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The Navigator Company: The path towards a **new cycle**? Which **investment** to choose?

Case Study

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Abstract

The Navigator Company case presents a realistic situation wherein a multinational manufacturer of pulp and paper enters in a new cycle in order to improve its international competitiveness. For that reason, three alternative investment opportunities arose. In the case study context, all alternatives are analyzed in order to assess the fit with the company's new motto and the compliance with the financial requirements. All that takes place in the year of 2014, with the entrance of a new CEO, coinciding with the period straight after the crisis. The circumstances that The Navigator Company faced at that time provide an interesting case study on the topic of strategic growth and M&A.

Company strategy

Investment alternatives

M&A

Introduction

After 6 years leading Açoreana Seguros, in April 2014, Diogo da Silveira assumes the position of CEO at Portucel. Despite his vast professional experience in command of several companies, this new cycle as CEO of a leading force in the international pulp and paper market will be full of challenges. Both his formation abroad and his professional career in Portugal, France, Sweden and Germany, in areas such as telecommunications, technology, industry and the financial sector, will leverage Portucel's objectives to become a brand with a strong international presence. In a press release by Portucel, it was affirmed that this is part of a new cycle in the management of the society, underlying its international expansion.

More precisely, the internationalization is based on the strategic development and creation of new business areas in order to reach a relevant and undisputed position in the global market. In that sense, several business alternatives arose: tissue and pellets. With lack of expertise in those new sectors, Diogo da Silveira faced a serious decision on whether to acquire, create a joint venture or built from scratch in order to pursue it. With different levels of commitment and risk, all these alternatives imply a serious investment that might affect the traditional and cash flow positive business area of Portucel, production of pulp and paper. This, straight after the crisis, was not easy to get.

Nevertheless, the company faced an immediate problem, the decrease in profits. In comparison with the corresponding period of the year 2013, Portucel's profit decreased 13,6% in 2014, to 181,5M euros. However, in that same year records of production and sales were reached. With the production growing at 2,5% to 1.564M tons and an increase in sales of 0,8% over the previous year. It was clear that the problem was not related with the mills' capacity to produce and market consumption of pulp and paper. The decline in prices of the

goods had an impact in the EBITDA to 328,2M euros, less 6,3% than 2013. Additionally, the financial results worsened, reaching 34,2M euros, more 141,4% than last year.

Besides the already spoken improvements and developments in the operational areas of Portucel, Diogo da Silveira and Manuel Regalado, company's CFO, are entitled to pursue with the renegotiation of debt. That will have an impact in the financial results of the company, which ultimately, will affect the capacity to have access to capital to invest and, as consequence, its position as a leader in the market.

As emphasized by the company and released in its 2014 motto, Portucel's main objectives are the consolidation and expansion of the existent brands and products in the international market and, the development of new and fast growing business lines. Despite what the forecasts predict for these alternatives, in a particularly difficult economic environment where the prices of pulp and paper continue to decline, there is the urgent need to focus also on the operational efficiency of the company. That, align with the negative financial results of 2014, could undermine the international competitiveness of Portucel. As consequence, there is an urge to make the right decisions, allocate capital in the right business areas and continue the path to renegotiate debt.

Overview of Navigator and the Portuguese pulp and paper market

1) The birth of a Global pioneer

The history of The Navigator Company dates back on the 1950s, when the grandfather of the current Chairman of the Board of Directors, Pedro Queiroz Pereira, opened Companhia Portuguesa de Celulose in Cácia, the first relevant pulp mill based in Portugal. However, the

first significant breakthrough was in the year of 1957, when a team of technicians were the first in the world to produce paper pulp from eucalyptus using the kraft process. It is an important milestone that marks the starting point of a journey from a local based pulp mill, into one of the world's leading manufacturers.

2) Period of restructurings and consolidations

Over the following decades, Companhia Portuguesa de Celulose grew and built new mills. Along that same period, other companies, as Inapa and Socel, followed the same path and started the production of pulp and paper. A key moment dates back to 1975, when Portucel was officially created throughout the merger of several Portuguese pulp and paper mills and packaging factories.

The route towards consolidation continued until the beginning of the 21st century. With the acquisition of Papeis Inapa, in 2000, and Soporcel, in 2001 an end of an era was marked. These two acquisitions were decisive to the effective consolidation of the Portuguese pulp and paper industry. The creation of The Navigator Company was one-step closer.

3) Holding company

In 2004, Semapa acquired 67,1% stake in Portucel, S.A.. Under new ownership, the company strengthened its position in the international market, by increasing its exports, that reached 3% of Portuguese export goods in 2007. At the same time, Portucel become a key player in the Portuguese economy, representing approximately 2% of manufacturer GDP.

4) Boost in production – “About the future”

With eyes in the future, it was constructed two new paper mills in Setúbal Industrial Complex. It was not just a milestone for the company, but a decisive boost for Portugal's

industrial capacity. Further national and international projects were done in the following years, more precisely the new venture in Mozambique, by setting up the largest integrated forestry, paper pulp and energy project in the country. That led Portucel as the leading European manufacturer of uncoated woodfree (UWF) printing and writing paper and placed Portugal at the top of the European ranking of countries manufacturing this type of paper.

5) “Commitment to an increasingly sustainable future”

Major capital projects were done in the years of 2009 and 2010, which positioned the company as a leading producer of electricity from forest biomass of Portugal. That shows an increasing investment in business units apart from production of pulp and paper and a stronger concern with corporate sustainability. However, the company investment strategy remained strongly associated with eucalyptus, a possible way of leveraging its expertise in working with that good.

6) “Expanding the horizons”

By the year of 2013, the company already reached record outputs in several of its plants.

Currently, at the beginning of 2014, with the signing of the contract related to Cacia’s capital project, Portucel’s leaders were wondering where to expand its investments.

That was exactly the situation that Diogo da Silveira faced as soon as he assumed the charge. However, this new cycle came with several goals and assumptions that would have to be taken into consideration at the time of the decision. So, in the first meetings all objectives and the resources available were scrutinized in order to come up with a more structure list of objects of study during the decision process.

(1) Replicate The Navigator Company’s strategy used in UWF paper

- (2) Invest in a growing market
- (3) Diversification of the company's portfolio
- (4) Ability to develop a competitive advantage with pulp integration
- (5) State of the art technology solution (The Navigator Company's DNA)
- (6) Become a very competitive player in the region

With these thoughts in mind, three alternative ideas arose:

- (i) Increase the efficiency of UWF paper production
- (ii) Build from scratch a pellets factory in US
- (iii) Invest in the tissue market by acquiring an existing factory in Europe

New cycle, new people, new obstacles, greater objectives

Now, in the start of 2015, it is up to the board to consider the three investment alternatives and decide which one pursue. For that, it is important to take into consideration both the new cycle and the historical path of The Navigator Company.

(i) Increase the efficiency of UWF paper production

Uncoated Woodfree paper production and market is currently the Navigator's core business unit and despite the recent struggle in margins and competition, characteristic of mature markets, there are still some opportunities out there in the market to be explored. The company's expertise in that area can be easily leverage to improve efficiency, conquer new markets and consolidate/ defend market share where it currently operates. Additionally, as the price of goods produced continue to decrease, the need to improve efficiency and safeguard

the company's margins and future competitiveness, were points favoring this investment opportunity.

In order to consider this investment, several internal analysis were conducted regarding: (1) Pricing, (2) Margins, (3) Investment (4) Return and ultimately the (5) Competition in UWF paper market.

(1) Pricing:

The relevant prices for UWF paper production are both the pulp and the paper prices. For pulp, the price is computed having into consideration the reference price of BHKP EUR/ton or USD/ton, to which is applied an average 25% discount to get the net price. For the price of paper UWF, the reference price is A4 B-Copy (Eur/ton), which is computed by averaging the practiced prices of a group of relevant producers from Europe. Additionally, Navigator's average price results from the average of prices from USA, Africa and Middle East, particularly the EURUSD. Despite this being considered an advantage in the pricing of the goods produced, if Navigator opts to invest outside Europe, there might arise concerns with the cambial differences, transfer prices across the company and ultimately the differences in the price fluctuations.

(2) Margins:

Navigator margins are superior, when compared to its closer competitors, due to its differentiation strategy. However, different regions have different production costs, which should be taken into consideration when computing the margin and return of the investment.

To compute the margin it is needed to assess all the relevant raw materials prices and production costs that constitute the cost of goods sold (COGS) of Navigator. Paper, pulp,

eucalyptus, electricity, working force and water should be taken into consideration for the analysis

For the purpose of this case, it will be assumed that management and administrative tasks are resources that the company currently has, meaning that overhead costs are already included.

(3) Investment

The purpose of this investment is related with the increase in efficiency by lowering the production costs. In the table below, the relevant cost reductions are listed according to the area of impact:

- Wood logistics: 6,2 M
- Energy purchases: 5,2 M
- Packaging purchases: 4,6 M
- Pulp and paper logistics: 2,2 M

That reduction in cost will have a positive impact in EBITDA of 18,2 M in 3 years time. The reduction in costs will continue every year over the lifetime of the factory.

To achieve this efficiency improvement, The Navigator Company will have to invest around 85M euros over the next 3 years. Additionally, after the investment is materialized, 5M euros are necessary to ensure cost reduction.

(4) Return

The Navigator Company's investment strategy has as baseline the historical return on capital investment (ROCE). So, all the investments pursued are required to have a ROCE above 12,8% in order to be considered for approval.

(5) Competition in UWF paper market

Another criteria that should be taken into consideration when analyzing the investment in efficiency, is the risk that might arise due to the increase in competition. With the decrease in prices of the goods produced, other relevant players in the market might follow the same path towards efficiency and undermine the margins of Navigator by entering in a price war. For that reason, it is estimated a decrease in price of 2,5% per year after the conclusion of the investment project.

Relevant competitors in pulp and paper market are listed below:

- Mondi is an international packaging and paper group with more than 7.000 million € in revenue and 100 production sites across 30 countries (Europe, Russia, North America and South Africa). As The Navigator Company, Mondi is a fully integrated value chain of the packaging and paper production. It manages all the activities from the growing of wood and the manufacturing of pulp and paper, to the conversion of packaging papers into corrugated packaging, industrial bags, extrusion coatings and release liner. It has listings on the Johannesburg Stock Exchange and the London Stock Exchange.
- Stora Enso Oyj is pulp and paper manufacturer headquartered in Helsinki, Finland. Stora Enso has significant operations in all four continents, generating more than 10.000 million € in revenues. The company was formed in 1998 by the merger of Swedish mining and forestry products company Stora AB and Finnish forestry products company Enso Oyj. In 2014, Stora Enso was ranked fifth in the world by sales, among forest, paper and packaging industry companies. It is a listed company in Nasdaq Helsinki, as STEAV.
- Upm Kymmene is a Finnish forest industry company, which operates in more than 13 countries. UPM's portfolio of products include pulp, paper, plywood, sawn timber, labels and composites, bioenergy, biofuels for transport, biochemical and nano products. The

company is the world's leading producer of graphic papers and second-largest producer of self-adhesive label materials. UPM shares are listed on the NASDAQ OMX Helsinki stock exchange.

- Svenska Cellulosa AB (SCA) is a timber, pulp and paper manufacturer, with headquarters in Sweden. Its portfolio of products include publication papers, solid-wood products, pulp and forest-based biofuel, generating more than 16.000 million € in revenue per year. SCA is Europe's largest private owner of forestland, with 2.6 million hectares. SCA shares are listed on the Stockholm stock exchange.
- Domtar Corporation is the second largest integrated producer of uncoated free-sheet paper in the world based on production capacity. Domtar operates in the paper market by designing, manufacturing, and distributing a wide range of business, commercial printing, publication and technical papers, which generate a total revenue of 5 billion dollars per year. Additionally, the company owns an extensive network of paper distribution facilities, that complements the production units. Domtar's shares are listed in NYSE, by the ticker TSX: UFS.

(ii) *Build from scratch a pellets factory*

Regarding pellets' opportunity, The Navigator Company is considering the construction of a pellets' mill in USA, South Carolina.

The amount of the investment is estimated to be around 110M USD, and the estimated production capacity of 460 thousand tons of pellets per year. However, several conditions must be taken into consideration at the time if the investment analysis:

- If the investment is to be started in the end of 2014, the factory will only be operational in the third trimester of 2016.

- The mill would be located in Greenwood, a region characterized by its favorable competitive conditions, namely the forest raw material and supply of energy.
- When considering the construction of the pellets factory, Portucel entered in negotiations with possible future retailers. For the investment analysis, it should be taken into account that 70% of the amount produced for the next 10 years, will be purchase at a fixed price. The remaining 30% goods produced are going to be sold at the market price, which is characterized by its seasonality over the year.
- Until the moment, 1,5 million € were already disbursed for negotiation and market prospecting purposes.

This Project constitutes an attractive investment opportunity, where Portucel can leverage its expertise in transformation of forest raw materials and industrial processes. Additionally, this promotes the consolidation of the entrance in the biomass, a sector with a relevant growth, which is emerging as a sustainable alternative to fossil fuels.

Moreover, by position the mill in USA, the internationalization criteria, presented in the objectives' list for the New Cycle, is fulfilled, enabling the strengthened presence in a market which is considered a reference in the production of good based on forest raw materials.

(iii) Invest in a tissue factory in Europe

The investment in a tissue factory in Europe is align also with the diversification strategy of The Navigator Company's portfolio.

Consider to be a fast growing market when compared to other paper products, Tissue manufacturing is, in accordance with all the six objectives, an attractive investment opportunity.

Having in mind the aim to become one of the relevant players in the European market, Navigator was targeting the most efficient tissue mill in Iberia, AMS BR Star Paper S.A.. AMS is a factory located in Vila Velha de Rodão, Castelo Branco, which has an actual production of 30 thousand tons of tissue and 50 thousand tons of converting. Currently AMS is developing a plan to double the production capacity, which will be fully operational by the end of the year. Last year, in 2014, AMS's total revenue reached 51,3M euros, with a normalized EBITDA of 9,5M euros, Net Debt of 20,63M euros and 31,6M euros of Equity.

In order to acquire AMS, reach relevant competitiveness in production and costs and replicate Navigator's strategy in UWF paper, it was estimated an investment of approximately 120M euros. This will guarantee a nominal production capacity of 70 thousand tons of tissue per year, which represents in euros a growth of 9% from the previously year.

Additionally, in this investment opportunity four premises must be taken into account:

- Quality, 100% pure pulp: Pure virgin fiber is the central raw material of our products, using an optimizing combination of fibers, with a high share of eucalyptus, granting outstanding softness and product quality.
- Integrated production: Development of a pipeline between the pulp mill and tissue mill to ensure the high consistency of the pulp quality and a more efficient operation, both from the logistic and energetic point of view, with the consequent environmental advantages.
- Innovation: State of the art equipment, allowing the production of a wide range of products with the best quality
- Customer centric: Production of goods that fit to the customer demand

Time for the decision

As referred above, all the three investment opportunities obey to the rigorous criteria's of analysis that were establish in the company's board meeting. However, due to the new cycle of the company and the competitiveness in the market, there is an urge to select the right investment and define the strategy that fits the most.

Annex 1: The Navigator Company's Financial indicator from 2013 Annual Report

ECONOMIC AND FINANCIAL INDICATORS					
Million euros	2009	2010	2011	2012	2013
Total sales	1,095.3	1,385.5	1,487.9	1,501.6	1,530.6
EBITDA ⁽¹⁾	222.2	400.2	385.1	385.4	350.5
Operating earnings (EBIT)	132.1	277.8	266.2	286.2	233.7
Financial earnings	-7.5	-20.1	-16.3	-16.3	-14.1
Net Profit	105.1	210.6	196.3	211.2	210.0
Cash Flow ⁽²⁾	195.2	332.9	315.2	310.4	326.8
Investment	505.4	95.5	33.0	30.1	16.9
Net debt ⁽³⁾	699.7	687.0	463.5	363.6	307.1
Net assets	2,561.2	2,672.5	2,821.3	2,724.5	2,819.7
Liabilities	1,290.6	1,369.0	1,343.1	1,243.6	1,330.8
Equity	1,270.6	1,303.5	1,477.6	1,480.8	1,479.8
Gross Debt	752.3	820.9	730.9	693.0	831.3
Cash and Cash equivalents	52.5	134.0	267.4	329.4	524.3
Treasury stock (market value)	29.8	34.3	40.6	108.0	144.4
Own shares held on Dec-31 st	15.1	15.1	22.1	47.4	49.6
EBITDA / Sales (in %)	20.3%	28.9%	25.9%	25.7%	22.9%
ROS	9.6%	15.2%	13.2%	14.1%	13.7%
ROE	8.4%	16.4%	14.1%	14.3%	14.2%
ROCE ⁽⁴⁾	7.1%	14.0%	13.5%	15.1%	12.9%
Equity to assets ratio	49.6%	48.8%	52.4%	54.4%	52.5%
Net debt / EBITDA	3.1	1.7	1.2	0.9	0.9
Euros					
Net earnings per share	0.14	0.28	0.26	0.29	0.29
Cash flow per share	0.26	0.44	0.42	0.43	0.46
EBITDA per share	0.30	0.53	0.52	0.54	0.49
Book value per share	1.69	1.73	1.98	2.06	2.06
⁽¹⁾ Operating results + depreciation + provisions					
⁽²⁾ Net profits + depreciation + provisions					
⁽³⁾ Interest-bearing liabilities - Cash and cash equivalents					
⁽⁴⁾ Operating results / (average equity + average net debt)					

Annex 2: EBITDA margins of paper production

EBITDA Margin - Paper Peers

