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Paper tiger

Evan Lorenz writes:

If, as the CEO of Brookfield Asset Management, Inc. and the president of Blackstone, Inc. separately agreed last week, it's a good time to sell, it must conversely not be a good time to buy. Selling and buying alike are the topics of this unfolding analysis, with private equity in the background and a revitalized 19th-century paper company, Glatfelter Corp. (GLT on the New York Stock Exchange), in the foreground. In preview, we're bullish on GLT and broadly bearish, still, on p.e.

In timing a sale of any investment asset, it helps to have friends in high places. Last month, the Asset Management Advisory Committee of the Securities and Exchange Commission gave its unanimous consent to a report recommending that the commission allow retail investors to invest in private equity funds. By rule and custom, institutions and wealthy individuals have had the p.e. market to themselves. Pending a green light from the SEC, the dear public may now provide the fatal eleventh-hour, top-ticking bid for the highly leveraged, illiquid businesses that the wise ones would like to unload.

Even so, this publication has taken a shine to Glatfelter, a serial acquirer that brings a p.e.-like strategy to the public markets. A maker of pulp-based engineered materials, GLT holds a commanding share of attractive niche markets and trades at an undemanding multiple. If it weren't so small and illiquid, and if it weren't periodically highly leveraged, it would be just the thing for widows and orphans. As it is, the risk-averse should avert their eyes.

Global mergers and acquisitions summed to $1.5 trillion in the third quarter, a 90-day record, according to Refinitiv, which lifts year-to-date deal volume to $4.3 trillion, itself a record, besting the $4.1 trillion set in the 12 months of 2007. So is this the top? Not at all, according to Berthold Fuerst. "I see current activity as the beginning of a multi-year upward cycle in M&A," the global co-head of Deutsche Bank A.G.'s M&A business told Bloomberg the other day.

Of course, there's a flip side to the deal rush. "I don't think I've taken a day off—a full day off—since Christmas of last year," Elizabeth Cooper, a partner at M&A heavyweight law firm Simpson Thacher & Bartlett, LLP, told *The Wall Street Journal* in September. First-year investment analysts at Goldman Sachs Group, Inc. may or may not enjoy more leisure, but at least their salaries are going up, to $110,000 from $85,000.

The hunt for talent, with the concomitant rise in deal-making costs, is rippling far beyond the North American buyout business. Last month, Greg Fitzgerald, chief executive officer of U.K. homebuilder Vistry Group plc, complained that the best and brightest in Britain want careers in private equity, not in publicly listed companies. If so, blame partly falls on the debt markets.

High-yield bonds are priced to yield 4.3%, or 1 percentage point less than the year-over-year rise in the August consumer-price index. Nor does the fixed-income contractual language, intended to secure the creditors' interests, compensate for meager interest income. In September, according to Covenant Review, 75% of the indentures that accompanied the loans that financed p.e.-sponsored transactions scored near rock bottom in terms of investor protections, compared with 52% in August.

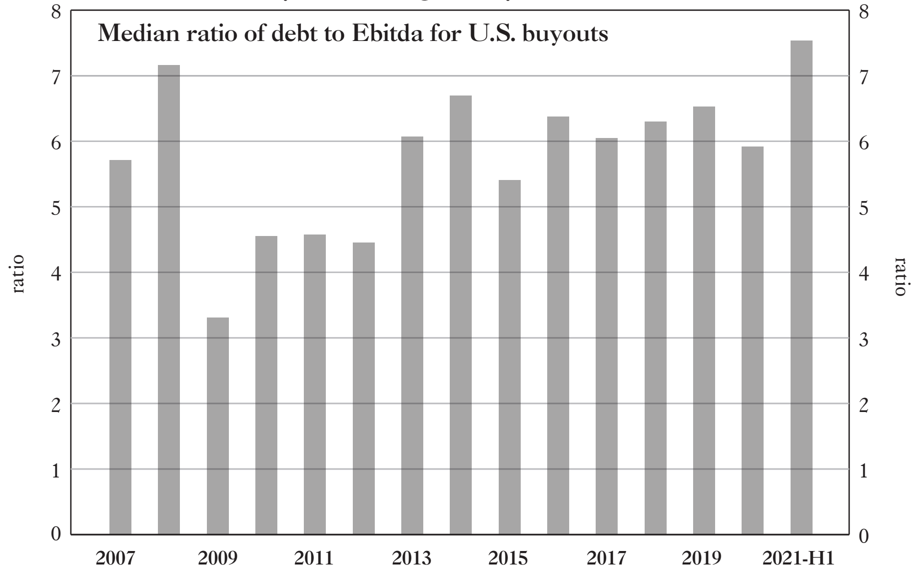
Then, again, it isn't clear that the yield-famished investors even notice. In the year through September, p.e.-backed companies raised $72 billion with which to pay dividends to their promoters; the previous full-year record for so-called dividend recaps was $54.4 billion, set in 2013, according to S&P Global Market Intelligence's LCD unit.

Recent wobbles notwithstanding, the S&P 500 trades at 37.6 times its cyclically adjusted price-earnings ratio, a level surpassed only at the tail end of the dot-com boom. According to Refinitiv, p.e. firms paid an average of 42% over public market prices to take U.S. companies private this year, the highest such premium since 1999.

As a result, the median U.S. buyout multiple in the first half of 2021 rose to 13.1 times Ebitda versus 12.5 times in 2008, based on data from Pitchbook. To fund these deals, promoters loaded the typical American buyout with net debt equal to 7.5 times Ebitda versus 7.2 times in the year Lehman failed. And because, since the housing bust, private equity has leaned so heavily on add-backs—i.e., on the anticipated cost savings and deal synergies that plump up reported Ebitda—a true, apples-to-apples comparison with 2008 might disfavor 2021 even more.

If there's one thing that the leverage merchants and deal-pushers don't need, it's rising interest rates. With the average junk bond yielding the aforementioned 4.3%, a leverage ratio of 7.5 times means that interest expense consumes 32.3% of Ebitda. The

Remember, they're *leveraged* buyouts



source: Pitchbook

Tax Cuts and Jobs Act of 2017 capped the deductibility of interest expense at 30% of Ebitda through 2021. Next year, the 2017 law will restrict interest deductions to a narrower definition of income, i.e., old-school earnings before interest and taxes, or Ebit. Buyouts will hence be paying more to Uncle Sam in 2022.

Since a nosebleed bid is required to sell a company that was purchased at a nosebleed price, falling stock prices are no more welcome than elevated borrowing costs. Mr. Market, in any case, would rather not contemplate them. According to a June survey by Preqin, only 16% of investors flagged private equity "exits" as a key concern, down from 45% in the same survey last year.

Since 2010, as *The Economist* observed in its Sept. 11 issue, investors have poured $8 trillion into private equity. "Yet the returns," Walter Bagehot's old weekly noted, "net of fees, that these vehicles have delivered to their 'limited partners' (typically pension schemes, endowments and other institutions) have been similar to America's comparable stock index—with vastly more risk." Still, hope springs eternal: According to the Preqin survey, 42% of LPs expect returns to improve while 15% expect the opposite.

A fundamental reason for the existence of private equity is the notion that public ownership is inherently the wrong structure in which to transform an underperforming and underleveraged business into an optimally performing one. Maybe so, but a September 2019 study by S&P Global Ratings of p.e. deals that closed between 2015 and 2018 finds a telltale gap between promise and performance: "[M]anagement projections at deal inception were aggressive, showing that, on average, actual reported net leverage was 3.1 turns higher than forecast for 2017 and 3.3 turns in 2018," S&P reports. "Overestimated earnings were the primary contributor to the leverage disparity, with reported Ebitda 35% below marketing Ebitda for both 2017 and 2018." Bain Capital's 2020 "Global Private Equity Report" reached a similar conclusion.

Prior to the financial crisis, private equity returns beat public market returns, hands down. "But there is a big difference—bigger than most realize—between what private equity used to do (buy companies at 6–8x Ebitda with a reasonable 3–4x Ebitda of debt) and what private equity does today (buy companies at 10–11x Ebitda with a dangerous 6–7x unadjusted Ebitda of debt)," as Daniel Rasmussen, founder of Verdad Capital, put it in the Spring 2018 edition of *American Affairs*. The subsequent boom years have not improved that arithmetic.

. . .

Which brings us to Glatfelter, a Civil War–era newsprint maker, founded in Spring Grove, Pa., that moved into higher-quality uncoated paper in the 1880s—and remained there, more or less, for the next century.

On Dec. 31, 2010, George H. Glatfelter II, the fifth generation of the founding family to run the business, retired as CEO. While the company's diversification into composite fibers and airlaid materials (on which, more later) had begun, commoditized paper products still produced the bulk of sales.

Dante Parrini, only the second nonfamily member to lead the company, was the new broom, and he proceeded to do his sweeping in the p.e. textbook fashion. Thus, in 2018, he sold the legacy paper segment, which had accounted for 47% of revenues, for $360 million. A secularly declining business, it fetched a lowly 5.1 times Ebitda, but the buyer assumed $210 million in pension liabilities, leaving the now-plump Glatfelter in a position to close its pension plan and return $33 million in cash to the stockholders.

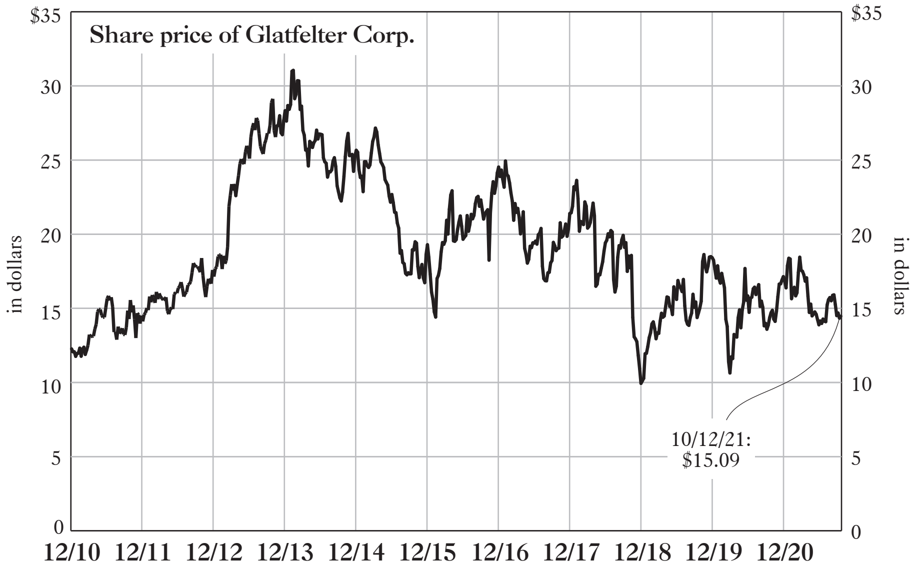
"From an earnings perspective, it looked massively dilutive, but it was the right decision," Josh Wool, an analyst at Carlson Capital, L.P., which holds a 5.2% stake in GLT, tells me. "They didn't predict what Covid would do to traditional printing and writing demand, but, even if you didn't look at that, it was the right thing to do because they swapped a capital-intensive, secularly declining business for growth in very attractive, pulp-based material niches. It was a smart move to do, but you had to have a long-term perspective."

On Parrini's watch, Glatfelter has transformed itself. It has settled environmental liabilities and moved its headquarters to Charlotte, N.C. (population 857,425 and home to suppliers and customers alike), from York, Pa. (population 44,022). It has employed debt opportunistically, borrowing when an attractive acquisition presents itself and deleveraging as cash flows allow for debt reduction. Corporate leverage, measured as a multiple of Ebitda, has ranged from 4.9 to 0.9.

This year has proven to be a banner year for acquisitions. On May 13, Glatfelter bought Georgia-Pacific, LLC's U.S. airlaid-products factories for $170.7 million. And on July 22, it announced the purchase of Jacob Holm, a leader in spunlace nonwoven fabrics, for $308 million.

As of June 30, Glatfelter organized

Mr. Market sees not



source: The Bloomberg

its business into two units: composite fibers (58% of second-quarter sales and 54% of Ebitda) and airlaid (42% of second-quarter sales and 46% of Ebitda). In the composite-fiber business, specialty pulp and synthetic fibers are deposited via a wetlaid process to make items such as tea bags, paper filters for single-serve coffee, the base material for wallpaper as well as metallized paper for product labels.

The airlaid unit assembles plant-based pulp into highly absorbent materials used by consumer packaged-goods companies to make feminine hygiene products, specialty wipes, table covers and the like. Airlaid, as the name suggests, means depositing fibers via an airstream. Legacy processes use water.

As most of these products are essential, Glatfelter had a good pandemic. Sales declined by 1.2% to $916.5 million in 2020, while adjusted net income rose by 12.8% to $37.4 million.

The airlaid business is the corporate crown jewel. For one thing, Glatfelter claims 63.2% of the airlaid market share in the Americas and a 34.5% share in Europe, implying 32.3% of the global market. For another, because the division uses plant-based fibers, not plastics, it's on-trend for environmentally minded consumers. Around 70% of airlaid sales feature commodity escalators, which make the earnings in this unit inflation-resistant (if not inflation-proof). The composite-fiber division, by contrast, has had to raise prices to cover a jump in the cost of goods sold; Glatfelter announced one price increase, of 8%, on March 9 and another, of 12%, on Sept. 16.

"Airlaid is probably the most difficult nonwovens technology to get into," Phillip Mango, a consultant who founded the airlaid division that Glatfelter acquired in 2010, tells me. "It's more of an art than most of the other technologies, because it has airflow and you are trying to move fibers around in an airstream. Procter & Gamble used to meet me once a year at the trade shows and ask me to help them encourage people to build airlaid lines. We couldn't find people to build them."

Jacob Holm's spunlace technology, which uses high-pressure water jets to entangle plant-based fibers into soft, durable sheets, is complementary to the airlaid division. "It's the second-largest spunlace producer," Mango says, "and spunlace is the leading technology for wipes." The acquiree generated an annualized $375 million in revenue in the first half of the year across three divisions: personal care (41% of sales); Sontara, a branded line of products used in cleanrooms, aerospace and medical applications (34%) and healthcare and skin (25%).

Glatfelter's market capitalization stands at $690 million. Adding net debt of $720.1 million (pro forma the Jacob Holm transaction) yields a prospective enterprise value of $1.4 billion and a ratio of net debt to Ebitda of 4.2 times. Trailing Ebitda, including the two recent acquisitions, comes to $171 million, thus valuing GLT at 8.2 times Ebitda. (Because Covid lifted Jacob Holm's business, our calculations annualize its first-half earnings.) Owing to the leveraged Glatfelter capital structure, the common shares will have a free cash flow yield of 11.6%; they are priced to deliver a 3.7% dividend yield.

Our math gives management no credit for the anticipated cost savings of the Georgia-Pacific assets (an estimated $4 million to $6 million) or Jacob Holm ($20 million). Incorporating these estimates into the pro forma figures would lower the valuation to 7.2 times Ebitda and reduce net debt to 3.7 times Ebitda. If Glatfelter succeeds in achieving such savings while paying down debt, shareholders would benefit from the equity component of

Glatfelter Corp.* at a glance

all figures in USD millions except per share data

	TTM**	2020	2019	2018	2017
sales	$939.3	$916.5	$927.7	$866.3	$800.4
operating income	53.2	49.2	54.6	21.9	33.3
net income	26.1	21.3	-25.2	-177.6	7.9
diluted shares	44.9	44.6	44.1	43.8	44.4
earnings per share	0.59	0.48	-0.49	-4.06	0.18
cash	84.2	99.6	126.2	142.7	116.2
debt	469.5	313.5	359.9	411.7	481.4
assets	1,460.1	1,286.9	1,283.8	1,339.8	1,730.8

* The legacy paper assets have been reclassified as discontinued operations.

** The 12 months ended June 30, 2021.

source: company reports

enterprise value increasing as the debt component declines.

There are reasons to believe that the Jacob Holm synergies might, in fact, be achievable. For one, as a privately held, family-run business, Holm may not have managed itself in an optimizing, lean-and-mean manner. Based on first-half figures for 2021, Holm's Ebitda margin was 9.6%. The Sontara unit within Holm should command margins in the mid-teens or higher, which implies that margins for the non-Sontara business may be in the single digits. In the second quarter, before corporate overhead, Glatfelter's overall Ebitda margin was 13.6%. Jacob Holm is also in the midst of a capacity expansion that could add as much as $8 million to earnings.

Also on the table of happy surprises are the revenue opportunities in Asia of which Glatfelter has yet to avail itself. Jacob Holm "has a very nice footprint in Asia-Pacific and has many commercial offices that we will look to further take advantage of in terms of the broader Glatfelter portfolio," Parrini told his audience at the Sept. 22 Sidoti Fall Small Cap Conference.

Only one lonely analyst covers Glatfelter, the giant—the Saudi Arabia—of airlaid products. "This is a name I don't get many calls on," Mark Wilde, who rates GLT a buy for BMO Capital Markets, tells me.

Neither the romance of the product lines nor the demonstrated financial commitment of the officers and directors commends the Glatfelter story to the Wall Street masses. Over the past 12 months, insiders have sold 25,555 shares for $399,384 in proceeds. However, for the record, Parrini, age 56, now finishing his 11th year as CEO, owns 369,376 shares of GLT worth $5.2 million and has options to acquire another 583,442 shares, exercisable at prices between $15.61 and $29.89 versus the current share price of $15.09.

"We want to execute on the integration of the acquisitions that we've made to make sure that they're done seamlessly, especially from a customer point of view, and that we quickly get after delivering the synergies, and allowing the cash flows from these new businesses to help us deleverage the balance sheet," the CEO told the Sidoti event. "We want to accelerate our innovation....And we also think that this would help support our ESG aspirations, which really look to leverage the majority of our materials that are using plant-based feedstocks. And, then, we want to continue to look at growth...but we want to do that very selectively as the balance sheet permits."

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