Diligent Due Diligence

Tailor-fit industry due diligence: Uncovering M&A risks and rewards

By Joachim Klein and Valentin Schenkenfelder

Introduction

Pulp, paper and packaging has (re)captured the attention of investors. Transaction volumes of M&A in the industry are steadily increasing. The sector is globally in the spotlight again. This is not only because of increased M&A activity but also because returns in most sectors have been very healthy for multiple years. Despite some large-scale M&A activity, the sector can still be considered as rather fragmented, which drives the interest and opportunity to consolidate.

However, as in any transaction the opportunity and the fit need to be carefully assessed to make the right investment decision. A properly carried out due diligence details and assesses all opportunities, risks and red flags and forms the foundation for the right decision, be it for or against the transaction.

For acquisitions to be successful, careful planning, precise analysis, impartial decision-making and dedication in integration are required. Effective, efficient and yet thorough due diligences are a prerequisite, not only for the acquiring company, but also for stakeholders, such as banks or private and public investors. This POV aims to highlight the specifics of Mergers & Acquisitions in pulp, paper and packaging (PPP), elaborating on one of the core elements of any M&A: A properly conducted due diligence.

The article is structured to provide an overview of recent M&A developments in PPP, followed by an overview of the financial state of the different sectors and an outline for a successful due diligence.

Recent developments

In recent years, M&A activity across the globe has increased. Short and long-term interest rates have remained low, especially in the EU, due to quantitative easing. With the low cost of capital, M&A activity steadily increased reaching a peak in 2015 both in number and volume of M&A deals around the globe[1]. 2016 did not fall far behind, despite the political and economic turbulences. The business environment has remained very positive in the manufacturing sector and especially in the strategic growth sectors of the pulp, paper and packaging industry. With average returns on capital of 6-17% and the low cost of capital of around 1-2% plus risk premium, it is not surprising that M&A activity is increasing.

Major deals have taken place, reshaping and consolidating the industry landscape. Especially the packaging segment has been much sought after with respect to strategic acquisitions, while in the graphic and publishing sector M&A activity has focused on consolidation and reduction of capacity. Overall, the PPP industry can still be considered fragmented, only North America has now reached a high level of consolidation in the containerboard and boxboard markets and the associated converting segments. In Europe, some consolidation has taken place and large multi-segment corporates are aiming to strengthen their portfolios strategically. Overall, the big players are now more focused on the core segments they want to operate in.

As indicated, 2015 represented a record year regarding M&A with successful deals exceeding a total value of $30bn[2] globally within the PPP industry alone. Some transactions included:

- *January 2015: Rock-Tenn merges with MeadWestvaco in a $9,2bn deal forming WestRock – a giant provider of paper and packaging solutions in consumer and corrugated markets*
- *May 2015: KapStone Paper and Packaging Corporation announces the acquisition of Victory Packaging/Golden State for $615m*

In 2016 the trend continued. The M&A volume, however, was only $11,5bn, which was a significant decrease compared to the previous year. The most noticeable deals were:

- *January 2016: Smurfit Kappa Group acquires INPA for $200m, positioning SKG as the largest pan-regional corrugated packaging supplier in Latin America*
- *May 2016: IP acquires the pulp mills of Weyerhaeuser for $2,2bn, diversifying business & creating a leading global fluff pulp business*

[1] JP Morgan 2017 M&A Global Outlook

[2] Forest, Paper & Packaging Deals Insights Quarterly Q1 2017, PWC

- *July 2016: Packaging Corp of America acquires corrugated products producer TimBar for $386m, expanding its client base, product portfolio and innovation capability*

For 2017, the sentiment across the industry was to see an increase in M&A activity, according to the survey conducted by StepChange for the RISI North America conference. Compared to previous years, however, the share of respondents expecting an increase in M&A declined from 88% to 58%.

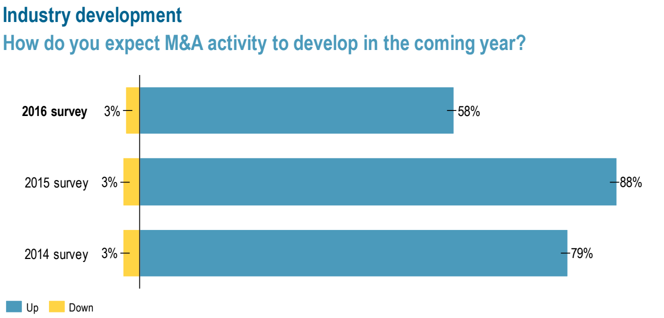

Figure 1: Industry sentiment towards M&A activity

Based on the developments in 2017, the expected increase in M&A activity has been confirmed. The year started strong, with an increase in deal sizes by 45% compared to Q1-20162. The biggest deals included:

- *January 2017: WestRock acquires Multi Packaging Solutions for an enterprise value of $2,28bn, which supports WestRock's expansion strategy in terms of products portfolio and geography (EV/EBITDA 10,5)*
- *February 2017: Sonoco, acquires Peninsula Packaging Company, a leading manufacturer of thermoformed packaging for fresh fruit and vegetables, for $230m in cash*
- *June 2017: DS Smith entered into a conditional agreement to acquire 80% of Indevco Management Resources, the holding company for the Interstate Resources Group for $920m expanding the geographic footprint of DS Smith*
- *September 2017: Paper Excellence (owned by APP) agrees to buy a BEK pulp mill (1,7m ton/year) from Eldorado. The deal is estimated at $4,7bn*

[3] The HHI ranges from 0 to 1 - 0 representing perfect competition and 1 representing monopoly. Categorization in low (<0.15), moderate (0.15-0.25) or high (>0.25) concentration.

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Even though M&A activity in the industry has been high in recent years, the markets are still fragmented and further consolidation can be expected. In pulp, the increase in capacity is expected to lead to lower utilization rates and eventually may be a driver for further market consolidation. The Herfindahl-Hirschman Index (HHI)[3], a measure of market concentration (0 = fragmentation; 1 = monopoly) is <0,07 for the hard-wood segment (including Eucalyptus), whereas the softwood segment has a value of <0,05 symbolizing a rather high level of competition and fragmentation.

In graphic papers, declining demand and overcapacity can be expected to be a driver for further consolidation or divestments. Demand for packaging is continuously growing, especially in flexible packaging, where the CAGR is expected to reach 5% until 2022. While the packaging sector is quite concentrated in North America, on a global scale the HHI is rather low (<0,02), signaling a high rate of competition and a large likelihood for further M&A activity.

Similar to many other segments, the tissue segment can also be considered rather fragmented from a global perspective despite some large regional and even global players. Globally the HHI is <0,04 and in North America it is <0,14.

Key financial indicators for 2016

Overall, the pulp, paper and packaging industry is performing quite well profitability-wise with the different segment's average EBITDA margins between 11,8% and 18,2%, and ROCE ranging from 6% to 17%. On average, the segments' EV-multiples are between 6,2 and 10,7 and debt levels between 54% and 74%.

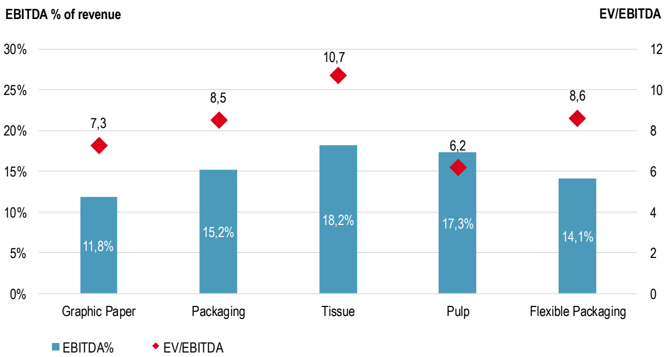


Figure 2: Average EBITDA[4] margins and enterprise multiples per segment

Demand for pulp has been steadily growing over the last years driven by growth in tissue and specialties, which make up a significant part of the demand for pulp today and substitute the decline of graphic papers. The EBITDA margin is the second highest compared to other relevant segments, while EV/EBITDA, ROCE and the debt ratio are the lowest in the whole industry. Profitability was negatively impacted by the 10% decrease in pulp prices in 2016. However, since the beginning of 2017, prices have recovered with an increase of 20%, which has had a positive impact on the sector's profitability.

The tissue segment performed well in 2016 and it is expected to grow on average 3,5% annually[5]. Since this segment is highly dependent on pulp, declining pulp prices had a positive impact on profitability, leading to an EBITDA margin of 18% in 2016 globally. In terms of ROCE, tissue is leading the industry and it is the only sector that saw an increase of ROCE in 2016.

Despite the decline of demand and revenues in the graphic paper sector, EBITDA margins remain high with almost 12%. However, profitability varies strongly by paper grade. Prices for newsprint in Europe remained stable compared to the previous year, albeit the continuing drop in demand. The sector is characterized by divestments and site conversions. IP, for instance, bought Holmen's newsprint mill in Madrid in 2016, intending to convert the capacity to recycled containerboard.

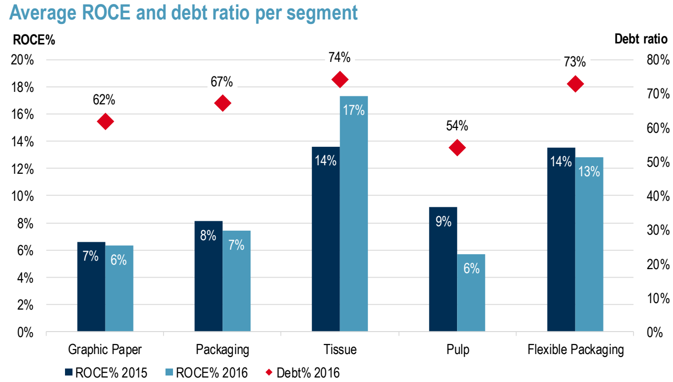


Figure 3: ROCE%[6] development and average debt ratio per segment

The packaging and flexible packaging peer groups have average EBITDA margins of 15% and 14% respectively. Flexible packaging had the second highest ROCE in 2016, with an EV/EBITDA multiple of 8,6 – similar to packaging. Overall, packaging is growing faster than other segments of the sector. Growth expectations remain promising, driven to a large extent by the growth in e-commerce and changing food consumption habits.

In summary, the sector is financially very healthy, which attracts capital and may further drive M&A activity.

The value of a diligent M&A process

For M&A deals to be successful, several critical elements need to be considered.

Strategy

For a successful deal, it is utterly important that the M&A strategy and approach are in line with the vision and corporate strategy of a company. The primary purpose of every acquisition (or divestment) is to increase the enterprise value of the company

[4] B3nch 2016 – a bi-annual report tracking the financial performance of the main players in the pulp, paper and packaging industry that are publicly listed. For further information contact: b3nch@stepchange.com

[5] RISI 2016

[6] B3nch 2016

and, therefore, ultimately increase shareholder value. Prerequisite for achieving these goals is a sound acquisition or divestment strategy and effective M&A capabilities.

Target identification

The definition of target criteria should be based on clear M&A rationales, which can be grouped into five main purposes:

- ***Market & asset consolidation*** *to expand market power, capture market share or eliminate competition*
- ***Improve vertical market position*** *to secure raw materials supply or demand or capture synergies*
- ***Capability development*** *to extend the product portfolio or acquire knowledge and R&D*
- ***Profitability improvement*** *to capture cost and revenue synergies, or sell unprofitable business segments*
- ***Opportunistic value*** *to acquire undervalued companies for turnaround, or sell overvalued business segments*

Possible targets will then be assessed according to their market position, their product portfolios, financial strength, operational competitiveness, and future potential and risks.

Planning and deal execution

When the target is identified, it should be approached impartially. To get a solid view of the value of a target and its synergy potentials, a proper due diligence must be conducted. A decision to acquire, or not to acquire a company must be fact-based and must be derived from carefully weighing all variables assessing both quantitative and qualitative information. This serves as a basis for the value of a target.

Due diligence data serves to identify potential risks, to identify synergies, to determine the terms of the deal, as well as to incorporate the findings in the planning for the post-deal optimization. Ideally, the due diligence starts during the deal planning phase, initially using already available information. It should then continue throughout the deal planning process as further proprietary information becomes available.

Every piece of available data contributes to the valuation process. In many cases, however, the acquirer might not have access to all the relevant information about suppliers, customers, channel partners or management personnel. Naturally, information sharing will always have to be within the legal and regulatory restrictions. To maximize the quality of the due diligence, it is important to deploy a team with the right skill set and relevant due diligence and industry expertise. Transactions that are completed without a structured and diligent due diligence increase the risk of failure and a potential decline of shareholder value.

Post-Merger Integration

A comprehensive and structured planning of the post-merger efforts, including a cultural assessment before the acquisition, is a must. Lack of cultural fit is cited as a key reason for unsuccessful mergers. Lacking cultural awareness and understanding of the acquired company often lead to resistance and a delay of integration success.

A proper post-merger integration should follow a precise plan with clear milestones, have a clear integration organization and defined roles and responsibilities to ensure synergies will be captured.

Due diligence – Make it or break it

While due diligence is only one part of the overall process, it is the most significant aspect of the whole M&A process. A due diligence can only be considered successful in retrospect, meaning the evaluation of the target is proven to be true in a later stage – even if the target was not acquired.

A thorough due diligence is crucial because it lends comfort to the decision-making process of management, stakeholders and shareholders. It is in every stakeholder's interest to ensure that a rigorous due diligence process is carried out, which provides relative assurance to the decision-making. The process needs to ensure that potential risks have been identified beforehand.

The due diligence process paves the way for a go or no-go decision. In many ways, a strong due diligence capability is one that more often will come to a negative than a positive conclusion. It can be observed frequently that M&A teams and stakeholders are involuntarily too often on the "buy" track. An independent investment review team should be nominated to avoid biased decision-making.

Before undertaking a due diligence, it is important to target those opportunities and risks that are likely to have the most impact on the value. Therefore, the due diligence should be tailored to the type and rationale of the transaction. The due diligence should also address the plans for the target once acquired. The process should further uncover post-merger impacts on existing operations and identify resource capabilities and constraints to be addressed after the acquisition.

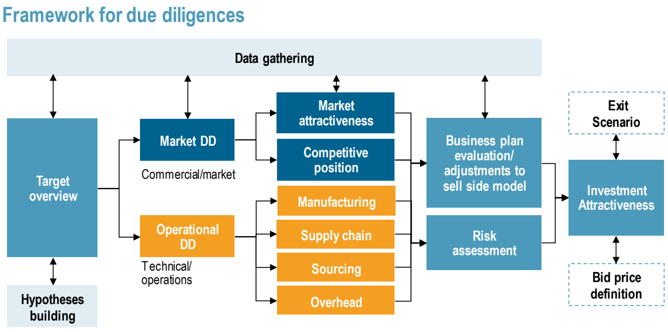


Figure 4: Timetable for operational and market due diligence

To obtain a thorough picture of the risks and opportunities, the due diligence process focuses on many different functions such as Finance, Tax, IT, HR, Legal & tax, R&D, Environment, Operations and Markets. Market and operational due diligences are, however, the key determinants from a forward-looking opportunity and synergy perspective. To conduct such due diligences properly, a thorough understanding of the industry is required.

Market Due Diligence

The target of a market due diligence is to assess the current and future market positioning of a company. The main questions covered are:

1. What is the current market position of the target?
2. How attractive is the current and potential future product & customer portfolio and geographic reach?
3. What are the growth perspectives and market opportunities and risks?

The assessment typically starts by reviewing market dynamics, assessing industry rivalry, reviewing the main market forces, their volatility and impact on the target. The market positioning should be carefully assessed to identify which macro variables are driving demand and which future development perspectives exist. Furthermore, the competitive position of the target should be evaluated on each of the markets, to identify future potential. Additionally, potential new market opportunities must be assessed.

Irrespectively of current product & customer portfolio and market presence, the brand value and expansion potential need to be reviewed. The objective of the product and customer portfolio analysis is to identify opportunities for developing/acquiring new customers, and to assess the risks of losing current volumes or profitability.

In case the target will be integrated into existing operations the potential customer and product overlaps need to be reviewed in terms of opportunity, risks and potential synergies. Pricing and margin analysis on customer and product level should be conducted if possible (assuming confidentiality and regulatory restrictions allow this) to learn more about the profitability.

By combining these findings with overall macroeconomic developments and the competitive position of the target, revenue potentials can be projected providing a view on the value of the company from the market perspective. Additionally, the operational value and risks need to be assessed.

Operational Due Diligence

The operational due diligence will yield:

1. Assessment of the asset conditions and future capital requirements
2. Operational efficiency / performance and potentials for improvement
3. Current and future cost competitiveness

In capital-intensive industries, such as pulp and paper, return on capital KPIs such as ROIC and ROCE are critical for the investment decision. Therefore, it is also essential to understand capital expenditure requirements (CAPEX) already during the due diligence. Thus, the condition of assets (such as production and converting machinery, stock/fiber preparation, energy production, auxiliary and water treatment assets), their cost efficiency, and potential risks (e.g. age, condition) need to be assessed. The findings of this assessment serve as a basis to project future investment or maintenance requirements and to assess the long-term competitiveness of the assets. Future CAPEX requirements may vary significantly, depending on the target's adherence to maintenance plans and the overall maintenance philosophy and capability. It is important to critically review existing CAPEX and investment plans while also reviewing past CAPEX to identify maintenance backlogs and capital requirements. A development strategy will have a significant impact on future capital requirements whereas a stay-in-business strategy usually requires lower CAPEX.

In addition to the future capital requirements, the condition of the assets will also influence the current operational performance. Assessing operational (excellence) capabilities by analyzing the Overall Equipment Effectiveness (OEE) helps to better understand production performance in general and provides details about time, speed and material efficiency. This can be benchmarked against other comparable assets providing a view on competitive ranking and potential improvement opportunities. Apart from the efficiency of assets, the operational capabilities of the target need to be evaluated. Site visits allow to assess the quality of management and staff, review operating and management procedures, process adherence and the improvement culture on the shop floor.

In addition to the condition of assets and production efficiency, the overall cost competitiveness is crucial. Understanding and benchmarking specific consumption levels and prices of the main cost drivers is essential. This includes raw materials, chemicals, auxiliary materials, energy, labor, distribution, and overhead costs.

As raw materials are a main cost driver in the paper industry, they impact competitiveness significantly. Assessment of operational consumption drivers, yield factors, material efficiencies and a review of the sourcing strategy and procurement operations will highlight potentials for improvement.

Improvement in supply chain management immediately drives costs of goods down, and increases the On-Time In-Full (OTIF) delivery. Thus, logistics operations and costs, such as transport costs, truck utilization rates, and warehouse flows, need to be examined and benchmarked. Finally, labor costs are a major component of the cost structure. The organizational efficiency will be analyzed. Benchmarking blue and white-collar staffing levels will help identify potentials for organizational streamlining.

Summarizing findings from the operational due diligence will provide a holistic view on strengths, weaknesses, opportunities and threats. The main interest of any acquisition is to generate returns on the capital divested or invested and increase shareholder value. By evaluating the core of the business, through a proper market and operational due diligence and combining the findings with the other due diligence areas a holistic picture will be created. This picture will then be the foundation for the go/no-go decision, dodging the likelihood of failure and creating a winning acquisition strategy with a tailor-fit due diligence.

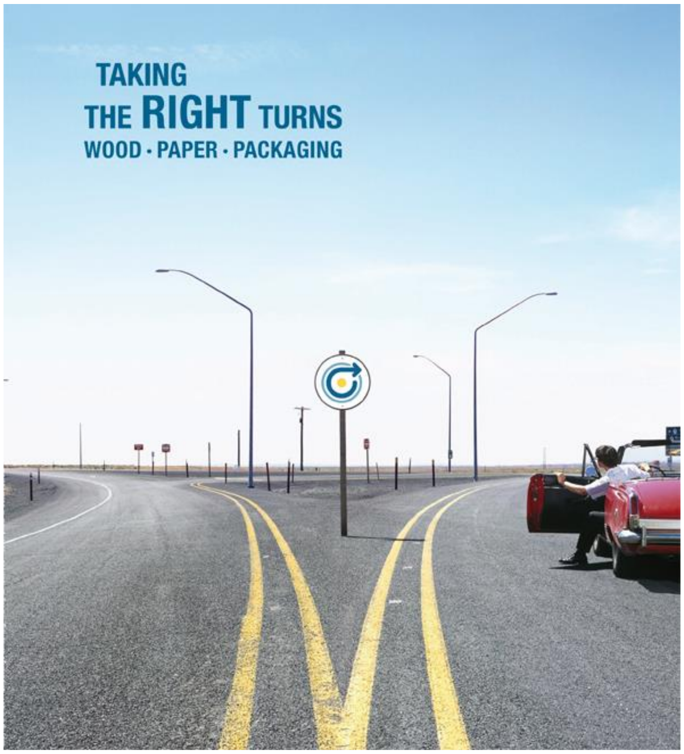
Tailor-fit due diligence - the StepChange Experience

Due diligences must not be considered a simple “check-the-box” exercise. A tailored industry-based approach is needed to master the challenges of a due diligence and come to a credible valuation. As an industry-specialized management consultancy StepChange is ideally positioned to support companies along the entire M&A process. StepChange has helped many industry players, debt and equity investors and stakeholders in target identification, due diligence and PMI with deal values ranging from $50m to $4bn.

StepChange provides strategic, operational and technical industry expertise and best practice support for clients planning to engage in M&A transactions. The foundation for this capability is based on:

- *Operational experience from numerous strategic and operational improvement projects for clients in pulp, paper, packaging and tissue*
- *Accurate valuations on revenue synergies, operational improvement opportunities, capex requirements and integration costs*
- *Availability of benchmarking data to compare targets to other relevant operations and competitors*
- *A diverse and global team of industry consultants, experts and managers that is ready and capable to hit the ground running to deliver results*

By employing this in-depth expertise from across all segments of the pulp, paper, packaging and tissue industry, StepChange can conduct a credible and realistic due diligence to reduce the risk of an acquisition and detail the relevant opportunities to maximize and secure investment return.



About StepChange Consulting

StepChange is an industry focused and independent management consulting company with a proven track record in supporting clients to achieve sustainable value. StepChange provides support to top tier organizations in the industry from strategy development to implementation of operational improvements.

With an international team of industry experts StepChange can hit the ground running. StepChange provides innovative and yet pragmatic solutions, placing an emphasis on delivering measurable business results.

For further inquiries and comments regarding this Point of View please contact us at *leapfrog@stepchange.com*.

Joachim Klein is founder and Managing Director of StepChange Consulting. He has more than 20 years of industry experience, advising global players in the paper value chain in strategy development, M&A, and overall profit and performance improvement.

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