



MADISON'S TIMBER PREVIEW

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Containerboard prices and inventory levels are an excellent indicator of future economic conditions. When retail sales and consumer product shipments are down, orders for containerboard also drop causing price softening. The reverse is equally true, when product manufacturers start to feel more confidence, when demand for their products increases, they order more packaging material in advance of shipment dates.

Containerboard production in mid-2010 increased 12.6 per cent over 2009 and, after a series of incremental hikes totalling US\$120, prices in June hovered around \$650 per metric ton. A few companies were announcing further price increases, but a consensus of analysts proclaimed containerboard prices would soften in the first two quarters of 2011.

In the first 28 days of 2011, prices have remained level, with at least one North American producer and two in Europe belying analyst predictions by announcing \$60 increases for the near future. Weekly pulp and paper price tracker FOEX Tuesday pegged linerboard prices at €603 per metric ton in Europe. As if this did not have industry watchers feeling bullish enough, the announcement late Sunday of Rock-Tenn Co's acquisition of the bankrupt Smurfit-Stone Container Corp sent waves of excitement through analyst and investment circles, with much re-evaluating of numbers. Refer to the June 24, 2010 issue of your *Madison's Timber Preview* for details on Smurfit-Stone emerging from bankruptcy.

The purchase deal is for US\$3.5 billion in cash and stock with the combined company to have annual sales of more than US\$9 billion, making it one of the largest North American paperboard companies with 7.5 million metric tons in annual production, and tripling Rock-Tenn's previous sales levels.

In addition to the US\$3.5 billion of equity value, US\$700 million of net debt and US\$700 million of after-tax unfunded pension liability bring the total purchase consideration to approximately US\$5 billion. At total capacity of 7.5 million metric tons, a US\$50 per metric ton price change would increase the combined company earnings per share by US\$3.40.

Both companies' boards agreed to the half-stock, half-cash deal. Norcross, GA-based Rock-Tenn will pay US\$35 per share for Smurfit, out of Chicago, IL, using a combination of its own stock and cash on hand. The deal is expected to close late in 2Q 2011.

Rock-Tenn has already revealed plans to raise new equity of US\$1.8 billion by issuing 30.9 million new shares. The market capitalization of the joined company will expand by nearly US\$2 billion with the issuance of these new shares.

Rumours abound that Smurfit agreed to purchase by this competitor because the deal provided the opportunity for debt-holders to quickly exit the company as an investment. A number of law firms across the US have jumped at the chance to launch a suit and quickly announced investigations of the Smurfit board for possible breaches of fiduciary duty by failing to adequately shop the company. Also in question is whether Rock-Tenn is underpaying for Smurfit shares, thus unlawfully harming Smurfit stockholders.

Rock-Tenn has an approximate EDITDA of US\$500 million, against a current enterprise value of US\$3.7 billion, equating to a 7.5 multiple. Smurfit-Stone has about US\$700 million in EDITDA, mul-

plied by 7.5x, equates to a US\$5.2 billion valuation and US\$45 a share. Monday morning's price for Smurfit was \$37 per share, suggesting about 20 per cent being left on the table.

Stock market reactions to the purchase were immediate; Smurfit shares climbed 27 per cent to close Monday at US\$35, while Rock-Tenn's rose 3.7 per cent to US\$28.81. Enthusiasm leaked into other packaging company shares, specifically Packaging Corp rose 2 per cent, to close at \$28.89, while Temple-Inland Inc rose 5.3 per cent.

Mark Wilde, equity research analyst for the paper industry at Deutsche Bank, sent a note early Monday morning detailing, "In this deal, Rock-Tenn will benefit from the use of Smurfit's approximately US\$500 million in net operating loss (NOL). If containerboard pricing remains strong and Rock-Tenn can leverage that NOL, debt could fall quickly. Moreover, the deal places a stumbling industry giant in the hands of a well-regarded management team. If they can turn around a demoralized Smurfit organization and boost relative margins, there could be real upside EBITDA leverage in this transaction.

"Smurfit's huge Stevenson, AL mill could go up against any corrugating medium-grade mill in North America. That mill was expanded and rebuilt for US\$500 million-to-US\$1 billion by MeadWestvaco in the late 1990s. Smurfit mills like West Point, VA were also recapitalized in the late 1990's, but others will pose bigger challenges," summed up Wilde.

Rock-Tenn made what proved to be an excellent deal for Gulf States Paper in 2005; nearly one-half of that acquisition debt was repaid within 3 years. Since 2008, Rock-Tenn's earnings power has reached a new and higher plateau, aided by the acquisition of Southern Container out of Dayton, NJ, capacity rationalization in paperboard markets, internal cost cutting, and solid execution. Surveys show industry leaders have consistently ranked Rock-Tenn as the most respected packaging manufacturer in the US, after Packaging Corp. Most of Smurfit's mill managers have been replaced in the past year after Michael Exner came on as Senior Vice President of Containerboard Mill Operations. Rock-Tenn was a 100 per cent recycled fibre producer, so another benefit is that the combined company will now use 55 per cent virgin fibre and 45 per cent recycled as feedstock. The reduced exposure to highly-volatile recycled fibre gives the firm a more diverse and stable cost profile.

Chip Dillion, research analyst at Credit Suisse, declared in his own note, "In fiscal 2012, we see Rock-Tenn with the ability to generate US\$12.20 in per share free cash flow (before dividends), up 35 per cent from the US\$9.05 we estimate on a standalone basis. In fiscal 2013, we would expect a modest improvement from our US\$7.95 free cash estimate."

Gossip currently floating around the industry suggests that many think there will be a merger of two out of Georgia-Pacific, Temple Inland, and Packaging Corp; Georgia-Pacific will almost certainly be involved. Others indicate that bidders for Longview, another producer rumoured to be poised for takeover, include Boise and private equity interests.

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