

CREATING VALUE IN THE MATURE PAPER INDUSTRY

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VALUE CAN BE CREATED BY SELLING, BUYING, OR BUILDING ASSETS

Editor's note: The following article is adapted from a speech given at the TAPPI 1998 Environmental Conference in Vancouver, BC, Canada.

I WOULD LIKE TO TALK TO YOU ABOUT A SUBJECT THAT might surprise you: value creation. What do these subjects—value creation and financial performance—have to do with us? Most of us have a technical background. We have been very involved and are key players in building our industry to the status that it is today, and we want to talk about the theme of this conference in terms of globalization and opening borders.

Those borders can only be opened if value is created. So we built a lot of things, but now the task of building is changing dramatically. What are our options? Perhaps most importantly, you might ask “Why is this so urgent?” It’s because company owners are unsatisfied. The returns from the industry are currently very poor for investors.

Prices are low because there’s a high degree of overcapacity, and from a North American perspective, others are becoming the low-cost producers. So this will change the whole dynamics of the industry at the same time that many of our owners are changing.

In my company, the major shareholder is a pension fund. Many retirement savings plans, bond holders, and so on are investing in our companies more than ever before. They have different expectations. Why are these people dissatisfied? The fact is that the financial results of the industry have relatively new benchmarks. Although these benchmarks have been around for a long time, as we have a change of ownership in the industry, there is a new move toward looking at other people’s standards.

INDUSTRY RESULTS

Figure 1 and Table I show the performance of our industry in North America over the last complete business cycle—from 1989 to 1995. Earlier in our industry’s history, we often compared our financial performance to

Canadian savings bonds and U.S. Treasury bills. Generally, we were very competitive, but the fact remains that the typical paper company interest rate (certainly in Canada) is over 10%. The typical bond yield last year was about 14%. From 1989 to 1995, the Standard & Poor’s (S&P) 500 index rose 15.3%. Last year alone, the Toronto Stock Exchange (TSE) 300 index rose 15%. In 1997, the Standard & Poor’s index increased almost 34%.

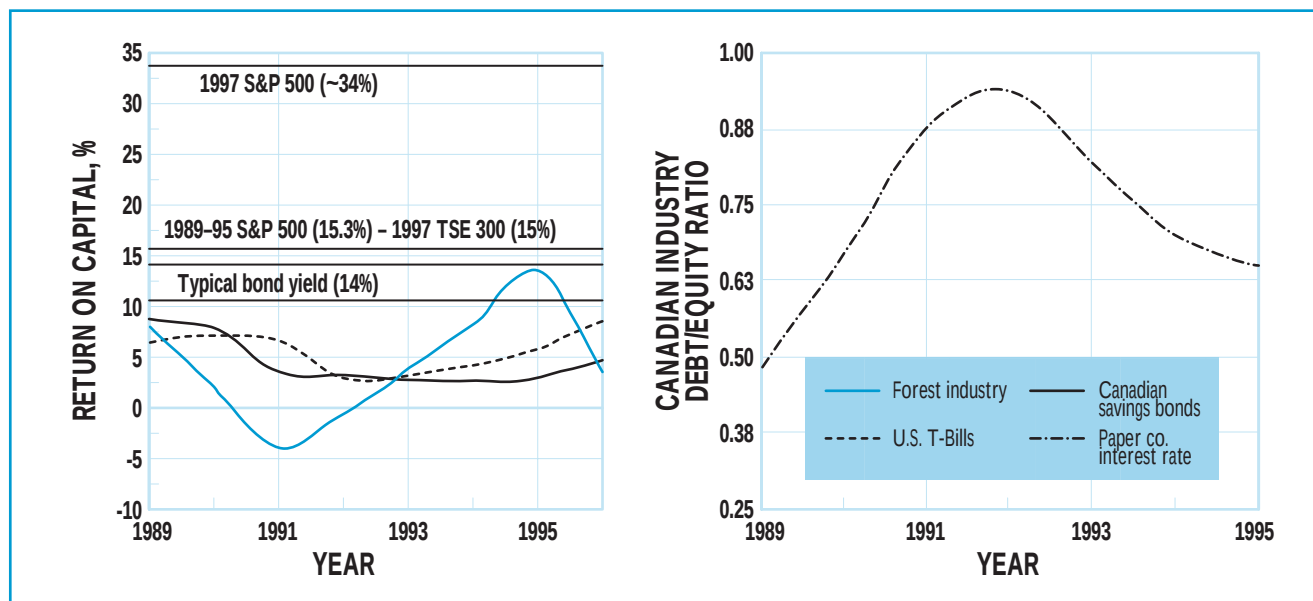
The industry has a high debt load, and that fact is very symptomatic of our problem. How did the debt grow so large? Because we borrowed a lot of money to build, and then we hit some tough times when we started to borrow money just to keep operations going. So we have to face up to a number of challenges. Returning to the industry’s 1989–1995 performance, the annualized income to shareholders of the 26 largest publicly traded companies in North America looks like this:

- Five companies had negative returns.
- Five companies made 0%–5%.
- Ten companies earned 6%–10%
- Six companies returned 11%–15%.

Remember that the Standard & Poor’s index during this period was 15.3%. Furthermore, only two other companies showed better-than-15% returns.

Because certain parameters are becoming more important in the minds of shareholders, one study tried to determine some of the key drivers. Considering the total return to shareholders, the proportion of the variation in total return associated with the variation in earnings per share yielded a coefficient of variation (r^2) of about 27% (**Table II**), whereas the earnings before interest, taxes, depreciation, and amortization give a much better correlation of 51% and an average return on equity of 62%.

Why is this so urgent? Because jobs and livelihoods are at stake. I spoke of the average bond yielding 14%. That may sound greedy, but if you’re a manager of a pen-



1. Financial results of the industry

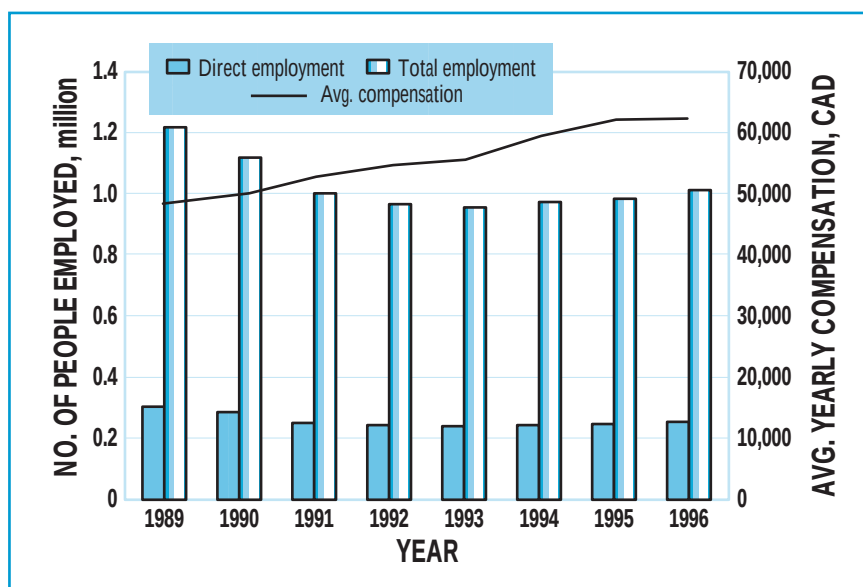
Return, %	No. of companies
Negative	5
0-5	5
6-10	10
11-15	6
>15	2
15.3	(S&P 500 index)

I. Performance of the Canadian paper industry for the business cycle 1989-1995. Annualized returns to shareholders for the 26 largest publicly traded North American paper companies.

Driver	Correlation with total return (r ²)
Earnings/share	27
Ave. EBITDA/assets ^a	51
Average ROE ^b	62

^aEarnings before interest, taxes, depreciation, and amortization
^bReturn on equity

II. Drivers of shareholder returns



2. Direct and indirect employment from the Canadian forest industry (Source: CPPA)

sion fund or a bond or savings plan fund and you return much less than that, you're replaced with someone who will provide those kinds of returns.

IMPACT ON EMPLOYMENT AND TRADE BALANCE

One in 15 working Canadians is directly impacted by the forest industry; the industry also provides an above-average income. As shown in **Fig. 2**, the average income of 1996 was slightly over CAD 60,000; that's well over twice the Canadian average. So there's a lot at stake, certainly in Canada.

I spoke of national economic health being at stake. Again, the Canadian forest products industry is by far the largest contributor to Canada's net

trade balance. As shown in **Fig. 3**, the net trade balance was CAD 34.1 billion in 1996, and the Canadian forest products industry contributed CAD 31.2 billion, much more than other sectors. So we're a big factor in the economic health of our country.

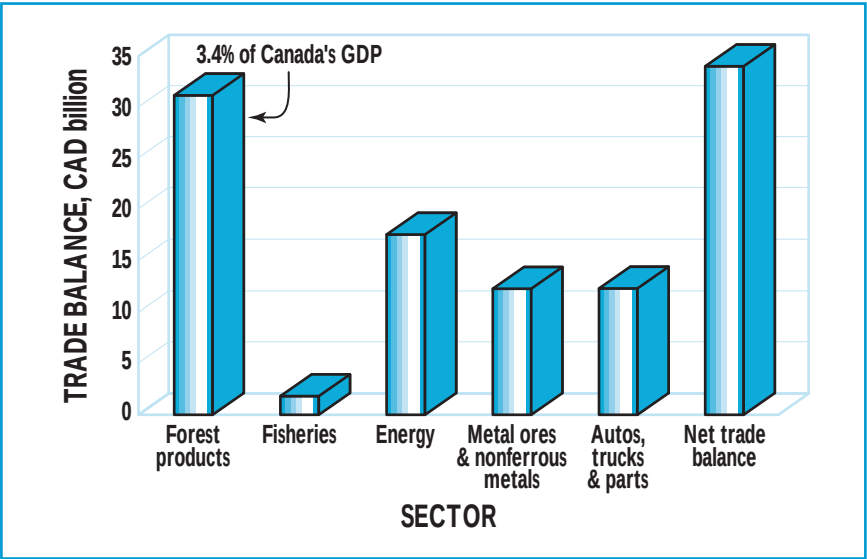
ENVIRONMENTAL IMPACT

How is our environment affected? We've made significant reductions in our emissions as have others in our industry worldwide (**Figs. 4 and 5**). However, these reductions have been expensive. In Canada, over CAD 4 billion has been spent in the last 5 years (**Fig. 6**). CAD 4 billion at a 15% return represents CAD 600 million of benefits per year required to justify these expenditures. To get this level of return on investment, those of us in technology-related jobs must continue to innovate and build our industry. In a way, we have to start thinking like an owner. We can't stop making environmental progress. The challenge to us is to continue reducing emissions without requiring an enormous level of investment.

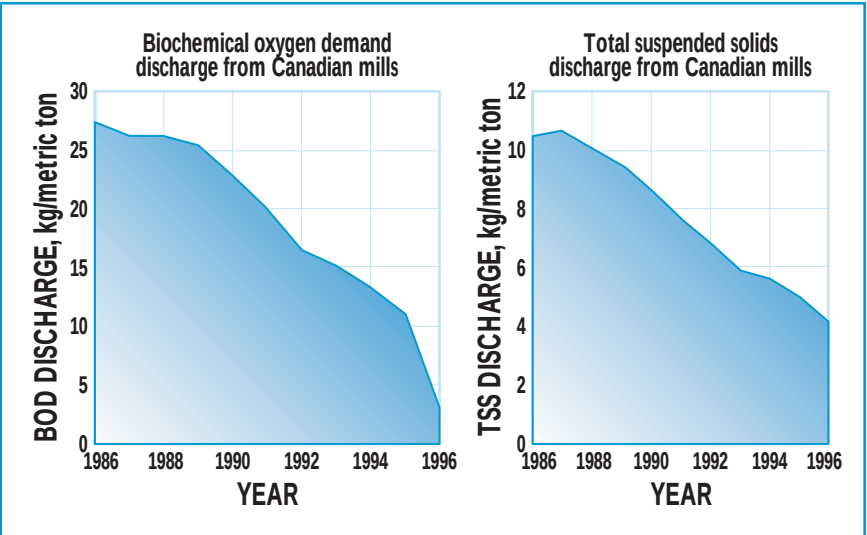
CREATING VALUE

How do we create value? On a large scale, you can sell real estate through spinoffs and divestitures, you can buy real estate through acquisitions and mergers, or you can build real estate that requires much capital expenditure. I'll briefly touch on each of these issues.

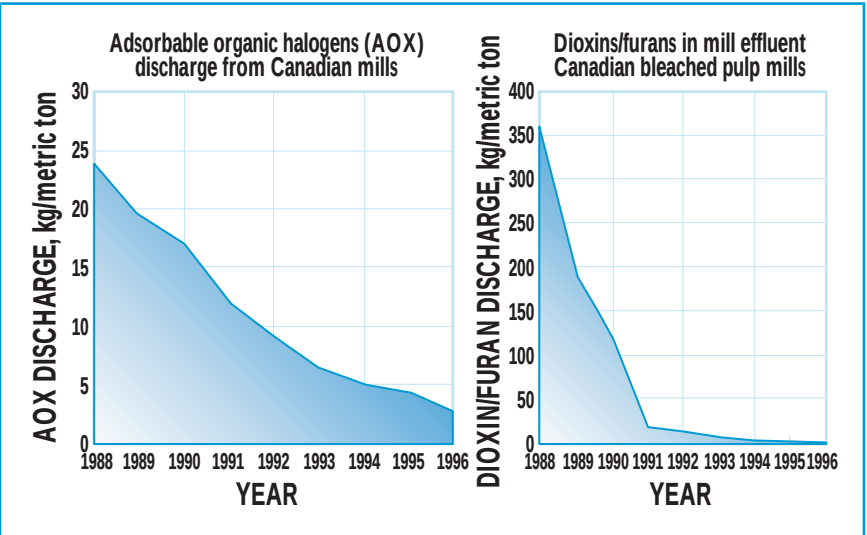
The first of the three options—selling real estate—can indeed create value. I'll give you a recent example: the Bowater-Avenor deal (**Fig. 7**). Since January of this year, Avenor shareholders have seen a 68.4% increase in the value of their shares. I have to give credit to some of the technology and business people in the Avenor organization who had the foresight to build some very good assets. However, no one recognizes Avenor as having had anything to do with creating this value. Ironically, it



3. Forest products—the largest industrial sector in Canada. Trade balance in 1996 by industry contribution. (Source: Statistics Canada)

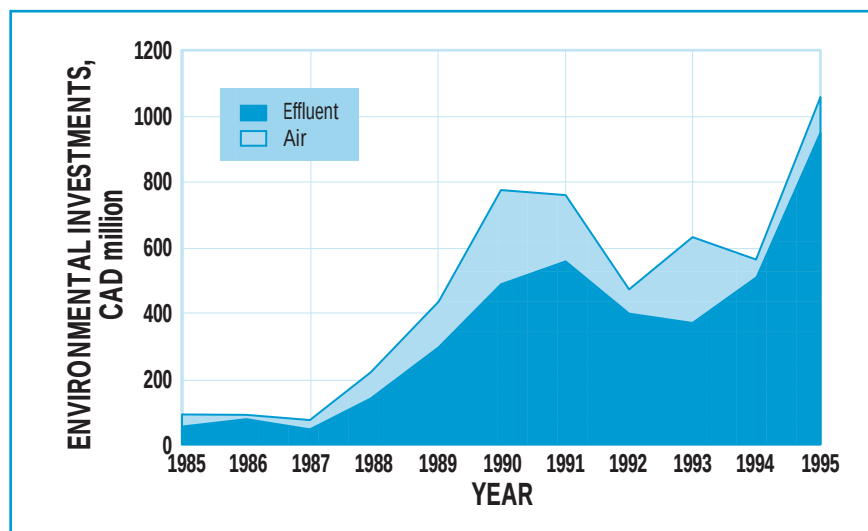


4. Continuing improvement in environmental performance (Source: CPPA)

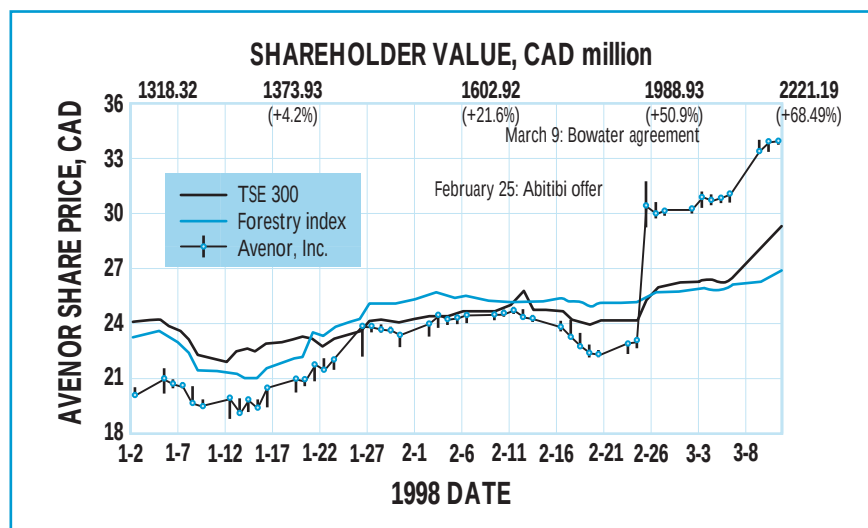


5. Virtual elimination of bleach plant pollutant discharges (Source: CPPA)

VALUE CREATION



6. Environmental investments by the Canadian paper industry (Source: CPPA)



7. Avenor's stock performance reflects merger agreement. The company is listed on the Toronto Stock Exchange.

was a competitor, Bowater, that has created this value.

Representing the second option in creating value, Bowater made a bid for Avenor, and the share price increased sharply. As a shareholder of those assets, you are 68.4% better off now than you were on January 1. That is shareholder value.

Finally, you can be a successful builder. For example, consider Willamette Industries. Willamette has been both a builder and a buyer, but it is noted for being a very good builder. As shown in Fig. 8, throughout this relatively weak period, the company never lost earnings per share. It has never been in a negative position, and its per-share

value has nearly tripled since 1988.

So it is possible for a builder to create value, but it's not as easy as it used to be. Building requires considerable capital expenditures. There are falling-trend prices in most grades, and there is limited incremental fiber availability in North America. There's a high sensitivity to these and other factors, such as the cost of a startup and the cost of developing an incremental customer base.

Consider trend-line selling prices (Table III). It's rather humbling to realize that, since 1982, newsprint in constant 1996 dollars has dropped 23.6%. Bond uncoated freesheet is off 20%, coated freesheet is down 30%, lightweight coated has fallen 24%, and linerboard has dropped 9%. The only grade that has held its own during this period is bleach kraftboard. So we are not seeing a rise in prices; in fact, we're witnessing deterioration.

The builder's challenge (Table IV) is strictly this: Take any category where you want to be a builder. The second column of Table IV shows the approximate capital expenditures required in U.S. dollars on a per-ton-capacity basis. The third column shows the required selling price to cover the cost of the capital expenditures. Obviously, there are some equity and debt assumptions made in these figures. The last column shows the average selling price, in 1996 dollars, between 1989 and 1997. If you consider these averages, you cannot afford to be a builder.

So how does a company like Willamette do it profitably? You can be a very good builder if you have certain things going for you. Willamette traditionally is a contrarian when it comes to capital expenditures. When everyone else is cutting back capital expenditures, it frequently spends more. It catches the market in a downturn, and prices are good for engineering and equipment; Willamette also does a good job in engineering its projects.

SENSITIVITY TO FLUCTUATIONS

Consider the industry's sensitivity to price and exchange rate fluctuations (Table V). A US\$ 10/metric ton change in

wood pulp means US\$ 115 million to the Canadian pulp industry and US\$ 281 million to the U.S. industry. For newsprint, a US\$ 10/metric ton change in selling price translates to US\$ 115 million for Canada and US\$ 46 million in the United States. In the case of lumber, a US\$ 10/1000 board ft change in price means US\$ 250 million to the Canadian industry and US\$ 317 million to the U.S. industry. Also, for Canada, a 1-cent change in the exchange rate translates to over US\$ 400 million—a lot of sensitivity.

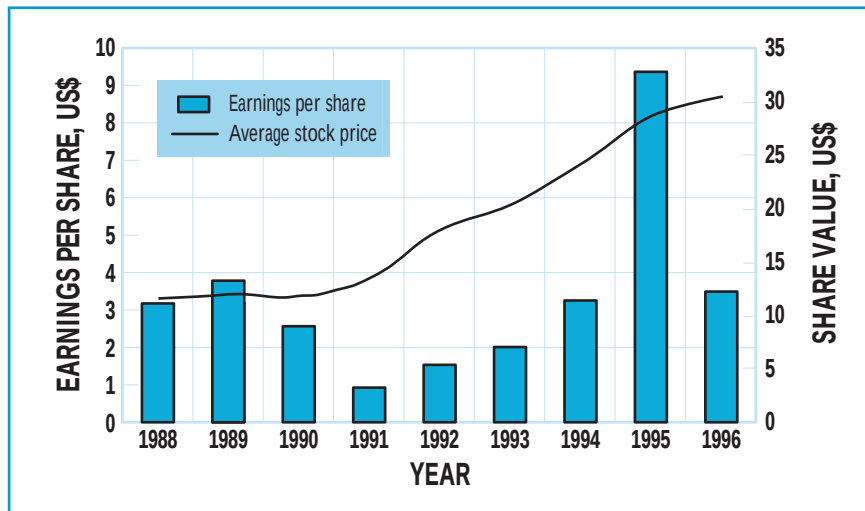
So why is a buying strategy so attractive to the current brand of financial analysts and investors? It's because, when you buy, you do not create incremental capacity. Buying generally reduces the size of an investment per unit of production. It obtains immediate access to cash flow, and it yields immediate access to a loyal customer base. You also gain a much greater critical mass to realize synergies and costs, product mix and geography, and transportation costs, and you establish new human skills and experience.

Therefore, whether you buy or build, maintaining and developing global leadership is important. That ability to open those geographical borders requires a continued diversification of global markets, rigorous cost containment, global partnership, customer development, and reduced capital cost. Whether you buy or build, long-term sustainability equals improved people performance. Decreasing capital costs, decreasing operating costs, increasing process efficiencies, improving forest management practices, looking at alternative fiber supplies, adding value to products, and creating mass customization all contribute to performance.

SUMMARY

What do we need? We need a faster, more flexible response. That's expected from us as suppliers. We must ensure that there's no negative impact on efficiency and the environment in the process of doing mass customization.

In conclusion, what can we say? Build people, not things. Be an owner, not an employee. People are investing in us being here. Let's roll up our sleeves and get to work. TJ



8. Willamette Industries' earnings and share prices

Grade	YEAR		DIFFERENCE	
	1982	1997	Price	Percent
30-lb newsprint	720	550	-170	-23.6
20-lb uncoated freesheet bond	1160	825	-235	-20.3
60-lb #3 coated freesheet—rolls	1470	1020	-450	-30.6
40-lb offset LWC ^b	1125	850	-275	-24.4
15/15-pt bleached kraftboard—C1S ^c	870	880	+10	+1.2
42-lb linerboard	445	405	-40	-9.0

^aSource: Jaakko Pöyry, Salomon Brothers
^bLightweight coated
^cCoated one side

III. Trend-line selling prices (1996 US\$/metric ton)^a

Product	Capital exp., US\$	Req'd selling price to cover cost of capital exp., US\$	Average selling price (1989–1997), US\$
Pulp	2000	730	590
Uncoated freesheet	2600	920	750
Coated freesheet	3100	1265	1075
Lightweight coated	2500	1060	950
Newsprint	1800	690	545
Bleached kraftboard	2500	1000	875
Linerboard	1000	450	375

^aSource: Jaakko Pöyry

IV. The builder's challenge: Approximate cost per metric ton for a new facility*

VALUE CREATION

Parameter	Unit change	APPROX. ANNUAL EFFECT ON GROSS SALES	
		Canadian industry, US\$ million	U.S. industry, US\$ million
Wood pulp	10 ^a	115	281
Newsprint	10 ^a	115	46
Lumber	10 ^b	250	317
Ave. exchange rate	0.01 ^c	411	-
^a US\$/metric ton			
^b US\$/1000 board ft			
^c US\$			

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V. Forest industry sensitivity to price and exchange rate fluctuations