

# Deals are Re-shaping the Forest & Paper Industry

Nearly \$26 billion in deal values took place in the global Forest & Paper sector in 2006 and Private Equity had a hand in it. So what's driving all this activity, what role has PE played and how does it operate?

By Clive Suckling and Geoff Lucas

**M&A activity continued apace in 2006** with global deal values nearly reaching a staggering \$4 trillion, breaking the previous record of \$3.3 trillion set in 2000 during the dot.com boom. The strong performance of global equity markets meant 2006 was a great time to sell unwanted assets. Continued low interest rates combined with strong cash flow and healthy corporate balance sheets and the huge funds managed by private equity drove buying activity. All-in-all, the conditions were near perfect for strong deal activity.

The fact that private equity was involved in 20% of deals by value last year, according to Dealogic, compared with only 4% in the previous boom year of 2000, is a measure of the progress made by this alternative asset class. In the US, the proportion was even higher with Thomson Financial reporting private equity backing of half of the top ten deals last year and 25% of the overall value. And records for individual deal size continue to be broken, with, as we write, the "club bid" for TXU at more than \$40 billion, aiming to set a new high.

For a community that has traditionally eschewed publicity, private equity is rarely out of the headlines these days. Their modus operandi has entailed measured concern about market abuse and conflicts of interest, as well as the potential systemic risk of their high leveraged structures to the orderly operation of financial markets. More emotively, there have been accusations of asset stripping and worse from trade unionists and politicians here in Europe.

Certainly private equity has come of age. In this article we look a little into the way private equity operates and attempt to take a measured view of its role and influence in M&A activity in the Forest & Paper (F&P) sector, but first we look at overall deal activity and drivers in F&P.

## THE INTERNATIONAL PAPER EFFECT

In F&P, there is no doubt that International Paper (IP) wrote last year's deal headlines. Of the near \$26 billion in global F&P deal values in 2006, IP's various transactions accounted for over 40%. A quick recap of some of the main deals in 2006 in the familiar IP transformation story provides insight to factors driving transactions industry-wide.

The US forestland estate was reduced to near 0.5 million acres, following the sale of over 5 million acres for over \$6 billion to Timber Investment Management Organisations (TIMOs); the North American coated and supercalendered papers business and Arizona Chemicals were sold in separate transactions to private equity and the beverage cartons business was

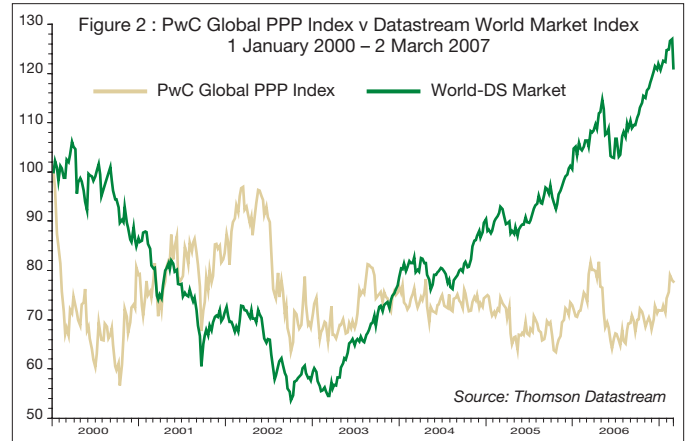
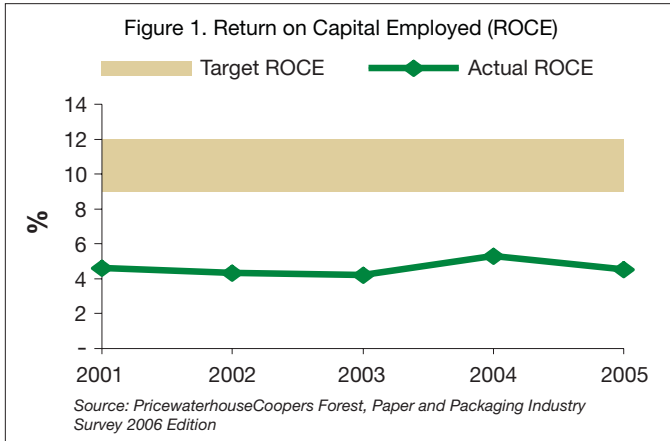
sold to New Zealander Graeme Hart, a new entrant to the F&P industry in 2005, when his Rank Group acquired IP's majority stake in Australasian-based Carter Holt Harvey.

On the buy-side, IP acquired joint venture interests in China in coated consumer board and in Ilim Pulp (awaiting completion), Russia's leading pulp and paper company. Last month, it completed a major asset exchange in Brazil with

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Votorantim Celulose & Papel (VCP), to focus on uncoated fine paper.

Hence, in quick time through M&A, IP overhauled its vertically integrated business model to become a product specialist with an increasingly global reach, focused on uncoated fine papers and packaging.

**WHAT IS DRIVING DEAL ACTIVITY?**

The value chain transformation theme as deal driver and as exemplified by IP is a key tenet of this article and sadly the story is all too familiar. Faced with at best slow growth, more radical strategies have become necessary to haul publicly quoted F&P companies from the trough of consistently inadequate returns. This is well illustrated in **Figure 1**, which shows the Return on Capital Employed (ROCE) of the PwC Top 100 Global Forest, Paper & Packaging companies, for the five years ended 2005. It shows a consistently significant gap between the average actual ROCE achieved and the minimum returns expected (9-12%) by investors in public companies. Results for 2006 are still being compiled, but they will not show a different story.

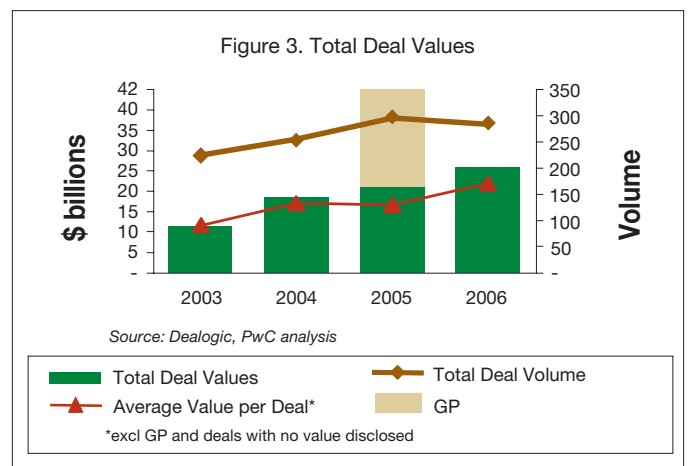
Disillusioned with the low returns, valuations relative to the market (see **Figure 2**) have been allowed to fall to levels making investment in the upside potential attractive to both corporate and private equity investors. Further fuelling the private equity mandate has been the fall in acceptable returns driven by the high levels of liquidity in the marketplace.

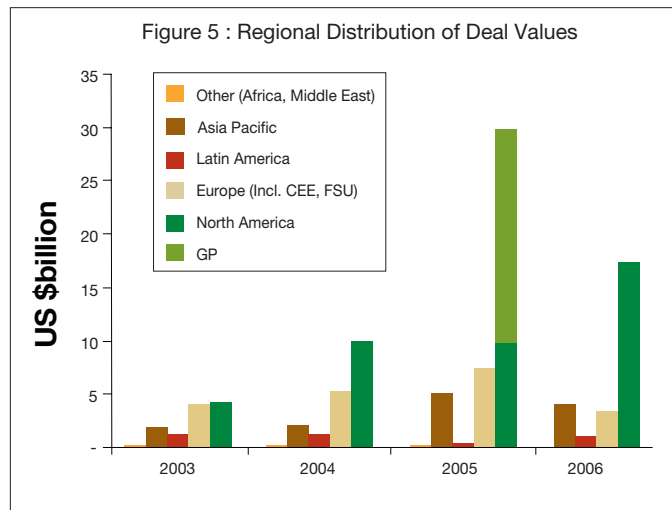
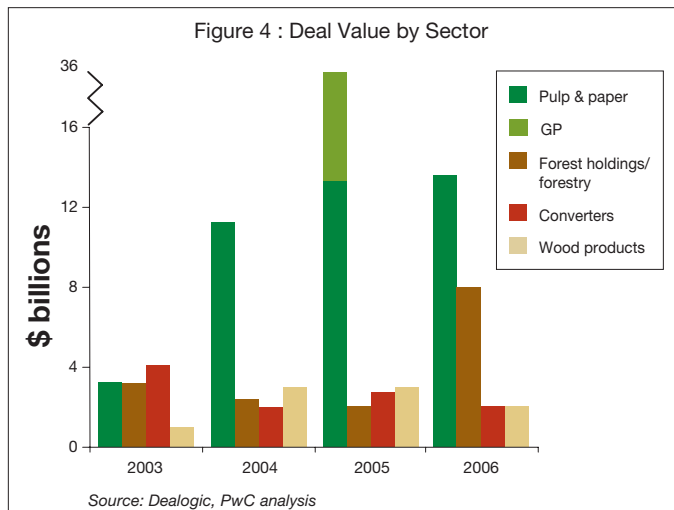
Industry players have responded and continued to discard their traditional vertically integrated models as they strive to return value to investors. It is this value chain transformation that has driven much of the divestment activities as companies seek to return to, or redefine, their core business activities, while new money enters the vacuums thrown up by this realignment, hoping to maximize returns in the new niche markets created.

Further impacting the landscape has been the continued strengthening of the emerging markets. “Traditional” North American producers, in particular, are being displaced by the new cheaper capacity, as, inter alia, distance to market becomes less of a barrier and geopolitical risk reduces.

**KEY DEAL TRENDS – HOW DID FOREST & PAPER MEASURE UP?**

How did these deal drivers translate into deal activity in 2006? In headline terms, deal values fell in 2006 (see **Figure 3**) to \$26 billion from \$43 billion in 2005. That is simply explained by the epoch busting \$22 billion acquisition of Georgia-Pacific (G-P) by Koch Industries in 2005, a major new entrant to the sector. Excluding G-P, total deal value rose in 2006 as it has done in each of the past four years over which we have tracked deal activity in detail; this is broadly consistent with the overall M&A market. Despite stuttering in 2006, over the same period deal volume has also increased, as has average deal size (G-P excluded). In fact, average deal size has almost doubled over the past four years, rising to \$170 million in 2006, a good indicator that deal confidence has grown as larger blocks of assets have changed hands in single transactions.





Looking at where the deals were made, **Figure 4** shows that Pulp & Paper continued to dominate with over 50% of total deal value. The largest transaction was Domtar’s acquisition of Weyerhaeuser’s uncoated fine papers business with a reported value of around \$3.3 billion. This deal illustrates two key drivers; it was a classic market consolidation for Domtar in a product area that has been on the defensive in North America for several years, and an exit for Weyerhaeuser from an area that had become non-core. The new combination will be the largest uncoated woodfree producer in North America and number two globally.

With the large IP sales, it is no surprise that forest-related deal values escalated in 2006. Since its peak in around 1980, when integrated F&P companies collectively were the largest owners of privately managed US forestland, there has been a near role reversal. TIMOs and Real Estate Investment Trusts (REITs) have taken their place, as producers have disavowed land ownership to ensure fiber security. Of the few public US F&P who retain significant holdings, none seem likely to maintain the full integrated model—witness Temple-Inland’s recently announced plans to sell off of its forestlands.

The geographic distribution of deals is revealing (see **Figure 5**). After hovering between 35-50% of total F&P deal values (G-P excluded) for three years, the North American share shot up to almost 70% in 2006. Some increase would have been expected given IP’s heavy divestment program. The surprise is the relatively subdued dollar value of transactions in Europe. Here, total deal value fell more than 50% on 2005 to just over \$3 billion—a mere 13% of the F&P total and counter to overall M&A trends. Of course the European F&P industry has never been as heavily invested in forestlands, but otherwise, the essential

conditions that have driven transactions activity in North America were present in Europe, not least a large pool of private equity money.

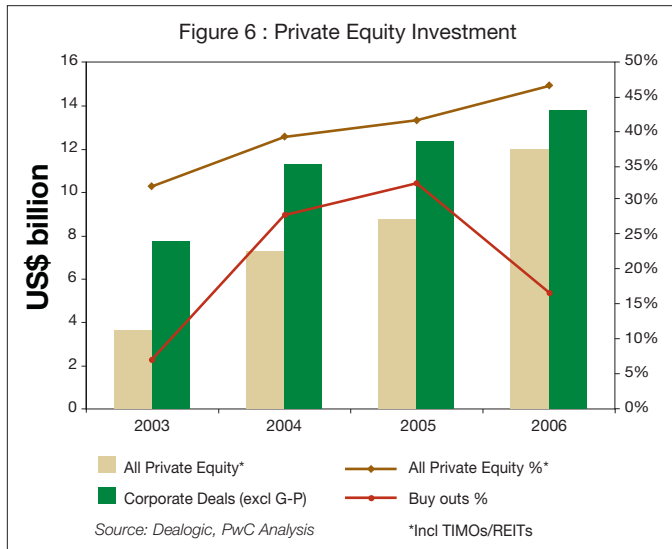
The reality is that there were plenty of F&P deals in Europe—107 or nearly 40% of global volumes. They were however much smaller in value, with an average deal size of \$90 million, half the global average. This is a pattern consistent with a less confident deal environment, which clearly was not the case in the M&A market as a whole; rather it indicates there are organizational and institutional barriers that are preventing or at least delaying the flow of major deals.

A spark was provided towards the end of 2006, when Graeme Hart’s Rank Group entered a \$2 billion bidding battle for Swiss-based SIG Holding, the world’s second largest drinks carton producer. The other contender was Elopak with backing from private equity house CVC Capital Partners (CVC), seeking to consolidate the number two position behind Tetrapak. At the time of writing, both of these bids remain on the table.

### WHAT IS PRIVATE EQUITY AND HOW DOES IT OPERATE?

Private equity is a much used term, but what is it and how does it operate? As an alternative asset class, private equity encompasses venture and mezzanine capital and special situations (e.g. distressed debt), but in the current context, the focus is on buy-out funding of generally mature businesses, including the headline-making, public-to-private deals.

In essence, the buy-out approach is fairly simple. It looks at the market, the business drivers, the cash flows and the financing structures the business can support, as well as the eventual exit strategy options, all with a view to seeing how value can be maximized, expressed as an Internal Rate of Return (IRR). With a typical buy-out fund life of 10 years,



these evaluations are generally made over a three to five year time horizon.

Equity is provided by the fund itself, with the fund managers (“the carried interest”) and the managers of the business (and often employees), also having equity stakes. The equity is geared up with layers of tax efficient debt. This gearing not only increases the potential IRR, but also imposes a tight financial discipline on the business. Further, through this approach, the interests of all parties involved are aligned with a focus on maximizing the net cash returns.

Institutional investors, indeed the very same institutions that look after our money, have been drawn to buy-out funds; many analyses (although not entirely unequivocal) show that investing in private equity has not only outperformed the public markets, but can also prove less volatile than quoted portfolios. Various sources indicate that private equity entered 2007 with record spending power of some \$2 trillion.

### PRIVATE EQUITY IN FOREST & PAPER

With presence on at least one side of 15% of the deals transacted over the past four years, private equity has certainly made a major impact in F&P. In value terms, its significance has been even greater with presence in 47% or \$12 billion of deals in 2006 (Figure 6). Further, private equity involvement has been consistently above 30% and rising in dollar terms over the last four years. At this level therefore private equity penetration seems to be higher than most other industries.

These raw figures for private equity in fact include two broad investor classes in the industry, annuity-based investors (TIMOs and REITs) and capital gain-based investors (buy-out funds). We have not tracked hedge fund activity, the

other major category of capital gain-based alternative investor group. TIMOs and REITs represent a specialized alternative asset class, which have proved attractive for institutional investors seeking comparatively low risk annuity-type investments. Being tax advantaged, TIMOs and REITs have been able to provide returns which are unavailable to traditional corporate players. The largest TIMOs have extended their reach well beyond North American forestlands, offering regional diversification to their investors.

Excluding forestry/forestland, a different picture emerges. This shows buy-outs accounting for 17% of deal values in 2006, down on the 33% in 2005, but at 22% of total deal value over the last four years it is on par with the overall market (20% in 2006). Buy-outs have been concentrated in Pulp and Paper and Converting businesses; there has been limited activity to date in pure Wood Products businesses, where private equity has been deterred by the particular risks of that segment. North America has been far more active than other regions with over 60% of buy-outs by value over the past four years,

Numerous private equity groups have been active ranging from small leveraged buy out funds to some of the largest. While some funds may have an industry focus, most, and especially the largest, tend to diversify. Apart from the generalist nature of most private equity houses and buy-out funds, diversification mitigates risk by avoiding undue exposure to any one sector. Among the largest houses, the following are the most prominent in F&P:

- Madison Dearborn Partners is Chicago-based and reports assets under management of \$14 billion. It has been the most active in F&P for the past several years with acquisitions such as Boise Cascade, Buckeye Cellulose, Graphic Packaging Corporation and Packaging Corporation of America. In addition it is the main shareholder in Irish-based Smurfit Kappa Group (SKG), Europe’s largest industrial packaging group, which recently announced an IPO.
- Texas Pacific Group (TPG) is Texas-based and is one of the largest private equity houses, with reported capital under management of over \$30 billion. In 2006, TPG acquired Smurfit Stone Container’s consumer packaging business for more than \$1.0 billion and through the bolt on acquisition of Field Container created a new consumer packaging entity called Alitivity.
- Apollo Management is New York State-based and has in recent years completed a number of substantial

transactions in the US chemicals sector, but is a relative newcomer to F&P, acquiring IP's coated and supercalendered business for more than \$1.3 billion in 2006.

- Cerberus Capital Partners is New York City-based. Originally specialising in distressed assets, Cerberus now has a diverse international portfolio. Although it has invested in and out of smaller F&P businesses in the past, its current main holding is New Page.

Outside North America, the largest private equity investor in F&P is London-based CVC, which reports having raised over \$18 billion in buy-out capital since 1981. In Europe, its two main F&P acquisitions have been the Dutch-based Kappa Group, now rolled up into SKG, and Lecta, a group that combines three leading coated woodfree paper producers in Spain, France and Italy, respectively. Via CVC Asia Pacific, a joint venture with Citigroup, it made its first moves into the F&P industry in China last year, completing the \$100 million acquisition of a local wood products business. Further, last year it almost struck a deal to provide expansion capital, reported at \$623 million, to Shandong Chenming, China's leading paper company, in return for a 30% stake.

At first glance, the F&P industry is not an obvious target for buy-out funds, with its commodity cycles and potentially high capital intensity. So what have these new investors been looking for? Perceiving the glass half full, rather than half empty, private equity has seen the opportunities hidden behind poor returns from public companies, the potential value creation opportunities through a sharper focus on the business and, in some situations, better management. The low cost of debt over the past few years has helped to make deals attractive financially also.

Those inside the paper industry often claim the buy-out model is inappropriate as its time horizon is too short for the long term investment horizons in the industry and that the cash tap can always be turned on in the short term by not reinvesting. Well, it is true that the investment time horizons of a buy-out fund are shorter than the payback period on a new paper machine. It is also true that they will take a hard look at capital spending. However, a buy-out fund is unlikely to have maximized its exit value if the competitive fundamentals of the business have been undermined. Further, it can be argued that with public company management under the hammer to produce quarterly earnings increases and having difficulty in convincing investors of

long term value creating strategies where they exist, the time horizons they operate under are in reality shorter than for the typical buy-out fund

Corporate managers have reasons to be grateful to private equity; buy-out funds have seen more value in their unwanted businesses than their peers. Indeed, there are many divestments of industry assets where the only interested acquirers are buy-out funds.

With more money flowing into private equity, where will the deals happen? A poll of North American buy-out fund managers earlier this year revealed that the vast majority are looking to do more deals in Europe and the emerging markets. While North America can be expected to remain a favorite hunting ground, the higher levels of private equity penetration, the greater competition for deals and the need to diversify to keep risks at acceptable levels, mean that it makes sense to be looking elsewhere. We expect a similar pattern in F&P.

### LOOKING AHEAD

What is the general deal outlook in F&P? This will be highly dependent upon several factors, including: an eye to value, the continued deintegration of older business models, consolidation efforts, movements on global interest rates, as well as overall economic conditions. Already, 2007 has started out with a bang, with Bowater and Abitibi-Consolidated announcing a \$2 billion plus merger in North American newsprint, and Brookfield Asset Management's agreed \$2.1 billion bid for Longview Fibre. By the time you read this, more major deals may have happened.

And deal sentiment is strong not just in North America. The recent PricewaterhouseCoopers Global CEO Survey, a survey including 1,100 CEOs across all industries, revealed that 27% of Forest, Paper & Packaging chief executives were planning a cross-border merger/acquisition versus 15% amongst the peer group.

If this is the tone of things to come, 2007 will be another busy year ...and for sure; private equity is here to stay and will continue to play a pivotal role in the transition to new industry models, structures and composition. ■

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