

2010 –What's next?

Remaining cautious in post crisis euphoria

By Joachim Klein and Harald Schmid

2009

2009 was all about the crisis and the recession. In late 2008 and early 2009 it looked like doomsday. Economic scenarios in early 2009 were all about how bad it could get and how long the crisis would last. Meanwhile stock markets were already starting to recover after having hit a long time low on march 9th, 2009. While different gloomy scenarios were being discussed the stock markets were already turning.

Ironically one of the best performing sectors, in terms of stock performance, since the trough in March 2009 has been the often bashed paper industry. Since then stock prices of many pulp and paper companies have doubled, tripled and even more than quadrupled in some instances. Although it was obvious that market caps were a real bargain in early 2009 no public company in the sector dared to try an anticyclical acquisition. Most acquisition attempts would most likely not have been successful with lack of financing support and probably lack of a willingness to sell. Ironically financial markets who have been criticizing the paper industry for lack of strategy with respect to capacity management did not force a consolidation during this time because of the overall structural issues in their own sector. Additionally the alternative fuel credits (black liquor subsidies) in the US supported an industry during a time of highest distress and may have kept some companies alive. Without these subsidies a necessary market consolidation could have resulted.

Governments were discussing bonuses of bankers, the pros and cons of a potential regulation of the financial industry and alternatives to the current global economic models as the financial industry was already beginning to recover and raking in record margins on the back of government subsidized low interest liquidity. What had happened? Apparently the globally coordinated bailout actions and infusion of government liquidity had provided enough confidence (and liquidity) to help markets recover. At the height of the crisis in late 2008 it seemed like economic activity came to a halt and most market participants were waiting for something to happen and other parties to take action. Meanwhile global inventories were declining rapidly as orders were canceled and investment activity was at an all time low. In the 2nd half of 2009 economic activity returned as companies were replenishing their inventories. The upswing has continued to last until now.

Sustainability of returning demand?

So all is well then? Probably not. A few factors may start to impact global stability in 2010.

- Record budget deficits – the abundance of (private) cheap money that caused the crisis is supposed to be the cure – the only difference – this time the cheap money is public spend
- Global economic growth driven by demand from China, originally backed by confident and ever-spending consumers in the US, may change to more restrictive consumer spending
- Instability of the Euro caused by budget deficits in Greece and potentially other member states
- Record debt and issue of government bonds may encourage the US to keep the dollar at a low value to encourage manufacturing and to reduce debt
- Productivity losses in 2008 & 09 were mostly covered with same number of employees – which effectively means that many companies will have to release personnel in order to stay competitive
- Rising unemployment and uncertainty about the future may impact consumption
- Bad loans from the housing crash still have to be covered by the financial sector

Concerning the paper industry the following risks still remain and will have to be considered in 2010

- Structural changes: Reduced demand for many grades especially in publishing and printing
- Financial distress – while liquidity has improved companies in the pulp and paper sector have all but healthy balance sheets – working capital and liquidity management needs to remain in focus

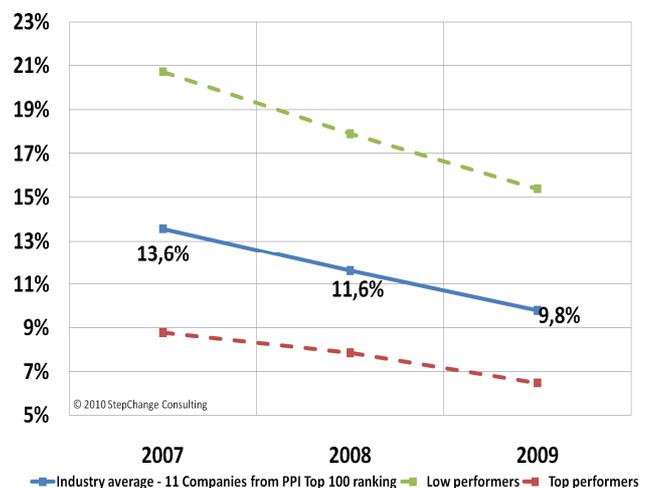


Figure 1: Working Capital Development of P&P companies

- Capacity management: The downturn forced closure, curtailment or mothballing of capacity. A return of demand will have to be met with capacity discipline
- Margin Squeeze: While demand and paper prices fell in 2008/09 so did input costs. Margins were still decent in many sectors. Since mid-2009 input costs, especially raw materials and energy, are increasing faster than paper prices – active cost and margin management with short response time will have to be installed
- Low willingness of banks to provide loans or only at high premiums for refinancing or investment activity

While risks remain opportunities also exist

In 2009 many companies focused internally to deal with the crisis and customer relationships may have been compromised. With returning demand and increasing stability, opportunities may lie in:

- Understanding customer demand and profitability
- Supply Chain collaboration to capture benefits across the entire process
- Selective mergers, acquisitions and capacity swaps

The end of the dollar in global trade?

The current economic situation was caused by a bubble in the housing market, backed by low interest loans that were in many cases granted on the basis of continuously increasing house prices. As more and more home buyers got into the market the system became a self-fulfilling prophecy as prices soared with increasing demand for housing. Banks were fast to provide loans for new home buyers even without the necessary credit rating. Meanwhile the loans were being bundled and sold off in secondary markets. As the markets were overheating, these loans were being passed like a hot stone from institution to institution adding margins and risk premiums while making a quick profit. What made this system work in the first place was more than a decade of low interest rates as a fiscal policy of the Federal Reserve. With cheap liquidity in abundance investors were seeking high return projects based on the assumption of continuous growth. This climate encouraged consumers to continue spending. While the US was spending, China was manufacturing and both economies were growing. The trade deficit grew in the US while China was building huge trade surpluses and dollar reserves - the two economies fatefully tied together. With a slumping economy governments decided to preserve the economic balance with huge stimulus packages and bail-out programs. Essentially this meant that the governments were taking up loans and printing money. At this stage cheap and direct

government money was pouring into the system compared to the indirect cheap money in the previous years. Interest rates have been kept at almost zero. However, the cheaply available money was not passed on to the consumer or companies in need for capital. Having learned from the lack of appropriate risk management systems in the prior years, financial institutions are now applying rigid credit management rules. Significant risk premiums are charged for any loan granted – all justified with a weary economic climate and increasing default rates. On the other side, banks have access to capital at a very low cost. The result? Record margins, required to cover the losses from the previous years. The risk in this system is twofold. On the one side the cheaply available liquidity may encourage additional risk-taking by those who have access to it, on the other side the restrictive lending practices and high risk premiums may lead to increased bankruptcy rates and consequently increasing unemployment.

While it may seem that the economic downturn has been successfully overcome, this view may be deceiving. Inflation may be around the corner.

The abundance of liquidity without continued economic growth will lead to a disparity between the amount of goods & services and the amount of money. This in turn will have to lead to price increases i.e. inflation. On the one hand, the option for government is to restrict liquidity by increasing interest rates which in turn may choke off any imminent recovery. On the other side governments may decide to keep liquidity higher than the productivity increases of the economy, allowing for inflation. The incentive to allow inflation is twofold, potentially reversing fiscal policy of the previous years. The US and other Western economies have accumulated record debt with the recent issue of government bonds. A controlled inflation will also devalue the debt. On the other side this will most likely have an impact on the value of a currency. Politicians may be inclined to accept a lower value of the US dollar or Euro in order to force a higher valuation of BRIC currencies. This will increase the competitiveness of exports and the manufacturing base at home – at least short term. Of course most politicians and industry leaders will argue that only a strong currency represents a strong economy. However, in the light of the massive debt to be repaid this rationale may be forgotten.

Additionally, the financial markets may be losing confidence in these currencies or try to bet against them. This may also just be the beginning in a global shift of fiscal power potentially extending the list of globally leading currencies. BRIC countries hold 42% of global currency reserves. Leaders of these countries are discussing how to become less dependent on the US dollar in global trade. Scenarios to use SDRs (special drawing rights - an artificial currency used by the IMF) as an alternative to non-US trade are being

discussed. These countries fear that the US fiscal policy and current government spending will influence the value of their own reserves. Executing such a plan would most likely lead to a self-fulfilling prophecy.

What will the consumer do?

All scenarios about the global economy will only work if consumers are willing to spend money. In the past years the growth in China and Asia has been carried by US and Western consumers. As wealth is growing in those regions the domestic consumer will gain importance. However, Asian economies still depend to a large degree on the western consumer.

In 2009 the GDP fell by 2-5% in western economies. With average growth rates between 1-2,5% in previous years, it will take a minimum of two years (due to the lower base) to reach 2007 levels.

A lot of western companies retained their staff during the crisis, supported by government programs in many countries providing tax breaks or complementing a salary in case of short-time work. With the end of this support companies have two options.

1. Retain their staff despite overall lower operating rates.
2. Reduce headcount

Assuming that operating rates are recovering but remain below pre-crisis level means effectively that labor productivity will decrease. Retaining pre-crisis headcount levels for a very long time will lead to a loss of competitiveness. On the other side a reduction of headcount will have two impacts. On the one side many companies have optimized their staffing levels to run their business processes effectively independently of output. A reduction of staff will therefore lead to increased training and recruiting costs in the future - potentially slowing recovery as it occurs. On the other side a reduction of staff will have an economic impact. Large scale lay-offs will harm domestic demand and recovery of national economies. Of course this is a macroeconomic dilemma companies will not vouch for single-handedly. Nevertheless further governmental support will lead to increased distress for national budgets. However, as economic development relies heavily on psychology and behavior of the individual it is important to support overall confidence building without reckless public spending.

The financial industry was the cause of the crisis but also heavily impacted by it. Huge losses had to be incurred that were partially covered with governmental support. Nevertheless the financial industry needs to increase overall profitability in order to cover for risks still hidden in the balance sheets. In order to fulfill new risk management and reserve policies companies are trying to maximize margins. Federal

rates are at a record low. On the other side banks are very conservative in their lending practices or are charging high risk premiums. This lead to record profits for many institutions in 2009. While it may seem cynical that the industry causing the crisis is now the fastest to profit from the recovery, it is clear that the world economy is dependent on a healthy global financial sector.

The impact on the paper industry

For the paper industry the economic upswing is not as positive as it may appear to be. 2009 was overall not a bad year for the industry. Compared to 2008 the average EBIT of the industry increased in 2009 by 45% according to a study conducted by StepChange.

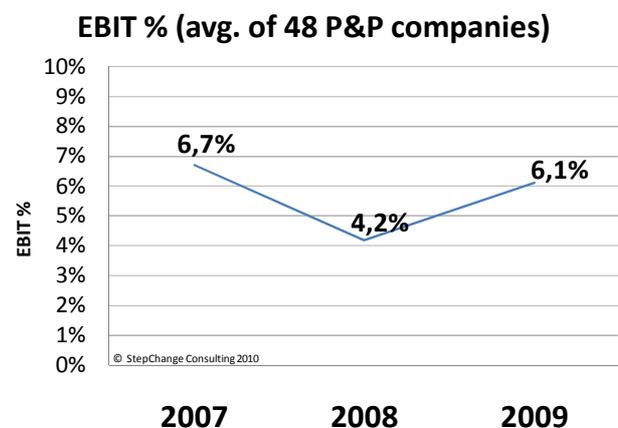


Figure 2: EBIT development of P&P Companies

While demand dropped in many segments especially in the first two quarters of 2009 compared to 2008 the industry for once was quick to take proactive measures to manage capacity. Seeing severe demand drops at the end of 2008 the industry took it seriously and prepared for the worst. While demand and prices dropped, input costs such as wood, pulp, waste paper and chemicals dropped even faster. With the economic slowdown global shipping and transport rates dropped from record levels in 2008. The logistics intensive paper industry profited significantly from this development. At the same time product prices allowed for acceptable margins. Combined with disciplined capacity management and working capital focus the industry was able to manage a healthy profitability overall. Of course results varied from segment to segment. The paper segments with shorter term contracts and closer to cyclical industrial customers were impacted harder than those with longer contracts. Non-integrated companies profited from record low pulp prices whereas integrated mills suffered. Many industry segments in pulp and paper such as print and publishing have been structurally impacted for years. Therefore, measures initiated even before the crisis, proved to be successful to deal with the additional challenges during the crisis. However especially within print and publishing the

crisis may have accelerated a trend to e-media which will have increased impact in 2010 and beyond. Despite increasing demand in 2010 the challenge will be dealing with the margin squeeze. In some segments such as print and publishing prices have even dropped since 2009 while input costs have risen dramatically. Companies need to be careful not to lose capacity discipline impacting prices even further. For many companies this is proving to be a critical test for survival. In other segments paper prices are increasing but raw material prices are rising even more. The industry's challenge in 2010 is not so much demand as it is overall margin management and profitability.

While overall liquidity has increased with the focus on cash during the crisis, the financial strength of many companies in the industry is still not satisfactory. Therefore continued focus on cash flow and liquidity is necessary.

As an additional challenge the global capacity balance is shifting, with China becoming a net exporter and further Asian and Latin American capacities going online.

Actions 2010

As described above the economic outlook remains mixed. While one may believe that the crisis is over there are too many structural issues that may lead to a negative rebound in the near future. Remaining cautious and prepared for another decline should be part of any mid-term business scenario. In the current environment the challenge for 2010 will be a proactive approach to counter the margin squeeze and to build a market and customer strategy that allows for growth and profitability.

While recovery of demand is highly welcome it is an imperative to understand and manage all cost drivers proactively. Volume alone will not help profitability. In the current environment raw material costs need to be monitored to understand the profitability of every marginal ton produced. Cash cost influencers in all areas including labor, energy, production and distribution costs need to be understood in addition to understanding the impact of fixed costs. Organizational structures and processes need to be optimized further to achieve long term profitability. Consolidating assets and organizational layers to further achieve economies of scale will help reduce overall costs. Managing capacities in is important in almost all paper segments. Even those segments with growth like the packaging sector are impacted by weak profitability because of constant oversupply in expectation of future growth.

With increased valuations, M&A scenarios will become more likely potentially supporting overall consolidation and capacity management.

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About StepChange Consulting

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