Euphoria: Sustainable or Transitory? Pulp performs and Tissue trumps again!

A review of the financial state of the industry

By Joachim Klein and Sarah Rabl

Going strong

The global economy is going strong despite the many different political challenges across the globe. All large economies have recovered or are in full recovery mode. The forecast for most European economies is looking optimistic again for the first time since the financial crisis. The US economy is growing strongly, Germany has record export and domestic spending levels, China continues to be the driver of global growth, and even Japan is growing moderately. With the continued growth, interest rates can be expected to rise again - not only in the US. So far, a reduction of quantitative easing has not impacted US growth and at some point, it can be expected that the expansive monetary policy will end in Europe as well, ending a long period of cheap money. While more restrictive monetary policies may impact growth, they may be a necessary measure to mitigate future risk.

With growth comes demand for commodities. While publishing grades continue to be impacted by structural changes many companies in the sector have nevertheless performed well. Paper and plastic packaging has been profiting immensely from economic growth and an accelerated growth in ecommerce. Recent eCommerce growth rates have come as a surprise to most companies in the industry as forecasts even in 2016 were rather signaling an oversupply of packaging grades. Many mills have been seeing operating rates of >100% and it seems that all new capacity additions will be absorbed quickly as well. Worrisome is that major information service providers were wrong in their forecasts and did not see these developments coming. Likewise, some of the recent overly euphoric forecasts should be regarded very cautiously.

The tissue sector has continued to develop steadily despite significant new capacity and a lot of oversupply in most markets. Profitability of the sector remains the highest of all segments in StepChange B3NCH. Flexible packaging continues to thrive as well, profiting from the economic growth and societal trends.

Economic growth combined with increased demand for packaging is driving the outperformance of many companies in the sector. However, there are many trends and developments to be watched that may radically change consumer behavior and subsequently demand for packaging. Some of these drivers are the increasing awareness and skepticism about packaging waste, disposable packaging, and the sustainability and CO_2 footprint of the whole value chain (including logistics). Additionally, the need for display packaging may be impacted altogether with the rapid growth of ecommerce. This growth drives a potential shift from physical shelf-driven marketing to online presentation of products.

For now, however, the industry has every reason and right to celebrate. Results are overall very positive and the industry is healthy across all regions after many years of restructuring and rebuilding. The following is a summary of the 2017 StepChange B3NCH financial peer group comparison from five different segments. B3NCH includes 64 stock-listed companies from different segments. Combined the market capitalization of these companies make up the StepChange B3NCH Index (SBI).

StepChange B3nch Index (SBI)

The performance of the index over a period from late 2012 until February 2018 shows the extraordinary performance of pulp, paper and packaging companies. The SBI outperformed the S&P 500 for a long time during the observed period and doubled in market capitalization since October 2012. Despite a correction in early February 2018, the SBI still slightly outperforms the S&P 500 (see Figure 1).

Historical development of StepChange B3nch Index (SBI) vs. S&P 500 (10/2012 – 2/2018)

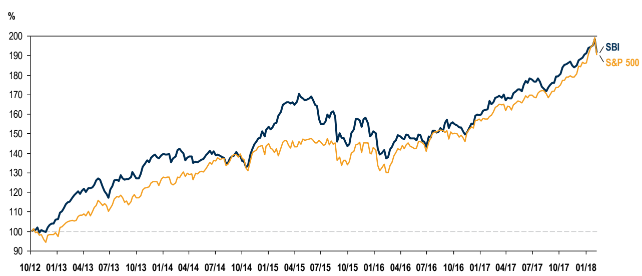

Figure 1: SBI vs. S&P 500 development over 5 years

The growth is primarily driven by the packaging segment with a compound annual growth rate (CAGR) of 14%, the flexibles segment (CAGR of 15%) and pulp (CAGR of 20%) since October 2012.

Comparison across peer groups[1]

The financial analysis covers major stock listed companies from North America, Latin America, Europe and Asia in the different sectors of pulp, paper and packaging from 2013 to 2017.

The peer group comparison shows that tissue remains the peer group leader regarding profitability with 10,3% in 2017, an increase of 2,7pp compared to 2016. The packaging peer group follows with 7,5%, (+2,5pp). The pulp peer group had a drop by 0,6pp to 5,5% compared to 2016. The profitability of the graphics segment grew again in 2017, after a multi-year drop, reaching 4,4%. (see Figure 2).

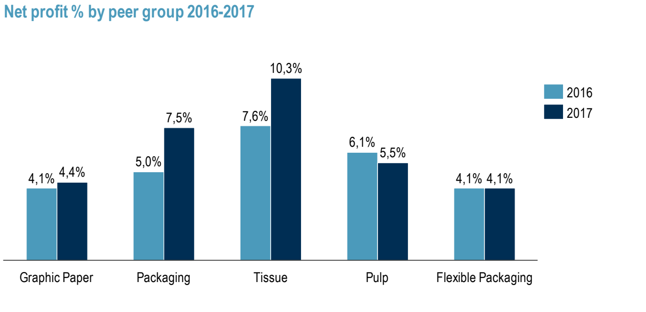

Figure 2: Peer group comparison of net profit results in 2016 and 2017

As in previous years, regional performances differ. In the graphics peer group, European companies are significantly stronger than companies in other regions (10,4% EBIT in 2017). In pulp, Latin American peers lead with an EBIT average of 13,5% which is an improvement of 4,1pp compared to the previous year.

In terms of Return on Capital Employed (ROCE), tissue continues to outperform. However, peer group results are significantly impacted by the high ROCE (35%) of Kimberly-Clark and Hengan International (ROCE of 28%), while the ROCE of other companies remains between -3% and 16%.

Working capital levels decreased for the graphics, packaging and pulp peer groups and remained stable for flexible packaging (Figure 3). Flexible packaging has taken over the leading position of tissue with the lowest working capital at 4,9%. Despite improvements compared to 2016, pulp and graphics peer groups have the highest working capital, at 18,4% and 13,8% respectively.

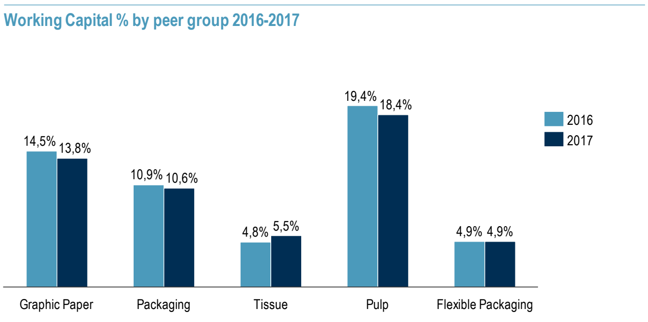

Figure 3: Peer group comparison of working capital performance

Following this segment comparison, the financial performance per segment will be outlined in more detail.

Graphic paper peer group[2]

Highlights: The regional comparison of EBIT from 2012 to 2016 highlights a positive trend for European and Asian companies. Companies from both regions had a positive performance over the past two years. On company level (Figure 4), Asian graphic companies have had stronger EBIT than companies form other regions, driven by the top two graphics players in the peer group: APP – Indah Kiat (16%) and Chenming (20%).

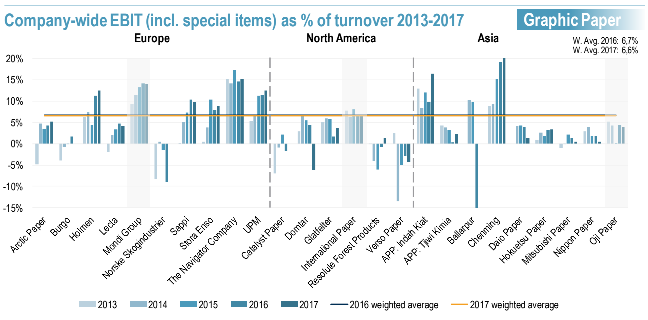

Figure 4: EBIT performance of companies in the graphics peer group

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[1] 2017 results are based on FY-2017 data or H1-2017 extrapolations if full year data 2017 was not available as of February 22nd, 2018.

[2] Data as of February 16th, 2018: Full Year 2017 results available for Holmen, Sappi, Stora Enso, UPM, Domtar, Glatfelter, International Paper, Resolute Forest Products. All other data based on extrapolated H1-2017 results.

The debt ratio in the peer group has remained stable compared to 2016. European companies successfully managed to continuously lower their debt ratios since 2013 such as Sappi, Stora Enso, UPM and Holmen.

Lowlights: Revenues for most companies in graphics are declining. Eight companies in the peer group show a negative multi-year revenue CAGR (see Figure 5).

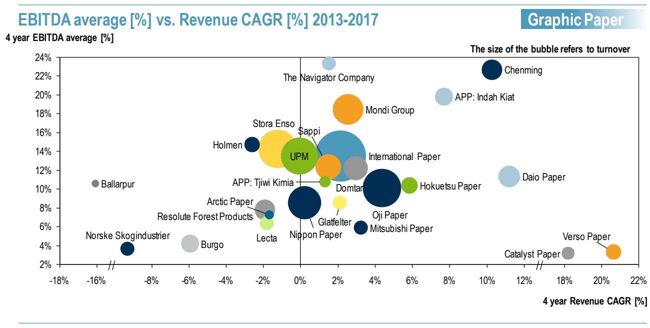

Figure 5: EBITDA average vs. Revenue CAGR of the graphics peer group

Working capital in the peer group remains unchanged on a high level. Working capital levels of North American companies are 6pp above their European competitors. Both regions remain far below the WC levels of Asian companies in the peer group.

Packaging peer group[3]

Highlights: Asian companies in the packaging peer group have taken over the lead from European companies in 2017 with an EBIT of 9,8%. The steep increase in Asia of 43% (2,9pp) compared to the previous year was influenced by strong results from APP (16%), Nine Dragons (17%) and Lee&Man (27%). Among North American peers (Figure 6), PCA outperforms in segment EBITDA (18%). European companies have a strong position in terms of debt ratio with the lowest level among peers.

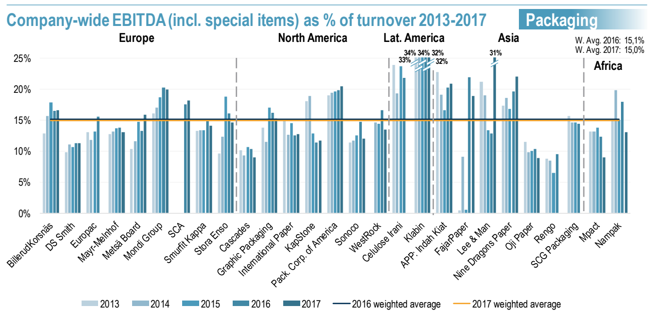

Figure 6: EBITDA performance of companies in the packaging peer group

Lowlights: Overall cash flows in the peer group have dropped. The EBIT results of North European companies are approximately 1/3 below other European companies with at the same time higher working capital requirements. North American companies show comparatively weaker results than European companies in terms of EBIT: Cascades (4%), IP (7%), KapStone (6%) and WestRock (6%). Asian and African companies show below average results for 2017.

Pulp peer group[4]

Highlights: The overall EBIT and EBITDA in the pulp peer group increased in 2017 compared to 2016. Two Latin American companies outperform with above average results in 2017: Fibria (41% EBITDA) and Suzano (42% EBITDA). These two companies also stand out in terms of their positive multi-year revenue CAGR. The recent merger intention will most likely create an even more successful company.

Average ROCE increased by 25% in 2017 compared to the previous year. All European, Latin American and Asian peers have shown a positive ROCE development. The regional leaders are Altri in Europe with a ROCE of 14%, Canfor Pulp in North America with 17% ROCE and Suzano in Latin America with a 13% ROCE. (see Figure 7).

[3] Data as of February 16th, 2018: Full Year 2017 results available for BillerudKorsnäs, Metsä Board, SCA, Smurfit Kappa, Stora Enso, Graphic Packaging, International Paper, KapStone, Pack. Corp. of America, Sonoco, WestRock, Klabin, Nine Dragons Paper, Nampak. All other data based on extrapolated H1-2017 results.

[4] Data as of February 16th, 2018: Full Year 2017 results available for Metsä Group, Rottneros, Stora Enso, UPM, Domtar, Mercer International, Fibria, Suzano. All other data based on extrapolated H1-2017 results.

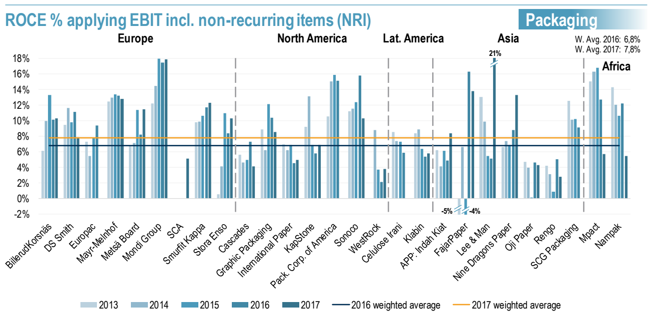

Figure 7: ROCE on a company level in the pulp peer group

Lowlights: Overall net profit for the pulp peer group is down by 10% or 0,6pp. In terms of EBITDA, all North American peers are below the peer group average of 18,5%, except for Altri and Ence. In Latin America, CMPC and Arauco are below the peer group average of 20,0%. Despite the 5% decrease in working capital, the pulp peer group still has the highest working capital compared to all other peer groups. Regionally, Latin American peers have the highest working capital, despite slight improvements (see Figure 8).

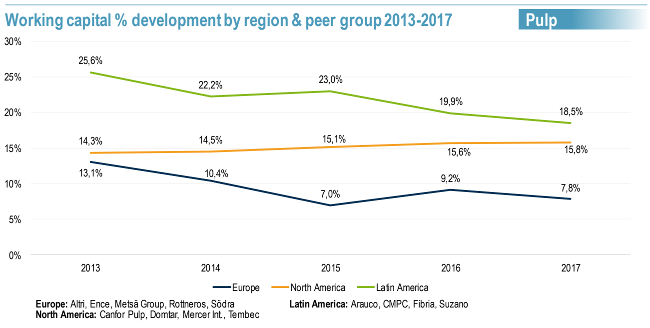

Figure 8: Working capital levels by region in the pulp peer group

Tissue peer group[5]

Highlights: The 2017 EBITDA results of the Tissue peer group remained on a similar level than in the previous year. Hengan continues to lead the peer group for the fifth year in a row, with an EBITDA of 31% in 2017. Kimberly-Clark also had a very strong EBITDA of 22%. P&G Hygiene is the leading tissue segment in terms of EBIT in North America. As for net profits, the peer group improved by 36%, driven by Cascades (23%), Unicharm (9%) and Essity (8%)- see Figure 9.

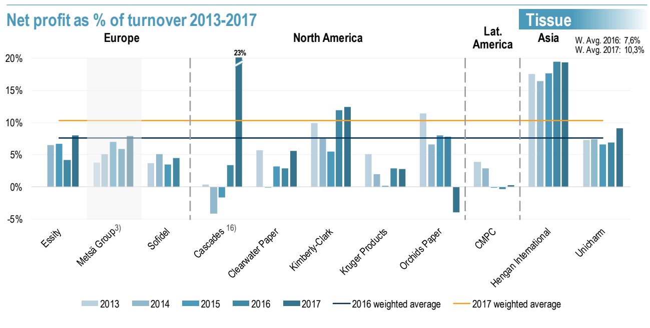

Figure 9: Net profit development of companies active in tissue

Lowlights: The working capital levels of the tissue peer group increased by 20% in 2017. Despite this increase tissue remains the peer group with the second lowest working capital. Companies with above average Working Capital were Hengan (22%), CMPC (24%) and Orchids (11%). Orchid's EBITDA also decreased to 5% - well below peer group average (see Figure 10). Regarding debt ratio, tissue remains higher than packaging and graphics.

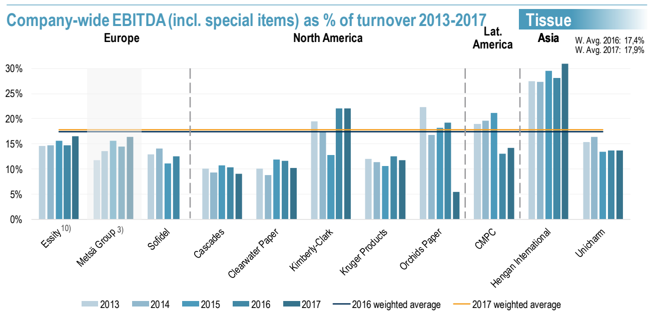

Figure 10: EBITDA performance of companies in the tissue peer group

Flexibles peer group[6]

Highlights: Most companies in the flexibles peer group have achieved an average multi-year EBITDA of above 10% and positive revenue growth (see Figure 11). EBITDA on a company level increased by 4,6% in 2017. Two companies reached an above peer group average of 13,6%: Amcor (15%), and Sealed Air (16%), (see Figure 11Figure 10). EBIT development per company remains stable in 2017. In terms of ROCE, the peer group experienced an 8% increase in 2017 compared to the previous year.

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[5] Data as of February 16th, 2018: Full Year 2017 results available for Essity, Metsä Group, Clearwater Paper, Kimberly-Clark. All other data based on extrapolated H1-2017 results.

[6] Data as of February 16th, 2018: Full Year 2017 results available for Amcor, Huhtamaki, Sealed Air, Nampak. All other data based on extrapolated H1-2017 results.

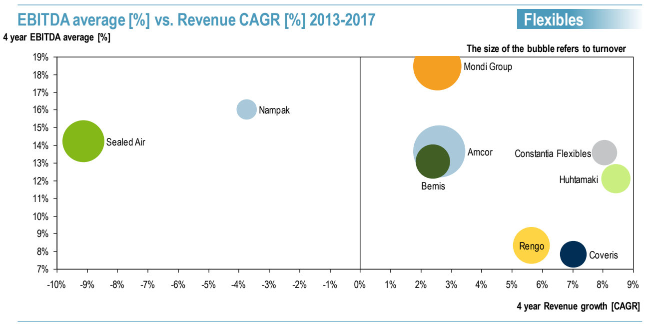


Figure 11: EBITDA average vs. Revenue CAGR of the flexibles peer group

Lowlights: Working capital levels of the flexibles peer group have remained stable. However, on a company level steep increases occurred for the following companies: Nampak Working Capital increased from 8% to 11%, Huhtamaki from 12% to 14% and Coveris increased from 9% to 12%. Operating cash flows declined by 26% compared to 2016. Sealed Air experienced the largest relative drop (Figure 12Figure 11). The segment is highly leveraged. Debt levels remain high with three companies above 90%: Amcor (90%), Coveris (97%) and Sealed Air (97%).

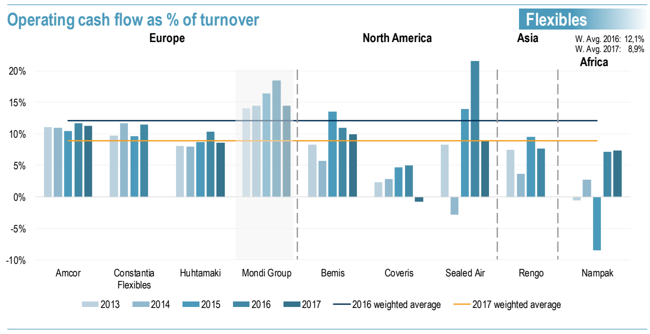
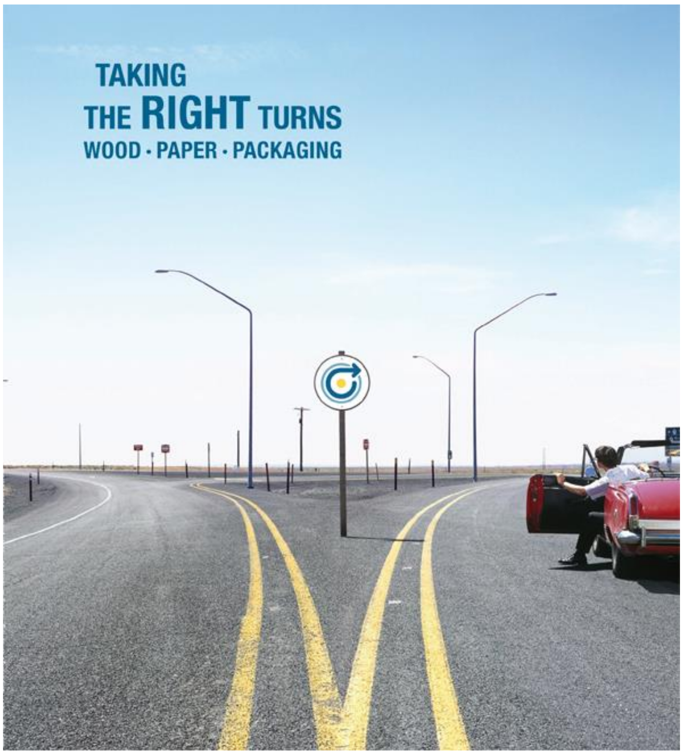


Figure 12: Operating cash flows in the flexibles peer group

Outlook

Most companies in pulp, paper and packaging are healthy and performing well. Profits have remained positive or even continuously grown. While tissue and pulp outperform, tissue shows more stable long-term results with less cyclical risk. Even many companies structurally exposed to declining markets in graphic papers are delivering significant shareholder returns. Across all segments cash flows are mostly positive and Working Capital under control. Debt levels and investments vary by region, with North American companies generally having a higher risk exposure and lower investment ratios. The global economy continues to grow and the industry is well positioned on the one hand for further growth but on the other hand also stable enough to withstand potentially upcoming storms. Overall the strong performance is attracting more interest from investors and the financial community. While there has been significant M&A activity, concentration levels in most sectors and regions remain rather low so that more M&A activity can be expected. Especially Europe and Asia are more fragmented than North America and Latin America. Looking ahead, industry dynamics can be expected to remain highly interesting in this sustainable industry. The industry has a unique position to create significant value for both its customers and shareholders with traditional products and services but potentially also with new opportunities. The industry is best positioned to leverage the best of two worlds. Sustainable and innovative value for the customer and value for its shareholders. From this perspective the industry may not have played its last trump yet.



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*.

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