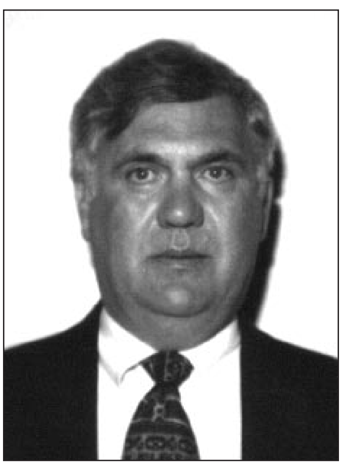
EQUITY PARTICIPATION IN PROJECTS

SALLY LOVE

Sally Love,
Paragon Consulting Group



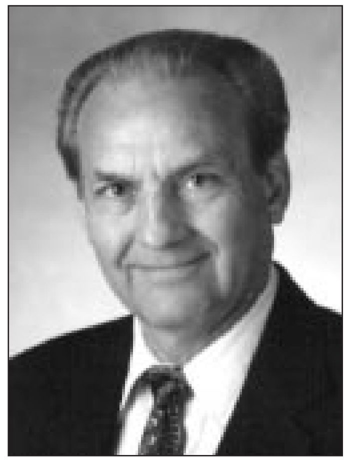
Tommy Thompson,
Union Camp Corp.

This is the fourth article in a series taken from the TAPPI Engineering Management Committee ROUNDTABLE discussion held during the 1997 TAPPI Engineering and Papermaking Conference in Nashville, TN.

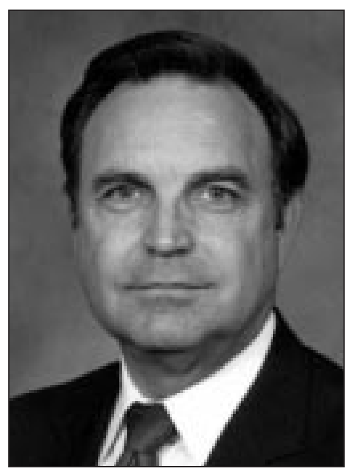
Tommy Thompson: I have a strong opposition to turning over my business to someone else. We realize that others have participated in equity participation, and it is an interesting situation. It is often a situation that you have engineering firms and construction firms essentially in competition with us---the owners. You might say they are joint owners of companies.

Elgie Harrison: We have done full equity relationships, and I am 100% for them. There are some reasons why you might enter into an equity relationship. In any large company, you have an enormous amount of competition for project dollars. Even if the project that you are trying to move forward has merit, it has to get in the queue. Sometimes that means waiting years to obtain funding. By going "off balance sheet" with an equity relationship, we were able to move the project forward.

Additionally, in our case the equity relationship was 50-50. An enormous amount of synergy came as a result. Each company has mutual responsibility not just to do the project, but long-term. You also gain constant involvement and performance toward incentives. You can manage it any way you choose, and you can construct it any way you choose, since you are getting two companies who have opportunities. You can structure a short-term relationship—say 3, 4, or 5 years long—where one buys the other out at the end of that period.



Elgie Harrison,
Cedar River Paper Co.



Howard Johnson,
Bowater Inc. Southern Division

Howard Johnson: We have some equity arrangements in our company. They are driven from a financial standpoint or because one of the partners in the arrangement might have expertise for the venture. They work quite well in many cases.

Gerard Closset: We have not done it. I think we would consider it for the right project. It makes sense that if the engineering or construction company has a stake in the project, is part owner, then it is human nature that they are going to do a better job. Other advantages I see are that you get a partner who really is interested in having the project start ahead of time and work well, because they depend on those profits from the plant.

Larry Crawford: We have considered equity relationships in some satellite situations particularly around power islands. On the other hand, we would not particularly want to pursue it in the core business of pulp and paper. If it is initiated by a customer drive, then it would be pretty attractive to us. Other than that, we want to maintain the corporate control. We don't make enough money as it is, and we sure don't want to share what little there is.

Dick Ellis: We are all in the same business. We are in a worldwide imbalance of supply and demand. If a company is not strong enough to compete adequately in the equity market for its capital investment, then I think we have trouble if we keep sliding money into the business. Every project creates a product. If you are in a supply and demand imbalance, you had better watch your creation of product. I think we are in a lot of trouble if we get into this third party financing stuff.

Jim Emerson: It comes back to shareholder value. In my own particular case, my company is heavily involved in joint ventures. We have learned perhaps too late and much to our dismay that the financial market place does not give you much credit or recognize the value of joint ventures. It does not matter if it is 51% or 45% or even 18% ownership. My position is changing. We must make up our mind what business we are in and control those businesses. We must then drive them to the highest return.

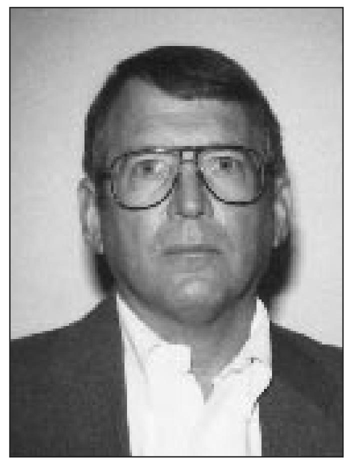
Ben Thorp: I think that in the long-term few joint ventures work because the interests of the partners are different. Sometimes it can be counter cyclical. One partner can be thriving with cash—although I do not remember what that is like—and wanting to invest and grow the business. At the same time, the other one can be on hard times and not wanting to invest. You end up with mediocrity that causes the joint venture to break up.

That brings us to another question. What about short-term? There are many reasons other than equity to want to joint venture. I think we have to think very carefully about how we want to structure the ownership and ultimate control. Since we know long-term does not work, let's also think about that up front. Put a definitive life on the joint venture and end it when it ought to be ended.

Howard Johnson: We have some joint venture arrangements in our organization that have been there for a long time. Picking a joint venture partner that has the same interest as you is the key. You cannot ask for a much better situation than picking a partner that uses the product that will be manufactured or you may pick one for their expertise.

Gerard Closset, Champion International Corp.

Dick Ellis: Those could probably be categorized as noble partnerships. If it is someone who wants to sell you a piece of equipment or something similar, that is probably the wrong kind of partnership. That is what I think of most of all when I hear about equity partnerships. You have to be careful. There can be different motivations. Common interest is the important thing. If you have taken that partnership on because you cannot raise equity capital, you are in trouble. That is the wrong motivation for it.



Larry Crawford, International Paper Co.

Does equity participation lower the cost of the project?

Dick Ellis: No, it increases the cost. It is easily 200 basis points or 2% against the owner. You are only doing it because you cannot obtain the capital some place else.

Byron Alvey: The cost of capital will be too high, and we are trying to lower our capital. It does not sound like this is moving us in the right direction.

Elgie Harrison: I tend to disagree. You can have a short-term equity relationship as we did, and you will

Dick Ellis,
Inland Packaging and Paperboard Inc.

Jim Emerson,
MacMillan Bloedel Packaging Inc.

Ben Thorp,
Georgia-Pacific Corp.

continue to have the same kind of projects and the same kind of partnership in the future. It might be with the same company. You will have developed synergies to make gains on the project. In fact, these synergies lower your capital costs. It certainly did not cost us any more.

Ben Thorp: It depends a little bit on how you raise the money. The cost of money is higher in some of these arrangements because the risk is greater, and the banks recognize this. If you are going to do your funding somewhat internally or largely internally, that goes away. We were grousing earlier about engineering being 8%–10% of the project cost. I have seen the legal bill be more than the engineering bill on some of these joint venture projects. We ought to be grousing about that, because as near as I can determine, it was a total waste.

Elgie Harrison: We were able to do the financial closing in a little less than six months on the first project. We got better the second time with three months. If youchoose the right partner, begin to understand the way each other's culture works, and what you are trying to achieve, you gain credibility with the lending institutions and can close with less effort and less cost than otherwise.

Howard Johnson: I think the key again is like a lot of other things. You must choose the right partners. The long-term goals of both parties have to be very similar.

Elgie Harrison: Choosing the right partners is the most critical part of the entire thing. If you cannot develop some kind of total understanding about how your partners are going to react in a situation, you should not be choosing them. You don't do this just because you want to get together with someone and do a project. You really have to understand where you are going and what you and they expect to get from it.

What kind of cultural issues must be overcome on a joint venture project?

Elgie Harrison: The biggest issues are the company history and their culture. It may be totally different than yours. You need to understand how that company is organized, how that organization impacts the work that needs to be done, what is driving that company and the people in it, and what the people are rewarded for. You go into a relationship with the very best of intentions. If you do not understand the other company to that depth, you are going to keep running into problems.

Ben Thorp: What do you do if you are into one of these relationships? You really thought through it, and you picked the right partner. You are doing well, you are in start-up, and then your partner gets bought by somebody with very contrary cultures to yours.

Elgie Harrison: We did not have that situation. Our partner did not get bought out. However, our partner had a culture very contrary to ours. We had to work through a lot of issues. I guess you would have to do it all over again. We never considered that somewhere along the way we would have a third party stirring the pot. That is something you would have to think about. It is one of the criteria for choosing your partner.

Ben Thorp: Been there, done that. Not pretty.

Elgia Harrison: I agree. That would be a real complication.

Ben Thorp: But, incidentally, some of that can also be mitigated by the contract. Planning ahead, you could put some mitigating circumstances around, if that does happen, exactly how that will happen.

Elgie Harrison: We have a contract. Most of this is not what you write down but how you deal with people. If you cannot get to that level, then what you sign on the bottom line will not do you much good.

I have heard the statement that when you participate in equity, you have made the supplier whether engineer, contractor, or supplier more viable than he has a right to be. When a supplier participates in an equity deal, does he cease to become a supplier and become a competitor ?

Elgie Harrison: You are looking for partners with whom you can form some synergies bigger than you can do alone. You are looking for skills and competencies across the whole system. If in fact your partner happens to build machinery, this does not disqualify him. What you form is one entity in which you use all those skills including building equipment or whatever they bring to the table. Beyond that, they are going to drop out of the equity arrangement at some time in the future and go back to building machinery. On an industry-wide basis, I don't think that denotes a competitive disadvantage.

Pedro Pedroso: I completely disagree. He is a competitor when he does that. He is competing against my product.

Elgie Harrison: That may be an issue with my competitors when they are dealing with that company for equipment. That is their deal. If it makes me more competitive, that is mine, and that is where I am going.

Larry Crawford: Except for some satelllite situations, it has a biblical history. It is called the Tower of Babel.

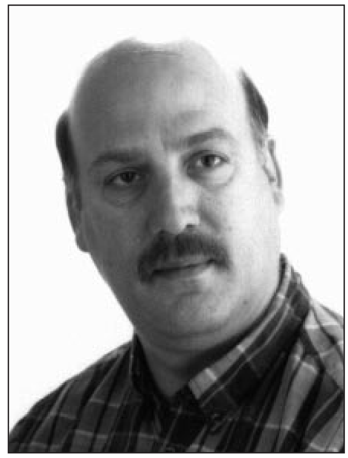
Elgie Harrison: I am not too sure that is the way we should look at equity partners. They do not have to have the same long-term goal; you would not expect them to. What you are really doing is forming a business deal, and you are going to do that for both of your mutual gains. If that gives you a competitive edge in the industry, so be it.

Pedro Pedroso: I disagree. That supplier is a competitor now. If that is what he decides to do, let him do his thing. Then I do not need to deal with him. I will deal with somebody else.

Elgie Harrison: If you are thinking in terms of relationships, you could form the same relationship with that firm or another if you wanted to stay competitive. If you do not want to stay competitive, that is your deal.

Larry Crawford: To me it comes back to the imbalance of supply and demand. There is only a certain amount of profit to be made worldwide.

Sally Love, president of Paragon Consulting Group, was moderator of this Engineering Management Roundtable.



Byron Alvey,
Willamette Industries Inc.

Pedro Pedroso
Georgia-Pacific Corporation