

Transforming a Giant

How IP's chief executive plans to make a big company "simply" better.

By John O'Brien, Managing Editor

John Faraci, Chairman and CEO of International Paper, has a lot on his plate. In July, he announced that IP would focus on uncoated papers and packaging globally and unveiled a transformation plan that could potentially generate \$8 - 10 billion in after-tax proceeds from the sale of non-core businesses.

But that's not all. IP is also in the midst of implementing company-wide cost structure standardization, a realigning of its mill operations in North America, evaluating emerging markets in Latin America, eastern Europe/western Russia and China, and relocating its Stamford, CT corporate headquarters to the site of its operational headquarters in Memphis, TN. Nothing to it, right?

In a sit-down with John Faraci in Stamford, PaperAge learned a bit about the man at the helm and a lot about the strategies in place at the world's largest forest products company.



When did you join IP?

I joined International Paper in 1974, right out of graduate school.

Was it the company or the forest products industry that interested you?

It was a little of both. I liked the resource nature of the forest products industry and liked the outdoors, and it seemed I had found a great opportunity in International Paper to get some first hand experience. It wasn't a training program either, but on the job training, which really appealed to me. And I've been with IP ever since.

Could you fill us in on the progress of IP's transformation plan?

We are pleased with how the transformation is progressing. Last year, we completed the sale of our shares of Carter Holt Harvey Ltd. to Rank Group, books are out for several of the businesses under evaluation, and we reduced our debt by \$2.4 billion in 2005 as well. In 2006, we're targeting capital to realign both uncoated and packaging mill operations in North America to lower our costs, improve our product offerings, and match our capacity to our customers' demands. We're fully focused on executing the transformation plan and delivering improved profitability and higher returns to our shareholders.

How did the transformation plan come to be?

We stepped back and decided to focus the company on areas where we think we can build a sustainable advantage and earn much better returns than IP and the industry have earned historically. We looked at the areas where we competed and how we competed and concluded that we can win in the uncoated papers and packaging businesses globally.

The sale of CHH must have been a tough decision for you personally, considering you were CEO and managing director of that company during the late 1990s. What factors lead to the sale?

The decision to sell our interest in Carter Holt Harvey was a difficult one. For me personally, I spent almost five years living in New Zealand. My family and I really enjoyed the area and we have many colleagues and friends there. But ultimately, it was about making the right choices to position International Paper for success. Many of our initial reasons for investing in CHH had changed since we first began acquiring shares in 1991, and we felt it was the right time to divest our interests. We feel good about the results and the timing of the transaction.

Coated Papers, Forestlands, Beverage Packaging, Kraft Paper and Wood Products businesses are currently on the market. What is the status of Arizona Chemical?

Arizona Chemical had a lot of turmoil with the hurricanes in Louisiana, in terms of both their suppliers and their customers. Rather than put the business on the market at that time, we thought it better to let that business get settled down, which it is in the process of doing. We want to be able to carefully manage the sale process and not race to get everything out.

EXECUTIVE HONOR

PaperAge has named John V. Faraci as our "Executive Papermaker of the Year." Mr. Faraci will be honored at a reception in New York City on April 10 during AF&PA's Paper Week.

Since 1988, *PaperAge* has annually selected recipients of its "Executive Papermaker" award based on corporate vision, strategic objectives and strong leadership both within the individual's company and in the industry as a whole.

Mr. Faraci has served as chairman and chief executive officer of International Paper since November 2003. He had previously served in leadership positions including president, executive vice president and chief financial officer, and chief executive officer and managing director of Carter Holt Harvey Limited in New Zealand.

Mr. Faraci, 55, has been a director of International Paper since Feb. 11, 2003. Additionally, he serves on the Grand Teton National Park Foundation, the National Park Foundation, the Citigroup International Advisory Council, and the National Council for Air and Stream Improvement. He is a member of the Business Round Table, the Denison University Board of Trustees and the Sustainable Forestry Board. In 2005, he was elected to the board of directors of United Technologies Corporation.



Could you discuss IP's "operational improvements" in 2005?

Our mills had a strong year, operationally, in 2005. We took over \$200 million in costs out of our global manufacturing system last year. We had record reliability and efficiency, set productivity and production records at many mills, and reduced our energy consumption as well. A lot of this progress was offset by skyrocketing input costs, but as input costs come down—and I do think they will moderate—the results of our cost reductions will be evident. Continuing to lower our manufacturing costs plays a big part in our strategy this year as we're targeting another \$200 million reduction in 2006.

Is there a special achievement that stands out in your mind?

One milestone I am really proud of is our safety performance at one of our larger paper mills in Bastrop, La. We went all of 2005 without a recordable accident—that's the first time we've done that in North America.

How is IP dealing with energy costs? Are you doing any hedging?

We have not had a hedge strategy in place during 2005. With all the volatility in the market we are developing a hedging program for natural gas.

What else can you do?

The best strategy is to reduce gas consumption. One of the things about being in the spot market is that it forced us to get very aggressive about reducing our energy consumption.

As you've mentioned, IP plans to focus on Uncoated Papers and Packaging. Why are these markets right for IP?

We believe we have more ways to win in uncoated papers and packaging than any of our competitors. We are the best positioned global producer of uncoated papers with superior return on sales in each region. We have strong positions in key grades with global customers; innovative, proprietary technology to differentiate products; low-cost manufacturing positions in the U.S., Eastern Europe and Brazil; and superior access to markets.

On the Packaging side, IP also has strong, leading positions from which to compete globally. Industrial packaging has an integrated low-cost mill and corrugated box plant system in the U.S. and we're growing our corrugated box business outside North America. Consumer packaging serves growing global customers with coated board and value-added packaging, and both businesses can earn cost of capital returns over the cycle.

Is the upgrade of the E1 machine at the Eastover mill in South Carolina complete?

The modernization of the E1 machine at our Eastover, South Carolina, uncoated paper mill is a centerpiece of our strategy to create fewer, larger, better facilities. Eastover is one of our largest and most modern paper mills with a first quartile cost position.

What did the rebuild focus on?

We rebuilt the E1 paper machine to improve sheet quality in our envelope and imaging papers and to reduce manufacturing costs. I'm pleased that the project is largely complete and delivering results.

IP appears to be increasing its stakes in Eastern Europe with the PM 4 rebuild at its Kwidzyn mill in Poland and the rebuild of PM 1 at Svetogorsk, as well as plans for a new pulp mill. How do you see this market area shaping up in the near future?

Eastern Europe is an emerging market and very attractive because of its better than average margins and demand growth. In fact, demand growth in Eastern Europe far exceeds what we're seeing in the U.S. and Western Europe. Because both Kwidzyn and Svetogorsk mills are low-cost producers, we're well positioned to meet the growing demand in that market.

Could you update us on the pulp mill project?

We are in the process of constructing a BCTMP mill that is part of an expansion at an existing site. The project is part of a \$300 million capital program in eastern Europe/western Russia. This is the last phase of it.

What are your thoughts on growth outside North America?

I think we have demonstrated that we can grow IP outside of North America. We've been very successful in Brazil and we have a very successful business in Eastern Europe and Russia.

Can you give us some insight on manufacturing in Russia?

For a U.S.-based company, setting up a manufacturing plant outside of North America is a challenge. It's a different business model. You have to be able to operate globally. What we're looking for is a combination of growing markets and good cost structures. And sometimes the growing markets and good cost structures go together, like in Russia. The market there is small, but growing at more than 10 percent per year. As to cost structure, if you look at the combination of fiber, energy and people, that's a big chunk of the cost of making paper and pulp. A region like Russia definitely has cost advantages.

Could you discuss IP's future strategies in Latin America?

As with Eastern Europe and other emerging markets, we see tremendous opportunity in Latin America, as a source of both local and export production. We are still considering the possibility of constructing a greenfield mill in Tres Lagoas in Brazil, and expect our board of directors will make a decision on that in the second half of the year.

Any other details about the possible pulp mill?

We're considering a greenfield hardwood pulp mill there. Our plantation in that area is eucalyptus. If we move forward with that project it would be a pulp mill and possibly a paper mill.

IP's coated papers mill in Brazil, Inpacel, is for sale. Why?

Our decision to put Inpacel on the market was really one about being out of the coated papers business and focusing International Paper on the global uncoated papers and packaging businesses. Inpacel is a very good business and one that will be a good part of somebody's portfolio. We just made a choice to go in a different direction with IP.

What, generally, is IP's long-term strategy in regards to China?

We have a presence in China today, and throughout Southeast Asia. It's a small presence, relative to International Paper as a whole, but I'm very optimistic we will figure out ways to grow our small base into a more significant one, both in terms of revenues and profitability over time, particularly as demand for packaging and paper increases in the next several years. We are learning as much as we can about the Asian markets and watching how the markets evolve, so we can develop a business model that takes advantage of the growth in the China market, while earning cost of capital on any investments made.

You have stressed that IP must establish a world class cost structure, and not just at the plant level, but through the supply chain to your customers. Has the company made progress executing this strategy?

Fifteen percent of IP's total cost is supply-chain related. That's over \$3 billion annually—a big opportunity for us. Our supply chain project is all about reducing our cost to serve and improving our customers' experience, and we are making definite progress. Right now, we're fully operational in our North American containerboard business, and the benefits are really starting to show up, particularly in the cost of getting products to the customer. We've reduced our demurrage by 50 percent, we've reduced the number of rail cars we use by a third, and we've cut the miles we ship product by 10 percent. When you think about International Paper shipping product about a half a billion miles a year, a 10 percent reduction across the company is huge dollars.

How is the cost structure changing?

Our focus on changing our cost structure revolves around cost to serve. If you add up all the dollars we spend to serve our customers, and to serve them very well, it's over \$3 billion. And it's more than simply customer service. It's how we take orders, how we schedule, how we ship and how we package.





And your plan of attack?

We've got a major effort going on at the company to look at that \$3 billion and figure out how to enhance our ability to serve our customers and how we can do that more effectively. We never had the capability to manage that slice of our cost structure. We've always managed costs in paper mills and S&A very aggressively, but supply chain has been one of these black holes where things just happen to get product to customers. This is an area where we think there's a lot to be saved and a lot to be improved.

What created the move to re-evaluate IP's cost structure?

As International Paper grew through acquisitions, we put together several companies that are now part of IP. All of them had their own supply chain systems and capabilities and had not been doing things one way across the company. What we've been working on is standardizing, simplifying, consolidating, and in some cases centralizing activities so that we can do them one way across the company, which makes us a lot more efficient and a lot easier to do business with if you're a customer.

Regarding uncoated papers, what strategic thinking is behind the push to a new standard of brightness (from 84 - 92 GE) for all of IP's uncoated free sheet papers?

We believe we have a distinct advantage in our ability to use technology to drive innovation. By using our proprietary technology and know-how, we believe that we can redefine the uncoated paper product as well as the market. That's what our Vision Innovation Paper (VIP Technologies™)

product line is all about. The first phase of this technology increases the brightness of our standard papers from 84 to 92, but more importantly, it uniformly increases the whiteness levels that results in sharper, better-printed text and images.

How has the marketplace responded?

Customer reaction has been overwhelmingly positive, and we still have two additional phases of VIP in the pipeline, designed to improve runnability and improve performance at lower basis weights.

What are the results?

The new shade of whiteness gave our customers a better product to sell to their customers. It also gave us an advantage in the marketplace, which allowed us to pick up good volume increases with some of our important strategic customers.

Are there other new products being developed that you could mention?

In addition to VIP, another area where innovation provides a unique competitive advantage is in home entertainment packaging. Our Shorewood Packaging division designs creative concepts for DVD and CD packaging. In fact, we received two Grammy nominations this year for packaging we designed for Ani DiFranco's "Knuckle Down" album and the Ray Charles "Pure Genius" box set.

Since June of 2000, IP has reduced its debt by nearly \$6 billion, from a figure of 17.9 billion to a December 2005 figure of \$12.2 billion. What is your goal by the end of 2006?

We're repaying debt in order to strengthen the balance sheet and solidify our investment grade credit rating. Originally, our goal was to reduce debt to \$12 billion by the end of this year, and we've already surpassed that goal, a year early. From here, we plan to use a portion of the proceeds from our divestiture program to further reduce debt.

Is there a "debt threshold," so to speak, as IP determines the use of proceeds from the sale of some of its businesses?

No, there is no magic debt number. We don't want to under-lever the company and there is an appropriate amount of debt for a company like ours to have an efficient capital structure. We think it's important at this point in time to have an investment grade credit rating, and that's one of our priorities as we look forward and one worth preserving.



Having a debt structure and a cash flow stream consistent with the kind of rating we desire is more important than setting a debt to capitalization number.

How do you balance reinvestment, debt reduction and return to shareowners?

You just said it: balance. At times, people may think we should do more of this or less of that, or a lot of this and none of that, but the aim is—and not next quarter, and not 20 years from now—how do we create a better, stronger, more profitable International Paper for the long term. When we accomplish these goals, our shareowners will be the beneficiaries.

How does xpedx fit in with IP?

It's an important channel for us in both paper and packaging. About 55 to 60 percent of what xpedx does is selling paper, and another 20 percent of the revenue is packaging related. xpedx has lots of sales people who are very close to our customers. This makes it a valuable vehicle for us in terms of understanding what is going on in the market.

How has the acquisition of Box USA worked out?

It has gone very, very well. It's a great example of us reinvesting at returns that are attractive and at the same time improving and strengthening IP's businesses. I'm very glad we made that acquisition.

IP is in the midst of relocating its headquarters from Stamford, Conn. to Memphis, Tenn. What prompted the move and is everything on schedule?

We announced last August that we planned to move our corporate headquarters to Memphis, where our operational headquarters has been since the late 1980s. Combining the two offices simply makes sense—it's a lot more effective to

walk down the hall for a meeting than to get on a plane. Having most of the company's leadership all in one place makes for improved efficiencies, in terms of both time and resources. We are on track to complete the move by the end of July, and I'm looking forward to making Memphis home.

IP, the State of New York and The Conservation Fund recently completed the first phase of a 257,000-acre Adirondack Park conservation easement. Tell us a little bit about this three-phase agreement.

The 257,000-acre Adirondack Park conservation easement will protect that land from being developed, and will provide open space and recreation opportunities. It's really about the compatibility of conservation and recreation in sustainably managed working forests. We completed the first phase at the end of December, and we expect the remaining two phases to be complete later this year. Also in the Adirondack Park last year, we dedicated International Paper John Dillon Park, the first ever wilderness park designed specially for those with disabilities.

International Paper has been named by FORTUNE magazine as the No. 1 company for the Forest and Paper Products sector in its annual report of "America's Most Admired Companies."

I'm very proud of that recognition. It's the 4th year in a row. And looking at the components of that ranking, we're really pleased that "employee talent" and "quality of management" are two of the areas where we rank No. 1 in our industry. Reputations take a long time to earn and not very long to lose.

I read where IP employees and the company, within days of the tsunami disaster in Southeast Asia, donated \$200,000 to relief efforts to help victims. That says a lot about the people that work for IP.

You are absolutely right. Mother Nature took its toll last year, with the tsunami and then Hurricanes Katrina and Rita. Through our Employee Relief Fund, International Paper and our employees donated over \$850,000 to help people in need last year. In addition, International Paper and the IP Foundation, our charitable giving foundation, gave out nearly \$8.5 million in contributions and grant funding to nonprofit organizations. Many of those grants went to organizations to which our employees volunteer their time as well. Over and over, IP and our employees have given their time and their money to help when they see a need. I'm really proud to be a part of that. ■