

By **Wiji Mies**, Editorial Director, News

Royer creates white paper giant

Merger of Weyerhaeuser's fine paper division with Domtar creates the leader in North American uncoated freesheet with the goal of achieving \$200 million in synergies

Domtar became North America's largest producer of uncoated freesheet (UFS) paper through an innovative \$3.3 billion transaction completed in March. The deal combined the assets of the Montreal-headquartered Domtar (then the second largest UFS producer) with those of Weyerhaeuser's fine paper division (which was the third largest) to form a new corporate entity. The arrangement creates the largest North American producer of uncoated freesheet with 5.0 million tons of capacity and a roughly one third mar-

ket share, as well as a leading position in market pulp.

That feat of corporate engineering won Raymond Royer, president and CEO of Domtar, RISI's North American CEO of the Year award for the second time. The award will be presented to Royer on October 11 at RISI's 22nd North American Forest Products Conference in San Diego, where Royer will give the keynote address.

The award is based on RISI's annual survey of investment analysts who make their nominations based on such criteria as lead-

ership, vision and strategic accomplishment.

RISI says the award recognizes Raymond Royer's leadership role in transforming Domtar into a world class paper company during a particularly difficult period for the Canadian pulp and paper industry.

Analysts nominated Royer for pulling off the deal, which they say has significantly improved the outlook for a company that had been facing a somewhat uncertain future because of the strengthening Canadian dollar and decline in the uncoated freesheet market.

"His ability to cement a deal with Weyerhaeuser should secure his company's near term future," one analyst said. "I can't think of another executive who has done more with so little."

The deal is also expected to have a major impact on the 13-million ton/yr North American uncoated white paper market. "Overnight, Royer's deal transformed uncoated freesheet from dysfunctional, to functional oligopoly," another analyst said. He has "turned lemons into lemonade."

Forces driving the deal

Royer has been at the helm of Domtar since 1996, after leaving Bombardier, the Montreal-headquartered diversified transportation equipment company, where he had been president and COO.

During the first half of the 1990s, Domtar had suffered from the recession, an earlier surge in the Canadian dollar, elimination of tariffs, frequent management changes and a diverse product mix. After joining Domtar, Royer took a number of steps to significantly expand the company, increase its focus on the white paper market, sell noncore businesses and expand its reach into the US market.

The most significant move was acquiring four Georgia-Pacific (G-P) pulp and paper mills in the US for \$1.65 billion in 2001. The deal more than doubled Domtar's share of the uncoated freesheet market and significantly expanded its position in the US mar-

"Success depends on improving our cost position, achieving customer support, managing customer risk, capital discipline and teamwork," says Domtar CEO Raymond Royer.



ket. The company rose from being the eighth largest North American producer of uncoated freesheet to the No. 2 supplier with about 2.3 million tons of capacity and a much larger presence in the US market.

"Years back, he turned around what people used to call 'Dumbtar' and made it into a disciplined and respected Canadian player," one analyst commented.

But the glow wore off for investors with the rise in the Canadian dollar and signs that the once relatively high growth uncoated

freesheet market had peaked and appeared to be starting a long-run decline. The loonie rose from a low of around \$0.62 to the US dollar in early 2002 to around \$0.95 today, which is a more than 50% rise, making it difficult for mills in Canada to remain cost competitive, particularly with rising energy, fiber and transportation costs.

At the same time, US demand for uncoated freesheet, which had grown at more than 2%/yr in the 1990s and 4-5%/yr in the 1980s, hit the wall. US demand peaked at 14.7 million tons in 1999 and by 2007 will have declined by nearly 17% to around 12.2 million tons, marking a 2.5 million ton drop, RISI estimates. The major cause, of course, is growing use of electronic information and the Internet, as well as increasing competition from less expensive mechanical substitute grades.

As a result of these negative trends, Domtar's profitability suffered in recent years, although the company performed better than most Canadian-based producers. Operating profit from continuing operations, excluding special items (due to restructuring, writedowns and closures), rose to C\$139 million in 2006, up from C\$23 million in 2005, which was down from C\$111 million in 2004. Operating margins narrowed to 3.4% in 2006 from 0.5% in 2005 and 2.5% in 2004.

Meanwhile, Weyerhaeuser was under pressure from shareholders, such as Franklin Mutual, to improve investor returns and to somehow extract more value from its vast timberland holdings. The company began a "strategic review" in 2005 and indicated that businesses that were not returning their cost of capital would be receiving particular

TABLE 1.
Domtar's rise through the ranks of the consolidating North American UFS market

Top North American Uncoated Freesheet Producers (% of total capacity)		
Year		Market share
2007		
1.	Domtar	33.7 %
2.	International Paper	25.2
3.	Boise Cascade	10.5
4.	Georgia-Pacific	7.2
5.	Glatfelter	3.4
Top 5 producers		80.0
2001		
1.	International Paper	32.7 %
2.	Domtar	15.5
3.	Boise Paper	10.1
4.	Willamette	9.7
5.	Weyerhaeuser	8.8
Top 5 producers		76.8
1996*		
1.	International Paper	14.9 %
2.	Georgia-Pacific	14.0
3.	Champion Intl.	7.9
4.	Boise Cascade	6.5
5.	Union Camp	6.2
6.	Willamette	6.0
7.	Weyerhaeuser	5.3
8.	Domtar	5.2
Top 5 producers		49.5

*Year Royer joined Domtar.
Source: *Pulp & Paper* grade profile.

TABLE 2.
Major Domtar milestones

Year	Milestone
1989	Windsor, QC, paper mill completed at cost of \$1.2 billion -- one of largest and lowest cost UFS mills in North America
Early 1990s	Suffered from recession, strong C\$ and tariff elimination, as well as management turnover
Late 1990s	Major restructuring by exiting newsprint/groundwood paper and building materials, as well as closing some small mills
1996	Raymond Royer joins Domtar as CEO, leaving Bombardier
1997	Domtar and Cascades form Norampac joint venture, the largest corrugated producer in Canada with seven mills and 20 box plants
1998	Domtar buys E.B. Eddy from George Weston for \$808 million, adding four mills and 550,000 tons/yr of value-added paper capacity
2001	Domtar buys four Georgia-Pacific mills in US for \$1.65 billion with 1.4 million tons/yr of capacity, doubling UFS capacity
2004	Consolidates merchant operations into Domtar Distribution
2006	Shuts Ottawa and remainder of Cornwall, ON, mills Sells 50% stake in Norampac to Cascades
2007	Completes \$3.3 billion merger with Weyerhaeuser's fine paper division, creating largest North American UFS producer Agrees to sell 11 wood products plants to Conifex for \$268 million Closes Gatineau, QC, paper mill and paper machines at Baileyville, Maine, and Port Edwards, WI; indefinitely idles Dryden, ON, paper machine

scrutiny. Last spring, the company said it was in "active discussions" to sell its cellulose and white paper business, which had not been profitable in recent years.

In August 2006, Weyerhaeuser and Domtar announced an agreement to com-

bine their white paper assets. The \$3.3 billion cash and stock deal was structured as a tax-free "Reverse Morris Trust" transaction in which Weyerhaeuser split off its fine paper division and offered the shares to its shareholders in an exchange offer. Domtar Inc

was merged into the new entity (which took the name Domtar Corp) for cash and stock, with Weyco shareholders ending up owning 55% of the new company and former Domtar shareholders holding 45%.

White paper powerhouse

The "New Domtar" is facing a much brighter outlook as the leading North American UFS producer, with roughly 5.0 million tons of capacity and a one third share of a more consolidated and disciplined market, according to analysts. The deal more than doubled its UFS capacity, enabling the company to leapfrog International Paper (IP) as the largest North American producer (although IP is still retains its position as the world's largest UFS producer).

With sales of around \$7 billion and nearly 14,000 employees, the company also has some of the largest and lowest cost mills in the industry and one of the broadest product lines.

It also has significantly less exposure to the strengthening Canadian dollar. More than 80% of its paper capacity at its 14 North American mills is now based in the US, compared with about 65% before the merger. The company's operational center is in Fort Hill, SC, and its executive vice president and COO is Marvin Cooper, a former Weyerhaeuser and Willamette executive.

Domtar has described the "backbone" of the new company as "six highly efficient world-class uncoated freesheet mills" that provide two-thirds of its capacity. Four of these mills are from Weyerhaeuser (Hawesville, KY; Plymouth, NC; Kingsport, TN and Marlboro, SC) in addition to the former Domtar's Ashdown, AK, and Windsor, QC, mills.

Ashdown, one of the four mills acquired from G-P, is the largest North American UFS mill and one of the lowest cost. Three or four of the mills are in the top quartile in cash cost for UFS commodity grades such as cut-size and printing and converting grades, according to RISI benchmarking services. Domtar believes that it has six of the nine largest paper

TABLE 3.

The New Domtar

Location	Paper Machines	Grade	Capacity (000 tons)
Ashdown, AR	4	Copy/offset	910
Windsor, QC	2	Copy/offset	630
Hawesville, KY	2	Copy/offset	610
Plymouth, NC	2	Copy/offset	470
Kingsport, TN	1	Copy/offset	420
Marlboro, SC	1	Copy/offset	380
Johnsonburg, PA	2	Copy/offset	360
Dryden, ON ¹		Copy/offset	325
Prince Albert, SK ²		Copy/offset	
Port-Edwards, WI ³	3	Value added	190
Nekoosa, WI	3	Value added	160
Rothschild, WI	1	Opaque	140
Woodland, ME ³		Opaque	
Gatineau, QC ³		Coated lightweight	
Port Huron, MI	4	Technical/specialty	115
Espanol, ON	2	Technical/specialty	80
Total	29	Uncoated freesheet	4,790
Columbus, MS	1	LWC	240
Total	1	Coated groundwood	240
Total fine paper			5030
			(000 tonnes/yr)
Kamloops, BC		NBSK	470
Prince Albert, SK ²		NBSK, NBHK	
Woodland, ME ³		NBHK	385
Dryden, ON		NBSK, NBHK	330
Espanola, ON		NBSK, NBHK	350
Ashdown, NC		SBSK, SBHK	175
Plymouth, NC		Fluff	160
Marlboro, SC		SBHK	80
Hawesville, KY		SBHK	60
Total		Dried pulp	2,010

1. No. 2 paper machine at Dryden indefinitely shut August 12, but mill is producing market pulp.
 2. Prince Albert indefinitely idled December 2005. Domtar reached an understanding with the province to reopen the facility as a 328,000 ton/yr NBSK market pulp mill.
 3. Reflects early August announcement of permanent closure of 125,000 ton/yr paper machine at Woodland mill in Baileyville, ME; shut of idle 35,000 ton/yr paper machine at Port Edwards, WI, and closure of 125,000 ton/yr coated lightweight paper machine at Gatineau, QC.

machines in North America and two of the 10 most productive UFS machines in the world (Kingsport's No. 1 paper machine and Hawesville's No. 2 paper machine).

The company also has five mills specializing in value added grades such as opaques and technical and specialty grades. In addition, the company has the former Weyerhaeuser coated mechanical paper mill in Columbus, MS. Domtar has capacity to produce 2.1 million tons of copy and premium imaging paper (42% of total capacity); 1.6 million tons of offset envelope forms bond (32%); 700,000 tons of opaques, text and cover, and trade book (14%); 200,000 tons of coated mechanical (4%) and 400,000 tons of specialty and industrial grades (8%).

In addition, Domtar is continuing to emphasize "differentiated" products, such as its EarthChoice product line of environmentally focused grades with FSC certification. Its products are sold through multiple sales channels, including marketing 20% of production through its own Domtar Distribution Group, the fifth largest paper merchant organization in North America.

Targeting \$200 million in synergies

Domtar has targeted \$200 million/yr of synergies from the merger in process optimization and lower operating, transportation and administrative costs — a goal management hopes to achieve by the first quarter of 2009. The company has already closed a number of high cost paper machines, sold its 50% interest in the Norampac corrugated venture and plans to sell most of its sawmills.

In early August, Domtar said it was permanently closing 285,000 tons/yr of paper capacity, including a paper machine at its Woodland mill in Baileyville, ME, a small paper machine at the Port Edwards, WI, mill and its Hull mill near Gatineau, QC, along with a related Ottawa converting operation. In August, the company indefinitely idled the remaining 315,000 ton/yr paper machine at its Dryden, ON, mill, bringing

the total of permanent and indefinitely idled UFS capacity to 500,000 tons/yr.

Domtar is continuing to run its Dryden and Woodland facilities as market pulp mills to take advantage of the strong global pulp market where prices are at the highest level in more than a decade. These mills are in addition to its 470,000 tonne/yr former Weyco market pulp mill in Kamloops, BC.

The company has total pulp production of around 5.5 million tonnes, of which 3.8 million tons is consumed internally. Pulp shipments from nine of its mills are currently around 1.7 million tons, but the company purchases about 700,000 tonnes/yr of pulp at about nine of its mills. As a result, Domtar's net pulp sales position is around 1.1 million tons (adjusted for recent paper machine closures). It produces virtually every major grade of bleached kraft pulp, including fluff at Columbus.

These figures do not include the Prince Albert uncoated freesheet and market pulp

mill which Weyerhaeuser closed at the end of 2005. In September, Domtar announced an "understanding" with the province of Saskatchewan to reopen the facility as a 328,000 tonne/yr northern bleached softwood kraft market pulp mill. There was no provision in the plan to reactivate the 280,000 tonne/yr uncoated freesheet machine or sheeting operation at the site. Royer said this was an "important step" in reviving the facility but this would depend on demonstrating "the mill will be a first quartile operation with a Canadian dollar at close to parity with its US counterpart."

Quevillon, QC, pulp mill closed in 2005. These operations could someday be potentially reactivated or spun off, if the company decides market pulp is not a core business.

For its first full quarter as a combined company, Domtar reported second quarter sales of \$1.62 billion and operating income of \$69 million, which came in somewhat below analysts' estimates due to heavy maintenance downtime and likely some disruption caused by the merger. Also hurting the situation was weak North American UFS demand, which was down 5% year-to-date, partly due to inventory reduction. The earnings shortfall caused the company's stock (NYSE ticker symbol: UFS) to drop from a high of \$12/share in May to a low of \$7/share in July before recovering slightly.

Profitability, shareholder commitment

But Royer remains confident that the merger will lead to higher profitability and creation of shareholder value. "Paper is a complex industry, where we can apply simple business principles," he told analysts during a September meeting at the company's Kingsport, TN, mill. "Success depends on improving our cost position, achieving customer support, managing customer risk, capital discipline and teamwork."

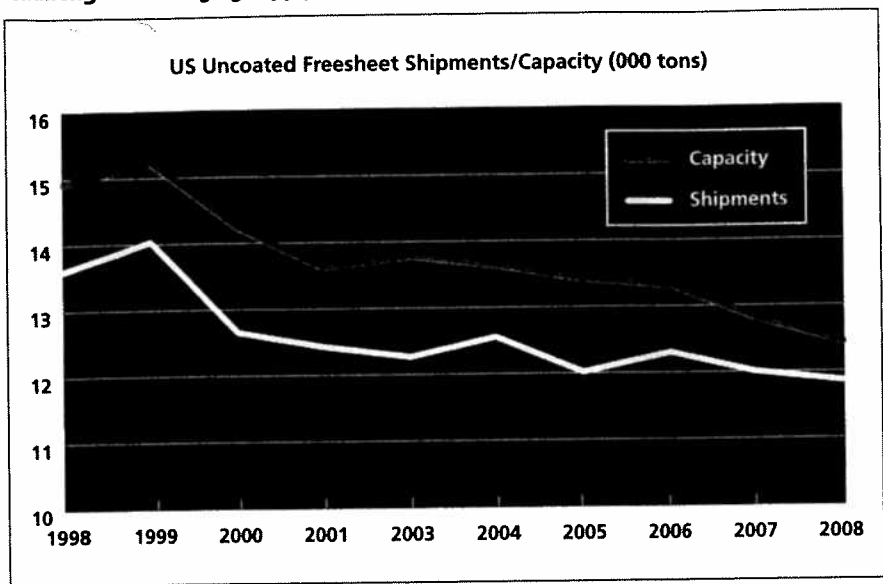
The company remains committed to keeping supply in balance with demand in a

TABLE 4.
Domtar paper product mix

	Millions of Tons	% Total Capacity
Uncoated freesheet		
Copy	2.1	40%
Premium imaging		
Offset	1.7	32%
Envelope		
Forms bond		
Opaques	0.7	13%
Text & cover		
Trade book		
Coated groundwood	0.2	5%
No. 5		
Coated freesheet	0.1	2%
UFS/CFS	0.4	8%
Flexible packaging	0.4	
Industrial		

*Before recently announced capacity closures.
Source: Domtar.

FIGURE 1.
Challenge of managing supply to meet demand in a shrinking market



North American UFS market, which is expected to decline at a rate of 1-2%/yr in the future (and even more this year). In the face of declining demand, Domtar's strategy is to "keep its best mills at the low end of the cost curve and take advantage of creep potential to rationalize operations," Royer said.

Management pointed out that Domtar has a number of paper mills with excess pulp capacity, such as Ashdown, Marlboro, Hawesville and Windsor. Paper production at these mills can be expanded at 2-3%/yr, while older, high cost capacity is closed. For example, the Marlboro mill has increased its production for 15 consecutive years at a 3.4%/yr rate from 652 tons/day in 1992 to 1,086 tons/day in 2007. Kingsport has increased production 2.9%/yr over the last several years.

Domtar also believes it has an advantage in delivered costs because of the geographic location of its mills and philosophy of "off-site converting" so that its mills and plants are located near major regional UFS markets. "Delivered costs are the right metric," Royer

noted. The cost of off-site converting was estimated to be 25% less than on-site converting at mills, and Domtar believes its 15 converting plants are the most productive in the industry.

"Capital discipline is our landmark," Royer told analysts. The company plans to spend only \$150 million (30% of depreciation and amortization) on maintenance and environmental expenditures. Another \$150 million (30% of depreciation) will be spent on projects with a return (IRR) threshold of 30% or higher, with emphasis on energy reduction, freight optimization and improving fiber yield this year.

As for the balance sheet, the company's goal is a debt-to-capitalization ratio below 40%, down from 44% at the end of the second quarter and 47% in the first quarter.

Senior vice president and CFO Daniel Buron provided several examples of how the company is going to improve profitability through integration and optimization. One example of network optimization is the company's Ashdown, AK, mill, which now can ship 97% of its production to California and the

Southwest compared with only 31% before the merger, while its other mills can more efficiently supply markets in the US East and South formerly served by Ashdown, resulting in a cost savings of around \$25 million.

New staffing benchmarks for salaried and hourly employees will reduce labor costs by around \$28 million over previous legacy levels at Domtar and Weyerhaeuser. Another example of adopting "best in class practices" includes projects to provide equal or better brightness and opacity at lower cost at six mills, as compared with previous technology, for a savings of around \$5 million.

"We are going to keep working on our goals," Royer told analysts. "The people side (of the deal) is already working and now we are addressing the processes needed for the new organization."

The Big Bet on UFS

As a result of the deal, analysts say that Domtar is now in a much better position to manage supply to meet possible future declines in demand in a shrinking market. The consolidation has left only one other major competitor in the market, IP, which also has a strong commitment to the UFS market and has shown a willingness to curtail or convert capacity in response to declining demand.

"The main future risk for Domtar in its large bet on uncoated freesheet would be if the decline in future demand turns out to be faster than expected, such as what has happened in the newsprint market," one analyst said. A symbol of how the company is tied to the grade is its stock ticker symbol, "UFS."

Past recipients of the North American CEO of the Year award include John Faraci of IP (2006), A.D. 'Pete' Correll of G-P (2005), Paul Stecko of Packaging Corp of America (2004), Raymond Royer of Domtar (2003), Steve Rogel of Weyerhaeuser (2002 and 2001), John Dillon of IP (2000) and Michael Smurfit of Jefferson Smurfit Group (1999). **P&P**