Forest Research Group

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## First TIMOs, Now MIMOs?

In a recent Forest Research Note (Vol 3 No 1), we discussed some of the concerns that had been expressed about Timberland Investment Management Organization (TIMO) ownership of timberlands in the Unites States. Some of these included the seemingly short investment horizons employed by these TIMOs and their impact on the forest products industry.

However, the growth in TIMO ownership of timberlands had been accompanied by the growth in MIMO ownership of wood-consuming mills. What are MIMOs? They are Mill Investment Management Organizations—more commonly known as private equity investors focusing on mills. While some have purchased sawmills or panel plants, there have been some spectacular purchases of pulp and paper mills.

In recent transactions and current developments:

- Madison Dearborn bought Packaging Corporation of America from Tenneco in January, 1999 and they then bought the paper and forest products assets of Boise Cascade in late 2004.
- Koch Industries bought some Georgia-Pacific pulp operations in 2004, then bought what remained of the company in 2005 (after G-P sold four mills to Domtar in 2001).
- Cerberus (New Page) bought MeadWestvaco's paper mills in 2005.
- Apollo (Verso) bought International Paper's coated paper mills in 2006.
- Stone Arcade (Kapstone) bought International Paper's kraft paper mill in 2006.
- Third Avenue Management is in the process of buying Catalyst Paper in BC.
- Obsidian is trying to buy Longview Fibre.

### *How is This Different than Years of Management Buyouts in the Past?*

In the past, mill managements have bought mills that were otherwise scheduled for closing. These were not investment groups placing private equity (though some of the financing may have been in the form of private equity placements), these were facility managers and unions buying the mills in an attempt to save jobs. Often the State or Province in which the mill is located would step in with tax breaks and other financial support to save the hundreds of jobs that might otherwise be lost if the pulp and paper mill complex were to close.

An example of this is the Blue Ridge Paper buyout of the former Champion International mill in Canton, North Carolina. In this case, a large company was shedding a single mill which it considered unprofitable. On June 22, 1999, the Wall Street Journal published an article about the Blue Ridge/Champion transaction with the following headline: "Paper-Mill Workers Package Their Own: Employees Save Their Jobs By Buying The Company".

The current situation is large companies shedding whole divisions at once, usually to focus on either paper or packaging grades. These whole divisions may have only been recently assembled, and in some cases, the "division" is a single mill.

For example, the 2006 sale of IP's coated and supercalendered paper mills in the United States included two former IP mills (Jay, ME and Sartell, MN), and two former Champion mill (Quinnesec, MI and Bucksport, ME) acquired in the 2000 purchase of Champion. The Bucksport mill was acquired by Champion in its buyout of St. Regis Paper.

Mead Westvaco sold its Papers Group to Cerberus Capital Management early in 2005 to focus on packaging and international operations. The Paper Group had only been in existence since 2002 when Mead and Westvaco merged. Cerberus bought five mills: 3 former Mead mills in Chillicothe, OH; Escanaba, MI; and Rumford, ME, and 2 former Westvaco mills in Luke, MD; and Wickliffe, KY. Mead had owned the mill in Maine for only 9 years, having purchased it from Boise in 1996.

Koch bought a Georgia-Pacific that differed greatly from the company that had existed just a few years before. G-P purchased Fort James in 2000, sold four mills to Domtar in 2001, then proposed to split the company back into essentially its original components in 2002, but refrained from doing so in the face of market conditions at that time.

In the single-mill-division category is, for example, Kapstone's purchase of International Paper's kraft paper mill.

## *A Distorted 30-Year History of the Pulp and Paper Industry*

Why is the pulp and paper industry shedding such large chunks of assets? The industry seems to adopt a new strategy every decade or so—and we are due for a new one.

### Make Every Kind of Paper

Years ago, paper companies were busy buying each other up, and the strategy appeared to be to produce every kind of paper and packaging that existed. Paper companies were buying packaging companies and vice versa. And they were buying or building wood products companies and divisions. For example, US Plywood and Champion Papers merged in ancient times (the 1970s) and formed Champion International. Not long after that, Champion picked up Hoerner Waldorf, a packaging company (which was then spun off and purchased by Rock-Tenn in 1996). Another ancient merger was the joining of Nekoosa Papers of Wisconsin and Great Northern Paper of Maine to form Great Northern Nekoosa.

Conglomerates were popular in those days and some were interested in adding pulp and paper production to their portfolios. ITT picked up Rayonier and Gulf & Western bought Brown Company, owner of the now closed Fraser mill in Berlin, NH.

### Own as Much Timberland as Possible

In the early 1980s, it was widely believed that paper companies needed to be self-sufficient in timberland and timber in order to be profitable. Wall Street calculated how much timberland each paper company owned and how fiber-self-sufficient they were. Container Corporation of America, then a subsidiary of Mobil, went on a timberland buying binge and added a quarter-million acres or so to reach over a million acres of fee and lease lands by 1985. (The company ended up as part of Smurfit-Stone Container, which sold the CCA timberlands to Rayonier in 1996.)

### Sell Timberland and Consolidate

By the mid-1990s, it was widely believed that paper companies needed to sell their timberland and consolidate in order to be profitable. This was an often-repeated theme of presentations at, for example, the AIMR conference in Vancouver, BC in 1996.

The theory on consolidation was that the industry had too much capacity in many paper and paperboard grades. But few companies were willing to shut down a paper machine because it would mean shutting down a quarter, or a third, or a half of that company's capacity in that grade. Through consolidation—by buying other companies—that paper machine might only represent a tenth of the larger company's capacity, and would therefore be easier to shut down.

There were some spectacular consolidation efforts: Fort Howard and James River merged, then were bought by Georgia-Pacific. International Paper bought Union Camp, Champion International and Federal Paper Board. International Paper ended up owning most or all of the pulp mills in some regions of the South. Stora Enso bought Consolidated Papers. Weyerhaeuser bought Willamette and MacMillan Bloedel. Mead and Westvaco merged.

Companies also sold their timberland. A New Hampshire forester noted that selling timberland is a powerful drug: it is an easy way to raise $50 or $100 million in a hurry, and you can do it year after year for several years—but then it is gone! Bowater, James River and Smurfit-Stone Container, among others, unloaded their timberland at this time. Georgia-Pacific put its timberland into a letter stock organization, which then merged with Plum Creek. Interestingly, the sale of timberland as advocated by Wall Street seemed to have little effect on the stock prices of those companies that sold. In an analysis done in 1999, stock prices of companies that added to their timberland holdings did no better or worse than companies that liquidated all their holdings. Master Limited Partnerships (MLPs), letter stocks and other innovative structures had little impact on improving stock prices (Lutz 1999).

## New Decade, New Strategy

Now the consolidation strategy appears to have fallen out of favor and been replaced by a strategy of focusing on one or a few grades. Weyerhaeuser is merging its fine paper division into Domtar—one of few sales ***not*** to private equity investors.

This comes at a time when investors appear to be disappointed with returns from stocks and bonds and are pouring funds into private equity investments of all kinds—including timberland and mills.

## *What Will Happen Now?*

Most of the new companies are smaller. The old (1990s) consolidation theory suggests they will be less likely to shut down machines because each machine again represents a large portion of the each company's capacity.

But the smaller, privately-held companies may be able to react more quickly to changes in their markets, and by focusing on a few grades they may be able to compete better in those markets.

Even at the operating level they may have some advantages over their bigger competitors. A former forestry classmate at a Maine mill belonging to one of the new companies says local management has been given significantly more authority to make decisions based on local conditions. The former parent was far more bureaucratic and slow to respond to issues at the mills.

That's the good news. But, it appears that the small companies are ignoring the fact that they are small and are actually shutting down machines and mills.

After its purchase of Georgia-Pacific, Koch moved quickly to close the mill in Old Town, ME, but is adding a paper machine in Oregon.

In early November, NewPage announced it was permanently shutting down a paper machine at its mill in Luke, MD. This machine was originally installed in 1904 and represented about 15% of the mill's capacity and nearly 5% of the entire company's capacity. 130 jobs are being eliminated. In addition, the company announced it was curtailing production on one machine at its mill in Rumford, ME for 3 months.

So it appears that we are going to have more efficient, smaller pulp and paper companies to sell wood to.

### *Why Does it Matter to Timberland Investors?*

In order to maximize returns, timberland owners need a market outlet for small or poor quality material. Pulp mills consume such material in huge volumes. Having one or more of the local pulp mills shut down machines can make it more difficult to remove it.

Some management regimes include thinning operations—removing some of the trees in a stand to allo(w the remaining trees to grow larger faster. Under such regimes, trees are planted relatively close together to help control competing vegetation and promote better tree form. At some point 3 or 5 or 10 or 15 years after planting, the tree crowns will have completely closed in and the trees will begin competing for room and nutrients. Thinning the stand at this time will create more room and allow the remaining trees to capture more of the available moisture and nutrients.

The stems removed during thinning operations are usually small. Without markets like pulp mills, the ability to thin may be greatly reduced. Stands can be planted and managed so that thinning is **not** required, but the stand must be managed that way from the beginning—the trees must be planted at greater spacing. If a stand is planted in such a way that a thinning operation is expected and required, then **not** thinning could have a significant negative impact on the growth rate of the stand and its eventual yield.

So having the local pulp mill close is not good. But, pulp mills aren't the only user of small and low-quality wood. Oriented Strand Board (OSB) mills have become an important replacement market for pulpwood. OSB capacity has increased rapidly in the South, which is good news for timberland investors in that region. Unfortunately for investors in the Northeast, though, OSB capacity has not increased much there. (Thinning is less common in Northern forests, but low quality wood is plentiful.)

### *Wood Products, Too*

We have focused on pulp mills, but private equity investments are also being made in wood product facilities. What is the likely outcome here? Will the new investors pump capital into their facilities to improve operations and efficiency and increase output? Or will they take as much cash as they can out of the operations and let the facilities fall apart?

Similar questions have been asked about TIMOs.

### *References*

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Jack Lutz, PhD
Forest Economist
Forest Research Group
66 Old Stagecoach Road
Alton, Maine 04468
(207) 827-1019
jlutz@forestresearchgroup.com
www.forestresearchgroup.com