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Contain your enthusiasm

The top intended consequence of EZ money was likely not the cartelization of American industry, yet ultra-low interest rates have facilitated mergers and acquisitions. Likewise, one might speculate, most Trump voters did not pull the lever for lower American exports, yet the Nov. 8 election has lifted an already airborne dollar exchange rate. Which brings us to the subjects at hand: Packaging Corp. of America (PKG on the Big Board) and KapStone Paper and Packaging Corp. (KS on the New York Stock Exchange). To anticipate, we're bearish on each.

Containerboard, the main product of these picks not to click—it delivered 80% or more of the two companies' third-quarter operating income—is the raw material from which corrugated cardboard boxes are made. Containerboard consists of a fluted layer of paper sandwiched between two flat liners. Maybe you, too, have a childhood memory of rolling up the middle, wavy part into the shape of a cigar, of lighting the end and taking a drag. It could put you off smoking.

The flute and the liners are made from recycled paper ("testliner") or virgin pulp ("kraftliner"). In America, with its fast-growing southern pine forests, kraftliner accounts for 65% of containerboard production. In the unforested nether regions, testliner dominates, though no country can make do without some kraftliner. You need it for strength and for the nice, gentle way it interacts with fresh fruits and vegetables.

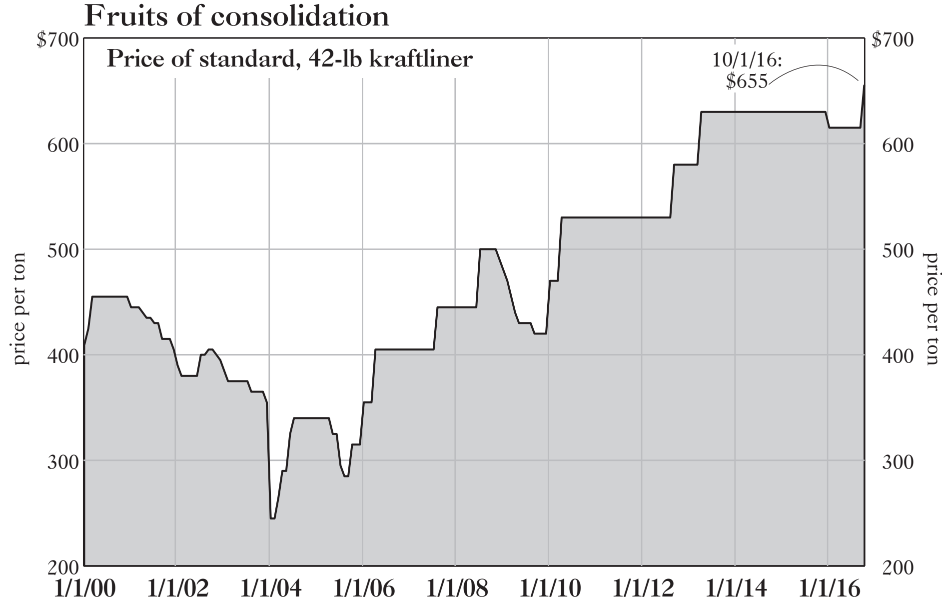
Say "cardboard boxes," and you may think of an Amazon delivery, hence of bounding growth. There is no such growth in containerboard. In the United States, 50% of cardboard shipping boxes contain food and beverages, 30% nondurable goods (paper products, chemicals, pharmaceuticals) and the balance durable goods. Total box shipments in 2015 had still not regained their 2006 peak. As for the boxes used in e-commerce, they account for single-digit percentages of industry volume. Their rapid growth has been neutralized by sluggish growth in boxed shipments of packaged foods (*Grant's*, March 25).

Yet—the paradox at the heart of this analysis—the containerboard business has never been more profitable. International Paper Co. (IP on the NYSE), which accounts for 33% of North American containerboard, generated a 13% return on invested capital in the third quarter, highest since at least 1981, when Bloomberg records begin.

"Source of the industry's newfound fortune," observes colleague Evan Lorenz, "is a massive wave of consolidation, hence of pricing power. The price of standard, 42-pound kraftliner had peaked at $455 per ton in 2000, the top of the dot-com boom. It stands today at $655 a ton."

The top five producers—IP, WestRock Co. (WRK on the Big Board), Georgia-Pacific LLC (a subsidiary of closely held Koch Industries, Inc.), Packaging Corp. and KapStone—now account for 75% of North American containerboard, up from 43% in 1995. Over the past seven years, the top-four public

Fruits of consolidation



source: RISI, Inc. Pulp & Paper

companies have spent more than $10 billion on acquisitions, no small part of their current combined market capitalization of $42.6 billion.

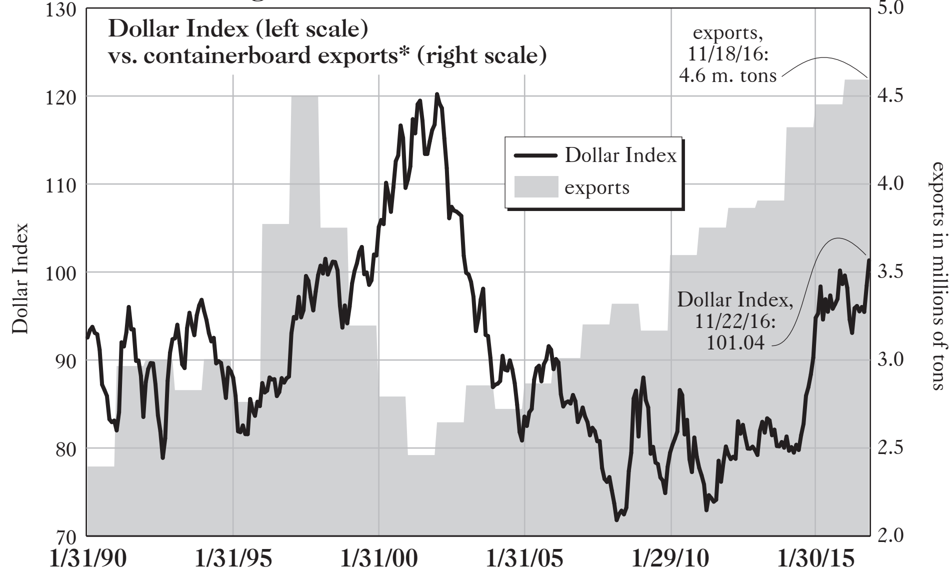
Big profits coax forth new production, as a rule, and the rule holds in containerboard. Thus, in the three years ended 2015, two million tons of new productive capacity came into the world, a 5.5% increase on the 2012 base. And more is on the way. As newspapers shrink, newsprint machines are being repurposed to make recycled containerboard, while dwindling demand for coated paper (the stock used in magazines, catalogues and brochures) suggests another latent source of containerboard supply. Just the turn of the calendar tends to augment supply, according to RISI Inc., as productivity enhancements add an average of 1.1% a year to existing containerboard plant capacity.

To battle oversupply, containerboard makers rely on exports and plant closures. In neither board nor boxes—to judge by price trends—have these efforts been entirely successful. Each of the four public containerboard companies confessed to softening in their respective price mix for board and boxes in the third quarter.

Then again, September delivered a 272-ton year-over-year decline in containerboard inventories, to 2.1 million tons. Oct. 1 brought an industry-wide price rise of $50 per ton on 42-pound kraftliner; press releases cited tightness in the supply-demand balance. A providential hurricane, causing preemptive closings at containerboard plants in the Southeast and another drop in inventories, to 1.9 million tons, has rendered the price hike effective at least to the extent of $40 a ton, according to RISI.

"A sign that something is out of kilter in kraftliner pricing is the widening gap between domestic and export quotations," Lorenz observes. "The same kraftliner that sells for $655 a ton in the United States fetches $434 a ton in Europe. For perspective, the gap usually has not been $221, as at present, but something closer to $50. U.S. exporters are probably making minimal, if any, profits on those exported tons. The arithmetic seems to undermine assertions by IP, WestRock and the other major producers that the U.S. industry is tight—after all, if production were struggling to meet demand, why is the industry exporting such tons at such low profits? Exports have become a domestic safety valve, and an economically dubious one at that."

Beware the greenback



*2016 exports based on annualized first 10 months.
source: American Forest & Paper Association, the Bloomberg

You hear it said that the American containerboard market is somehow isolated from foreign influences. In the wake of the interest-rate facilitated consolidation wave, 85%–90% of box makers produce both containerboard and boxes. So situated, they have no incentive to import cheap foreign stock, the argument goes. What they want is high box prices *and* high containerboard prices.

Besides, the argument continues, importing recycled containerboard from Europe would defy economic logic—old corrugated cardboard, the raw material from which that European board is manufactured, is sourced in America. Why ship it to Europe only to haul it across the ocean again?

Price makes it logical. European containerboard is $300 cheaper than U.S. board today, as the independent box makers have not failed to notice. "I was talking to independent box plant converters," Danny Moran, an analyst at Macquarie Securities, tells Lorenz. "I was asking, 'Why wouldn't you buy European board at $300 cheaper even if freight is, worst case, $100 per ton? You would still be buying board at a net $200 cheaper.' The answer was they are starting to do it on the coasts, the East Coast and the West Coast. I even talked to one independent box plant converter in the Midwest. It is cheap to get board to the ports, but it is more expensive to get it shipped inland. [But] even the Midwest box plant converter said it is compelling at this time."

So no, we conclude, America is no containerboard island unto itself but a more or less integrated part of a world market. Certainly, America is not the only forested land mass. Arboreally favored Brazil and Russia are both exporters of kraftliner, and the decline in their respective currencies has made Brazilian and Russian exporters more competitive. Nor is the United States the only country adding capacity. Europe, which imports one million tons of kraftliner a year, mostly from the United States, is slated to add new plants with a capacity of around 675,000 tons of kraftliner by the end of 2018. As to virgin liner, Europe may reach self-sufficiency in that year as well. Including recycled containerboard, the Continent is set to expand its capacity by four million tons through 2019, a jump of 15% from current levels.

There is a precedent for big declines in export volumes. U.S. containerboard exports shrank by 45% to 2.5 million tons from 4.5 million tons between 1997 and 2001 during a bout of dollar strength. "Following a period of strength in 1997, industrial packaging markets weakened during 1998," according to International Paper's 1998 10-K report. "Excess capacity, rising imports and a collapse of export markets all played a role."

Exports recovered to the 4.5 million level only in 2015. Based on the first

10 months of 2016, the United States is on track to ship 4.6 million tons of board overseas. If those exports are now peaking, one could once more roll out the adage that while history doesn't repeat, it can rhyme.

Not only have the box and containerboard makers joined forces but so, too, have their customers. Kraft Heinz Co., Anheuser-Busch InBev SA and Unilever NV are themselves super-sized. Their respective front offices are well aware of the price differential between American and foreign boxes. They likewise monitor the rate at which American containerboard makers are operating—the October reading was 95.5%, slightly below the 95.8% average from 2012 to 2015. A meaningful decline in capacity utilization would present the mega-customers with the opportunity to demand lower board and box prices from their mega-suppliers.

"High prices are the certain answer to high prices, if Adam Smith has anything to say about it," Lorenz points out. "Recall what happened when Canadian, Russian and Belarussian potash cartels kept the price of that key plant nutrient artificially elevated. The very prosperity of the cartelized producers elicited new competition from outside the cartel. Thus, the price of potash in Vancouver declined, to $216 per ton today from $483 in February 2012. OPEC's pricing strategy can be said to have underwritten the U.S. shale revolution, which presaged the collapse in the oil price."

StealthWrap™, unveiled on Nov. 7 by Sealed Air Corp., is a packaging invention designed to render boxes obsolete; maybe it will figure into the microeconomics of containerboard. "When applied," says the Sealed Air press release, "StealthWrap™ shrinks and adheres to the dimensions of the product, obscures any markings or identification of the product inside, and provides a strong, damage-resistant covering." XPO Logistics, Inc., Sealed Air's launch customer, is giving StealthWrap a try.

Shaving a few percentage points off costs is more important than it may sound. For hyper-competitive e-commerce retailers, who often throw in free shipping, it could be manna. The promise of StealthWrap™, XPO Logistics tells Lorenz, is (a) a cheaper and lighter alternative to containerboard and (b) technology that can reduce the labor required to stuff and seal consumer orders.

To judge by deeds alone, WestRock and International Paper would themselves appear to entertain a cautious view of containerboard. Thus, on July 2, 2015, WestRock acquired MeadWestvaco Corp. for $9.7 billion worth of shares, a strategic move that reduces the containerboard contribution to WestRock's operating income to 54% from 69% (consumer packaging—e.g., folding cartons, displays, dispensing, interior partitions—is the new focus). On May 2, International Paper similarly moved to reduce its exposure to containerboard with an announced $2.2 billion acquisition of Weyerhaeuser Co.'s cellulose fiber pulp mills, makers of the absorbent material used in diapers and feminine hygiene products.

Packaging Corp. and KapStone, which derived 80% and 88% of third-quarter operating profits from containerboard, remain the most vulnerable to the deteriorating economics of cardboard boxes. To judge by the companies' fancy price-earnings ratios—17.8 and 20.5 times trailing earnings, respectively—you'd think that they are somehow less exposed to the cyclical elements than are IP and WestRock, which trade at 13.5 and 17.8 times trailing earnings. It's a dubious proposition, we believe.

The Street (to read its mind) assumes that the hurricane-assisted October price increase will stick, that export sales will hold strong and that the Trump economy will hum. Of the 15 analysts who cover PKG, eight say "buy." Of the 10 analysts who follow KS, six say "buy."

"If," notes Lorenz, "these companies don't get the $50 price hike, exports wobble, or the U.S. economy slows, Packaging Corp. and KapStone will surely disappoint. In 2017, PKG and KS are expected to increase earnings per share by 17% and 35%, respectively. Short interest amounts to 3.9% and 5.6% of Packaging Corp.'s and KapStone's floats."

Rated Baa3/triple-B, Packaging Corp. shows debt, net of cash, equal to 2.1 times trailing earnings before interest, taxes, depreciation and amortization (EBITDA). In the third quarter, Packaging Corp.'s operating income covered interest expense by 8.8 times.

Unrated KapStone shows net debt equal to 4.3 times EBITDA. In the third quarter, operating income covered interest expense by 5.4 times. Bank debt rather than bonds is KapStone's preferred medium of indebtedness, a fact that would put the company in an awkward position to deal with an upside lurch in rates. Note the following exchange from the Sept. 8 RBC Capital Markets Global Industrials Conference:

> RBC analyst Paul Quinn: "Your balance sheet. . . . not a lot of fixed interest debt, a lot of it is in the variable side. How are you feeling about that? In this interest-rate environment, sounds like you guys made the right call."
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> KapStone vice-president of finance Michael John Murphy: "Probably one of those where we're better to be lucky than good. We've been proven right to have the variable-rate capital structure really since our inception."

Over the past 12 months, Packaging Corp. insiders have sold a net $1.4 million worth of shares, whereas KapStone insiders have purchased a net $477,245 worth of shares. An asterisk might be affixed to the KapStone buys: Most came earlier this year when the stock traded below $10 following a January decline in kraftliner prices. KapStone's share price has subsequently doubled.

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