

5 April 2009

Paper & Packaging

Is The Party Ending? Black Liquor Credits Threatened?

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Reports from Washington DC suggest that Senate Finance Committee Chairman Max Baucus (D-MT) and Ranking Member Charles Grassley (R-IA) may be preparing to introduce legislation to eliminate the paper industry's ability to qualify for \$0.50/gallon alternative fuel mixture tax credits. In recent weeks, a number of paper companies had announced plans to qualify for the credit by adding small amounts of diesel fuel to the black liquor burned in their recovery boilers.

DB estimates for the potential '09 benefit were impressive

In the case of International Paper, we estimated that the 2009 excise tax credit could amount to \$1.27B. (See summary estimates on page 3 from our note, "Liquored Up? Analysts Carried Away on Fuel Credits?") We've also noted the tenuous nature of the program and the risk that the tax credits might not survive through 2009. It seems clear to us that the paper industry's application for the tax credits fell outside the intent of the original legislation.

Recent reports suggest that the paper industry's application of the program is attracting scrutiny and could be curtailed in the coming weeks

The threat of action by Senators Baucus and Grassley has gotten the attention of industry leaders. An intense lobbying effort appears inevitable over the next several weeks. As an aside, we note that not all paper industry leaders appear equally supportive of the tax credit. For example, based on channel checks in recent weeks, it is clear that some owners of recycled mills (not eligible for the incentive) are far less supportive of the tax credit.

Implications?

The threat of near-term legislative action to eliminate the black liquor excise credit looks like a modest negative for equity holders. Stocks across the sector have rallied on news of the potential tax benefits. While we don't think stocks had fully discounted the upside from a full year of tax benefits, the spectre of a quick disqualification seems likely to throw a near-term chill on the stocks. With Q1 having already closed, we think Q1 benefits are likely "safe." Depending on the success/speed of any disqualification effort, the industry probably has a decent chance of retaining Q2 benefits. Importantly, we don't think most industry leaders have been banking on these benefits in their financial planning. The credits are "found money". As we heard repeatedly from the CEO and CFO of International Paper in a recent non-deal roadshow, the tax credits simply provide a measure of additional financial headroom in a very tough economic and financial environment.

Valuation and risk

We use various methods to value the stocks, including PE, P/book and EV/EBITDA. Paper companies and packaging companies appear to be trading near the bottom of their normal historical ranges, 1.1x book and 6.4x '09E EBITDA, respectively. In addition to the upside/downside risks associated with the tax credit issue addressed in this note, the primary risks involve momentum in the economy, the health of demand, and additional energy, chemical, and freight cost inflation. Foreign exchange rates relative to the CN\$ and the Euro are also important in some cases.

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Industry Update

Companies featured			
International Paper (IP.N),USD7.96			Hold
	2008A	2009E	2010E
EPS (USD)	2.01	0.00	0.50
P/E (x)	12.3	-	15.8
EV/EBITDA (x)	7.7	6.1	5.3
Greif Inc. (GEF.N),USD37.58			Buy
	2008A	2009E	2010E
EPS (USD)	4.18	3.30	4.00
P/E (x)	14.8	11.4	9.4
EV/EBITDA (x)	4.5	2.6	1.4
Glatfelter (GLT.N),USD6.54			Hold
	2008A	2009E	2010E
EPS (USD)	1.04	0.60	0.70
P/E (x)	12.5	11.0	9.4
EV/EBITDA (x)	6.0	4.3	3.7
MeadWestvaco (MWV.N),USD13.32			Buy
	2008A	2009E	2010E
EPS (USD)	0.66	-0.00	0.40
P/E (x)	34.9	-	33.6
EV/EBITDA (x)	7.7	-	6.6
Packaging Corp. of America (PKG.N),USD13.73			Hold
	2008A	2009E	2010E
EPS (USD)	1.35	0.65	1.00
P/E (x)	16.1	21.1	13.7
EV/EBITDA (x)	6.8	6.2	5.2
Rock-Tenn (RKT.N),USD29.38			Buy
	2008A	2009E	2010E
EPS (USD)	2.77	3.50	3.70
P/E (x)	11.3	8.4	7.9
EV/EBITDA (x)	7.3	5.4	4.9
Temple-Inland (TIN.N),USD5.86			Buy
	2008A	2009E	2010E
EPS (USD)	0.10	0.35	0.80
P/E (x)	119.9	16.7	7.4
EV/EBITDA (x)	6.6	3.1	2.3
Domtar (UFS.N),USD1.04			Hold
	2008A	2009E	2010E
EPS (USD)	0.17	-0.20	-0.00
P/E (x)	30.4	-	-
EV/EBITDA (x)	6.1	6.8	4.3
Weyerhaeuser (WY.N),USD31.06			Buy
	2008A	2009E	2010E
EPS (USD)	-1.21	-3.20	-1.50
P/E (x)	-	-	-
EV/EBITDA (x)	307.9	-	32.2

Is the Party Ending?

- **The party around black liquor tax credits may end abruptly.**

Reports from Washington DC suggest that Senate Finance Committee Chairman Max Baucus (D-MT) and Ranking Member Charles Grassley (R-IA) may be preparing to introduce legislation to eliminate the paper industry's ability to qualify for \$0.50/gallon alternative fuel mixture tax credits. In recent weeks, a number of paper companies had announced plans to qualify for the credit by adding small amounts of diesel fuel to the black liquor burned in their recovery boilers. At least 2 companies, International Paper and Verso, have announced significant Q4 tax benefits from early applications with the IRS.

- **In a recent note, DB estimated potential '09 company-by-company benefits from the program.**

In the case of International Paper, we estimated that the 2009 excise tax credit could amount to \$1.27B. Our summary estimates for coverage companies are shown in Figure 1 (page 3). We also noted the tenuous nature of the program and the risk that the tax credits might not survive through 2009. It seems clear to us that the paper industry's application for the tax credits fell outside the intent of the original legislation. The burning of biofuels like black liquor is a generations-old practice found in kraft pulp mills around the globe. The tax credits change little. Moreover, in order to qualify as alternative fuel mixers, pulp mills must blend a small amount of fossil fuel (diesel) into their black liquor -- thus, increasing, not decreasing, fossil fuel consumption. In fairness, it appears that the only energy-related environmental benefit is in skewing the industry cost curve away from recycled-content mills which require purchased fossil fuels and toward black-liquor based virgin fiber mills which are largely energy self-sufficient.

- **Recent reports suggest that the paper industry's application of the program is attracting scrutiny and could be curtailed in the coming weeks.**

Press stories in The Washington Post and elsewhere have raised the public profile. The threat of action by Senators Baucus and Grassley has gotten the attention of industry leaders. An intense lobbying effort appears inevitable over the next several weeks. As an aside, we note that not all paper industry leaders appear equally supportive of the tax credit. For example, based on channel checks in recent weeks, it is clear that some owners of recycled mills (not eligible for the incentive) are far less supportive of the tax credit.

- **Implications?**

The threat of near-term legislative action to eliminate the black liquor excise credit looks like a modest negative for equity holders. Stocks across the sector have rallied on news of the potential tax benefits. While we don't think stocks had fully discounted the upside from a full year of tax benefits, the spectre of a quick disqualification seems very likely to throw a near-term chill on the stocks. With Q1 having already closed, we think Q1 benefits are likely "safe." Depending on the success/speed of any disqualification effort, the industry probably has a decent chance of retaining Q2 benefits. Importantly, we don't think most industry leaders have been banking on these benefits in their financial planning. The credits are "found money". As we heard repeatedly from the CEO and CFO of International Paper in a recent non-deal roadshow, the tax credits simply provide a measure of additional financial headroom in a very difficult economic and financial environment.

Figure 1: Estimated Annual Cash Tax Credit Benefit

Company	Estimated Effective US Capacity * Pulp Capacity * (tons)	Estimated '09 Production Rate	Implied '09 Production	Estimated Annual Benefit (\$MM)
Domtar				
Bleached				
Uncoated Free Sheet	2,500 K	@ 0.90 =	2,250 K	\$394
Total Benefit				\$394
Glatfelter				
Bleached				
Integrated Pulp	500 K	@ 0.95 =	475 K	\$83
Total Benefit				\$83
International Paper				
Bleached				
Market Pulp	1,000 K	@ 0.50 =	500 K	\$88
Uncoated Free Sheet	3,000 K	@ 0.90 =	2,700 K	\$473
Bleached Paperboard	2,000 K	@ 0.95 =	1,900 K	\$333
Unbleached *	5,600 K	@ 0.90 =	5,040 K	\$378
* includes allowance for semi-chemical medium				
Total Benefit				\$1,271
Meadwestvaco				
Bleached				
Bleached Paperboard	1,600 K	@ 0.95 =	1,520 K	\$266
CNK	1,100 K	@ 0.90 =	990 K	\$173
Total Benefit				\$439
Packaging Corp				
Unbleached				
Kraft Pulp	1,400 K	@ 0.90 =	1,260 K	\$95
* includes allowance for semi-chemical medium				
Total Benefit				\$95
Rock-Tenn				
Bleached				
Market Pulp	100 K	@ 0.90 =	90 K	\$16
Bleached Paperboard	335 K	@ 0.95 =	318 K	\$56
Total Benefit				\$71
Temple-Inland				
Unbleached				
Kraft Pulp	2,400 K	@ 0.90 =	2,160 K	\$162
Total Benefit				\$162
Weyerhaeuser				
Bleached				
Market Pulp	1,500 K	@ 0.85 =	1,275 K	\$223
Bleached Paperboard	240 K	@ 0.95 =	228 K	\$40
Total Benefit				\$263
Assumptions				
Unbleached				
Assumed Benefit Per Ton				\$75
Bleached				
Assumed Benefit Per Ton				\$175

Source: Deutsche Bank Estimate, Company Filings, RISI and Industry Sources

Appendix 1

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Equity rating key Equity rating dispersion and banking relationships

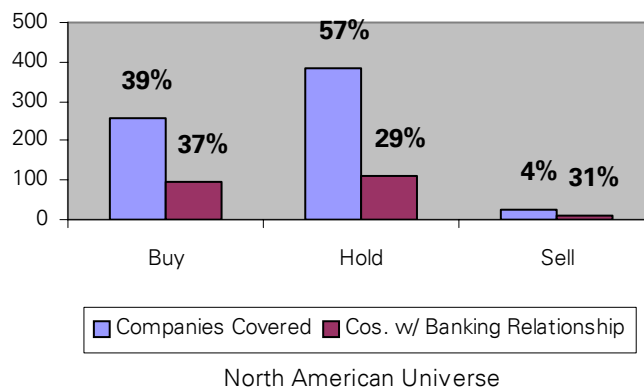
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