Canada: Fight or Flight

It seemed to happen too quickly. But through the combination of government apathy, lack of capital investment, management/labor problems, and shifting global demand, Canada's forest products industry is faltering and now faces the challenge of its life.

By Daniel D. Veniez

Not more than 30 years ago the Canadian forest products industry was the world leader. There's a consensus today that this sector is a case study in decline that features board complacency, managerial ineptness, trade unions gone wild, and governmental inertia.

If there is even a kernel of truth in that characterization, it still remains a harsh indictment. There can be little doubt that it's the combination of these factors—and not any one actor or event in isolation—that got us where we are.

Capital markets have turned away from the Canadian forest sector as a result. At a time when liquidity in the system has never been more abundant, we have been shut out. And who can blame them? Who in their right mind would risk their money in a sector that's shown a remarkable propensity to destroy value, not create it?

We seemed to be paralyzed. I suppose it's quite normal to put out of our minds that which we think we can do nothing about. Consequently, we appear to have resigned ourselves to slow death. But it is far from too late to resuscitate the industry. In fact, I think we are at an historic inflection point.

The genesis of my interest in the forest industry was George S. Petty's passion for it. [editor's note: the late George Petty was the founder of Repap.] He had a steadfast commitment to research and development, and an intrinsic understanding of the underlying forces that shape competitive advantage. That turned me on to the industry's vast possibilities. George made a powerful case that competitiveness rests in an incessant and ceaseless drive for productivity improvement and innovation. Buying discarded mills was his platform. He knew that for them to have a future they would have to be comprehensively modernized. Collecting undervalued assets and not reinvesting in them is an inevitable recipe for disaster down the road.

The year 1992 was about the time when a confluence of forces that had been taking shape for at least the previous decade began to surface. Repap's days would be numbered, and the wheels were about to come off the industry in Canada as a whole. Central banks had decided that inflation needed to be dealt a decisive blow. Tight money policies that led to crippling interest rates soon followed. If this wasn't enough, a floundering global environmental movement in search of new fundraising sources discovered their new sugar daddy. It was called

Clayoquot Sound. The response to it was the Harcourt/Clark Forest Practices Code, a regressive and repressive over-reaction, and every social engineering socialist's wet-dream. The hard cash and opportunity cost of that regulatory nightmare remains impossible to fathom, much less calculate. Against this backdrop, the Canadian economy was forced into adjusting to the new Free Trade Agreement without much, if any, government support. That was itself a shock to the system.

Union voices grew more strident after many years of being conditioned by management. By the mid to late 1980's, the lesson that unions learned was the louder they threatened, the more they were likely to get in industry negotiations. Management buckled under the threat of costly and protracted strikes. What resulted was effective control of billion dollar assets shifted from mill managements to union locals.

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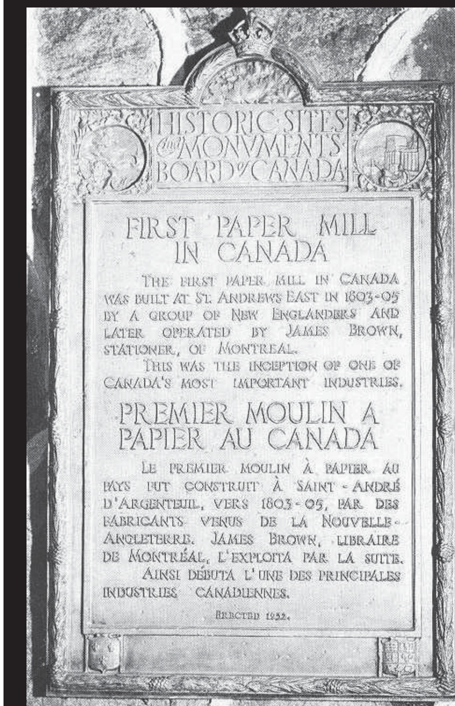
My parents, both union members, explained to me as a kid that there is no such thing as a bad union, only bad management. The fact is it always takes two to tango. But the undisputable onus for building a consistent wealth generating business rests solely on the ownership and managerial leadership of the enterprise. That means setting a tone, establishing expectations and standards, creating an environment and culture, providing the tools to perform, and assessing and adjusting to the competitive landscape. My own experience has further informed and deeply reinforced that conviction. History shows us that the cumulative effect of poor management decisions over a period of time creates bad unions. Once that culture takes hold and becomes entrenched, change is an arduous and painful process, even in the best of circumstances. If you need an illustration beyond the forest sector, look no further than the major North American carmakers. Both industries are almost literally handcuffed with untenable labor arrangements.

While unions were taking control and managements throwing in the towel, provincial governments taxed the daylights out of firms through stumpage and property taxes. They also imposed an impossibly complex and arcane set of regulations to allocate and manage fibre. An underlying objective was the "social compact" with communities. Policy decisions were being made that had no bearing whatsoever on what made economic sense.

Meanwhile, new high-technology monster capacity was being built in Brazil, Indonesia, Chile, Scandinavia, and Europe, many of them smack in the middle of tree farms. This drove world prices down at the same time that manufacturing costs of Canadian producers were steadily rising. Governments, industry and labor were not only slow to react; they didn't know what hit them. A culture of entitlement and complacency had set in and everyone blamed the other guy for institutionalizing the status quo. So while we slept, the very foundations of the global forest industry were radically being transformed.

At the same time, everyone lost sight of a fundamental tenet of business. Peter Drucker summed it up best when he said: *"A business has failed if it does not produce economic results. A company can make a social contribution only if it is highly profitable."*



Most important industry.

A bronze plaque on the cairn at St. Andrews commemorates the historic construction of Canada's first paper mill, which was built by Walter Ware and Benjamin Wales.

The plaque reads: THE FIRST PAPER MILL IN CANADA WAS BUILT AT ST. ANDREWS EAST IN 1803-05 BY A GROUP OF NEW ENGLANDERS AND LATER OPERATED BY JAMES BROWN, STATIONER, OF MONTREAL. THIS WAS THE INCEPTION OF ONE OF CANADA'S MOST IMPORTANT INDUSTRIES.

Today, the operations that are still in business are at the wrong end of the global cost curve. Our assets are too old and are growing into obsolescence. We just can't compete with those who have poured billions into state-of-the-art high capacity. When you don't drive productivity improvement through investing in new technology what you get is what we got—red ink and lost jobs. Our labor agreements are too restrictive. And our fibre costs are too

Mounting Casualties. Domtar permanently closed its Cornwall, Ontario mill in March 2006, a few months after shutting down the facility's pulp mill and a paper machine. The mill had the capacity to produce 265,000 tons of uncoated and coated printing grades on three paper machines as well as 160,000 tons of pulp. Over 900 workers lost their jobs.

high. As long as we keep doing what we're are doing, our decline will accelerate and intensify. Capital markets have fled the Canadian forest sector. They won't come back unless we make it attractive for them to do so.

Is it too late to turn this around? I think not. In fact, there's an opportunity in the carnage we've subjected ourselves to. Precisely because of the condition the sector is in, unions, governments, and industry leaders are faced with an historic opportunity to fundamentally recalibrate some of the most dysfunctional and entrenched precepts.

SO WHERE DO WE START?

The old play book must be thrown out. Everything must be on the table. That must include the role of boards, senior management compensation and accountability, union contracts, and government taxes and regulations.

First, boards must demand performance from managements. That seems pretty basic, but is far from standard practice in the industry in Canada. How many firms have fired their CEO's for non-performance? I can't think of a one. Is that because they have been so good at creating value? Not a chance. Like clockwork, they rationalize poor performance by turning attention away from the fact that their firms consistently report net losses. They manage that by talking about how great they are in wringing out synergies from a four year-old acquisition ...How progressive they are by offering unions more than they could afford ...How many quality certifications they've received ...What wildlife preservation boards they sit on ...How bad markets are ...How short-sighted the Bank of Canada is ... How smart they are that they've closed a 60-year old mill that has not seen meaningful capital improvement since the end of the Korean War and has been hemorrhaging cash for a decade.

You get the picture. A common thread is that non-performance is everyone's fault except the leader of the enterprise. That should no longer be acceptable.

It all starts at the top. Boards must decide that value destruction is a firing offense and will no longer be tolerated. Holding the CEO closely accountable for strategy and execution is the most solemn duty of any board of directors. On the other hand, if a CEO performs and creates value, then they should be richly rewarded.

I am convinced that everything else will flow from a reinvigoration of corporate boards and management. Take capital markets, for instance. What signal are we sending them when CEO's at major public companies are still at the helm after five years of destroying shareholder value? Not a good one. Similarly, how do we expect union leaders and their members to react to 'don't worry, be happy' boards and CEO's? And how can we hope to credibly drive change within our organizations if we don't raise the bar for ourselves, in the first instance, and thereby set a positive example?

But assume for a minute that we get over that legitimacy hurdle. What kind of relationship does a modern industry require of its unions?

That's another easy one: Entirely new union compacts must be developed. They should be based on a shared desire to ensure the consistent profitability of the businesses they are a part of. That means that the ability to contract out non-core functions must be at the discretion of management. It means that trades' flexibility is a necessity. It means that all of the "bull session" items that have grown out of control by neglectful incrementalism are no longer enforceable contract rights, but company policy to be defined according to the specific needs of individual operations. It means that wage increases must be replaced by roll-backs more in keeping with the value of their work. And it means that rich post-retirement benefits must be scaled back for those that have them. That could be accomplished through a negotiated buy-out. For future entrants, these benefits should be eliminated entirely.

In return for helping to reduce labor costs through improved productivity and cost effectiveness, union members would receive quarterly bonuses based on agreed metrics, the most critical of which would be profitability. Union members should be drawn into the management of the operations. Mill management will be surprised at how much low hanging fruit they will find with the help of union members that are treated as partners, especially if that attitude is backed-up by strong financial incentives.

And last but certainly not least, what role should government play and where should it change? To start, municipalities, which in Canada are the creatures of the provinces, should and must drastically reduce their onerous property tax rates. Many of these one-industry municipalities have come to rely upon the mills as their revenue gravy train. They have ratcheted-up property tax assessments not because of any fair and economically based formula, but because they could.

Of course, one of the greatest costs and uncertainties in our business is the access to and cost of fibre. In 1947, British Columbia's chief forester, F.D. Mulholland, was eerily prescient when he said: "St*udy of ownership in the better organized forest countries of Europe indicates that an even division between State and private ownership is best. Administration by decentralization of authority and cooperation between independent organizations is better than legal compulsion by the State. A forest dictator is not wanted in Canada. Unless the tide can be turned and private enterprise persuaded to acquire and properly manage much more forest land, the future of the industry will not be bright*."

Last one standing. The last saleable roll of paper was signed by workers in Norampac's Red Rock Mill in Ontario. The mill shut its doors towards the end of November 2006.

The last 50 years have borne out the wisdom of that advice. Government ownership of timber assets and stifling regulation surrounding them has been a central problem for decades. The uncertainty of public ownership and the politicization of forest management has over time repelled capital from the industry. It has also led to costly trade disputes with the United States. Real land reform is the only thing that will disarm U.S. protectionists once and for all.

Modernization of the forest sector will require billions in new investment. And modernize it must. Before financing on that scale is committed, capital markets will insist upon a few elementary, but critical assurances. First, it has to know that industry, labor and government are serious about becoming competitive. Massive regulatory changes and fibre security is an essential component. So too are radically different labor agreements, fresh leadership at the top, and compelling incentives through lower property taxes and investment tax credits. If these pieces are in place, investors will see that attractive returns on capital are possible in Canada. Once that is clear, building state-of-the-art operations will begin again, after an all too long hiatus. But it is clear that only when the industry's glaring and neglected structural deficiencies are systematically addressed will rational decisions begin. They will include much needed consolidation, modernization and rebuilding programs, and innovative energy projects.

Most will agree that these constitute essential preconditions to any meaningful reinvigoration in our industry. Many will also dismiss them as a pipe dream. It doesn't have to be. What it takes is something our industry has been lacking – leadership. ■

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