry will rush headlong into the kind of capital spending binge that characterized the period of 1989 through 1992. But it also is not likely that the unusually slow capacity growth rates of the late 1990s will be maintained indefinitely in the face of continued price and profits improvements.

For example, new spending plans recently announced by Willamette Industries could possibly signal the beginning of a new, if somewhat restrained, round of capital investment in the pulp and paper industry.

Willamette said that it will buy and restart an idle hardwood market pulp mill in Port Wentworth, GA. The company also plans to build a new uncoated freesheet paper machine and a virgin pulp line at its Kingsport, TN, mill. Willamette's CEO argues that his company can compete with low-cost Asian pulp producers in North American markets and that growth in demand will absorb production from the new machine.

Some of the larger companies have found it more advantageous to buy additional capacity rather than build it. For example, International Paper has acquired both Union Camp and Champion in recent times. But most companies are not in a position to buy their competitors, and sooner or later, rising demand, competitive pressures

and creeping obsolescence will force them into capital spending to increase production or improve quality, or both.

FINDING CAPITAL FUNDS

Very large companies with very deep pockets may be able to write checks for capital projects. But most companies cannot, and they must turn to one of the two major categories of fundraising: equity or debt.

The simplest and usually the least expensive form of capital project financing is traditional corporate borrowing. The company simply borrows money from a bank or other institutional lender on the strength of its own credit rating and the evidence of its balance sheets and annual reports. The better the company's performance record, the more economical the debt will be.

Equity fundraising involves selling a piece of the action through offering stock in a corporation, either publicly on the stock market or privately to investors. This could take the form of selling existing corporate stock that is held by the corporation itself, or through a new stock issue. Also, separate corporations have been formed by larger corporations and the stock in the new entities sold for the purpose of building greenfield mills. It is quite possible even to form a corporation for the sole purpose of building and owning a new machine in an existing mill and this, in fact, has been done.

The advantage of equity fundraising is that the money does not have to be repaid. Its disadvantage is the tendency toward dilution of existing shareholder equity, a tendency which must be carefully managed in order to avoid angry uproar at the next stockholders' meeting.

Also common is raising money through the issuance of instruments of debt, commonly bonds. A fixed rate bond is essentially an IOU with a schedule of interest to be paid to the bond buyer and a date on which the seller promises to repay the loan in its entirety.

The interest paid to bond buyers is usually taxable, a factor that the buyer must consider in sizing up the bond

as an investment. But for qualifying investments, the interest payments are not taxable. The federal government permits cities and counties to issue a certain amount of these bonds for purposes that are deemed to be in the public interest.

Tax-free municipals have been issued for the purpose of building a number of new urban or suburban mills that use 100% recycled fiber. The public interest that justifies them is the diversion of paper from landfills. The mill builders, not the municipalities, are the backers of these bonds; the city or county authorities are merely the issuers.

Companies that are big enough and strong enough to be rated well by Moody's or Standard and Poor's credit rating houses will have a fairly easy time borrowing

money or selling their bonds. Unrated companies that are typically small and/or have no appreciable operating history must construct detailed strategic plans for presenting their case to lenders or investors.

Lenders want to know who is going to repay the money, and how, and when are they going to do it. Equity investors tend to look at the upside of a project; how much money is it going to make and when will it make it. Bond investors tend to be more aware of the downside possibilities; what could cause the project to fail and bring on bond default.

For all types of fundraising, it is

absolutely necessary to build a strong and convincing case for the proposed project.

BUILDING A CASE FOR THE PROJECT

Lenders and investors want some assurances about the risks involved in the project. If these assurances can be provided by the parent company on the basis of its track record, the task of finding expansion money is greatly simplified. Planners of new and untested ventures without the financial histories to back them up will have to work a little harder.

Paper companies generally do not like to think of themselves as commodity producers, but that is the way lenders and investors generally see them. Their image of paper companies also is darkened by the fact that so many papermakers did not earn the cost of capital during most of the 1990s. And the investment community's perceptions weigh more than the self-images of the paper producers.

To the detriment of their own cases, too many papermakers tend to think first and foremost about hardware. They like to describe marvelous machines that will make the finest of paper at supersonic speeds. This is almost always a mistake when presenting a financing proposition to lenders and investors.

The money people generally accept technology and hardware as a given. They want to know about raw materials, manufacturing costs and markets. It boils down to this: can the project owners buy adequate supplies of raw materials at reasonable prices, produce finished goods at reasonable costs, and sell adequate amounts of the finished goods at profitable prices?

RAW MATERIAL SUPPLIES AND PRICES

Statements about raw materials must be backed up by evidence. If the project is to be based on virgin fiber, it will be necessary to show that the trees are not only standing, but available at reasonable cost for the foreseeable future, within a reasonable radius of the mill. The same kind of evidence must be presented for the availability of recovered paper, if the project is to be based on recycled fiber. The supply and demand picture, not only for fiber, but for fillers and any other ingredients of the product are part of the examination, as well as a report on the suppliers.

This section of the presentation will include an examination of demand and competitive uses for the material by grade or type. A documented projection of supply and demand is essential, along with historical and projected pricing.

The presentation must include examination of the local demand for the fiber and other uses for it with which the papermaker might have to compete. Historical and projected pricing, not only for fiber, but for other raw materials as well, will have to be presented. Still other factors that must be presented in the raw materials report will include procurement and delivery costs, brokerage fees, storage and handling charges and estimated net yields per each finished product grade.

THE MARKET OUTLOOK

A description of the markets for finished products from the project should begin with an explanation of grades and quality levels and include predicted volumes by grade and/or basis weight.

The overall size of local, regional and/or national markets (depending on the expectations of the project) along with historical supply and demand ratios and price histories and trends should appear next. An examination of demand drivers—past, present and predicted—is important for building the case. Next come projected supply and demand factors and their probable effects on



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operating rates and prices. And no presentation is complete without a look at the competition: who they are, their market shares, and their marketing strategies.

Off-take contracts are critical to a successful presentation. Who has agreed to buy how much product, at what prices, during what period of time? Having sales contracts in hand will earn points for the case. This portion of the presentation will include the relationship of the sales agreements to current market share, terms, pricing and commission arrangements, renewal options, grade mix guarantees and recourse for nonperformance.

The market outlook section is completed with contingency plans for alternative distribution and, finally, estimated freight, storage and handling costs.

PRODUCTION TECHNOLOGY

Hardware is generally third on the list of what lenders and investors want to know about a project, but is nevertheless very important for demonstrating that the project has a good chance of success.

A site review should demonstrate that the project planners are not intending to put the right equipment in the wrong place. The suitability of the site and the building and equipment layout should preface the description of the technology.

A technology review will include validation of the finished product quality capabilities being engineered into the project. Next comes validation of raw material usage and yield estimates. This will be followed by evidence of the suitability of the planned process equipment. Presenting the environmental compliance capability of the equipment also is essential.

An operations review will present verification of production capacity per grade and/or basis weight. The availability of utilities and their costs should be included. Adequate and proper waste disposal must be assured.

Finally, the technology section will present startup curves showing volumes, quality levels, grades and yields per month.

CAPITAL COSTS

If an engineering, procurement and construction (EPC) contract is part of the picture, it should be reviewed by an independent reviewer and the results included in the presentation.

Overall capital costs of the project should be benchmarked against other, comparable projects. There are standard categories—direct and indirect—in which costs should be broken down and compared to other projects.

Direct costs include site preparation, machinery and equipment, piping, electrical work, instrumentation, painting and insulation and spare parts. Indirect costs will include payment for premium time, sales taxes, temporary facilities, engineering, construction management, startup costs and contingencies.

Performance guarantee levels should be balanced with design levels. A construction milestone schedule and cash flows (by month) should appear in this section. The planners will want to report on warranties, guarantees, acceptance tests and provisions for liquidated damages.

OPERATING COSTS

The operating costs section of the presentation will include variable, semi-variable and fixed costs. The variable items include the direct costs per unit of production, which are raw material usage (units per finished product), raw material costs (\$ per unit), utilities and chemicals. Semivariable costs are labor—both salaried and hourly—and maintenance.

Fixed costs include depreciation, interest expense, leases, rents and royalties.

Operating costs should be benchmarked with those of the competition. And any operating and maintenance contracts should be presented in terms of the participants (their stability and experience) terms, prices, renewal options, performance guarantees and nonperformance recourse.

TRACKING THE MONEY

The final portion of the project presentation should track the funds for the project from source to disbursement. This will include existing and proposed sources and uses of cash, interest rates and amortization schedules. Lenders and investors will want to see a consideration of taxes. Illustrating the flow of funds, including construction allocations matching the EPC schedule, a debt reserve and miscellaneous funding, is very important.

The financial startup curve must include all expenditures and interest accumulation during the construction period, as well as the production ramp-up and revenue expected per month when product begins to come out.

This section will be completed with a normal operation cash flow generation schedule for the duration of the debt and, finally, a project performance pro forma projected through the duration of the debt.

Hard work in the planning of the project and the preparation of its presentation will go a long way toward convincing lenders and investors that your project is a good investment. Neglecting your homework will likely get you only a “thanks, but no-thanks.”

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