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International Paper Co. (IP)

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CORPORATE PARTICIPANTS

Andrew K. Silvernail
Chief Executive Officer & Director, International Paper Co.

OTHER PARTICIPANTS

Philip Ng
Analyst, Jefferies LLC

MANAGEMENT DISCUSSION SECTION

Philip Ng
Analyst, Jefferies LLC

Good morning, everyone. I'm Phil Ng, Jefferies Paper and Packaging analyst. We're excited to have the International Paper team with us today. Kicking things off, representing the company with me right here is Andy Silvernail, the CEO. Tim Nicholls, CFO, is in the audience as well, as well as Mark and Michele.

QUESTION AND ANSWER SECTION

Philip Ng
Analyst, Jefferies LLC

Q

Andy, I mean exciting times. A lot to talk about. I guess to just kind of kick things off, I think we're all excited to hear how you unlock value. You gave us some framework how to think about the next few years, bringing your business from, call it, $2 billion of EBITDA to perhaps $4 billion in the medium-term. What are some of the big buckets in terms of that unlock and how do you get from A to B?

Andrew K. Silvernail
Chief Executive Officer & Director, International Paper Co.

A

Yeah. So, I think – thanks, Phil. First of all, it's good to be with everybody. I appreciate it very much. Before we get started, I think, as everyone knows in the audience, we're involved with kind of the last stages of our acquisition of DS Smith. And just because of that, we're going to have to be careful about a number of things that we talk about in terms of timing or things that can be interpreted as a forecast. We don't want to find ourselves in trouble with the authorities and then extending the timeframe of the deal. So, at least I'd say that upfront as we jump in.

So, Phil, when I think about the unlock of value, first and foremost, I ask myself is the potential there to do that? So, when you think about the ability to expand profitability in this business by a couple of billion dollars, that question of is it actually there, is it viable to go get. And for those of you who sat through the second quarter call or the 80/20 101 session that we did, I think it's self-evident that it is there and we are the barrier to getting there. And what I mean by that is if you look at the potential profitability that we start with what we call material margin.

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So, think of sales minus the input costs of a business. That's nearly $13 billion in our business. And over the last five years, our input costs, our material margin has actually grown by $1 billion. So, it's increased by about $1 billion in the last four or five years. At the same time, our overhead costs or I shouldn't say overhead cost, our operating cost, total operating cost, SG&A and manufacturing overheads have increased by $1.7 billion, and so obviously there's been inflation there.

But I would argue it's really all of what is stuck, so to speak, in terms of profitability is due to complexity. It's due to complexity of how we think about customers and products. It's due to complexity with how we manage in a pretty heavily matrix structure and it is not aligned toward how value really flows to and from the customer. And so that's really where my focus is, is how do you unlock that. And I kind of break down value creation into two pieces when I think about IP.

The first piece is really around what I'll call a profit reset, which is how do you get to a baseline level of profitability that's possible with the current portfolio that we have in the "medium-term" and I apologize, but I'm not going to define medium-term back to my opening.

Philip Ng
Analyst, Jefferies LLC

Q

Sure.

Andrew K. Silvernail
Chief Executive Officer & Director, International Paper Co.

A

And so, when I look at that, when you look at roughly $19 billion of revenue on the current portfolio, that idea of getting to $4 billion of EBITDA, given those material margins and given the reality that we are in the way of it with the complexity, I think that's very possible.

The second part is, is in the medium-term to forever, which is can you consistently grow value, which we've been challenged with, right? We've been challenged with principally around two things. One is around organic growth. So, actually keeping pace with the market and eventually actually growing above market in terms of revenue growth. And then secondarily, that cost issue, which we talked a lot at our dinner last night about our lack of a continuous improvement culture.

So, for those of you who know me well, I came out of business school 25 years ago, and really from then through my time through IDEX, I've spent the vast majority of my time in a Danaher-type culture where I joined Danaher out of business school. And in the companies that I was part of, headed their lineage with leadership, including myself from there. And so that really aggressive continuous improvement culture around safety, quality, delivery and cost is not something that's embedded in our culture and it's something that needs to shift.

So, as we think about those two tranches, getting to the profit reset, being significantly more profitable than we are today and then, ongoing, how do you drive value creation over time in terms of organic growth and in terms of a culture of productivity. Those are the two big buckets.

Philip Ng
Analyst, Jefferies LLC

Q

Okay. A lot to unpack, right? So, on the cost side, there's a complexity I wanted you to talk about.

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Andrew K. Silvernail
Chief Executive Officer & Director, International Paper Co.
A

Right.

Philip Ng
Analyst, Jefferies LLC
Q

When do you think you're going to be in a position to know what the game plan is to take costs and where you need to take costs out, and how do you kind of reduce complexity and unlock that cost base, which could be pretty significant.

Andrew K. Silvernail
Chief Executive Officer & Director, International Paper Co.
A

Yeah. We're pretty far down the path already. And part of the difficulty in articulating that as clearly as we want to and you want us to is the DS Smith deal, right? There are just simply some things we cannot talk about and we just can't dig into at this stage because of the restrictions around that deal. And so our expectation is as we go into the fourth quarter, things will become more evident. So, when we do our third quarter call, there will be some specific things that we'll talk about and that we'll – they will execute as we move into the fourth quarter. And then when we get the deal closed, we could be a lot more specific and we expect that to be the end of this year, the first part of next year, given where we are in the regulatory process.

Philip Ng
Analyst, Jefferies LLC
Q

Okay. And then, Andy – you reminded me, Andy, people that don't get the 80/20 part is there's a huge cost element but you wouldn't be doing your job to create long-term value unless you reinvest it, right?

Andrew K. Silvernail
Chief Executive Officer & Director, International Paper Co.
A

Yeah.

Philip Ng
Analyst, Jefferies LLC
Q

And then you made the point in your first earnings call, we have earned our performance because...

Andrew K. Silvernail
Chief Executive Officer & Director, International Paper Co.
A

You know we have.

Philip Ng
Analyst, Jefferies LLC
Q

...you have invested, right? So, I think there is a view that there's just a CapEx element. There's that. How are you going to do that? But there's also obviously a P&L impact in terms of maintenance, reliability maybe from a capability and then sales force side of things. Just help us unpack where some of the areas that you think IP is underinvested and where you guys are planning to attack that going forward?

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Andrew K. Silvernail
Chief Executive Officer & Director, International Paper Co.

A

Well, I think, Phil, first, what I'd say is we have no intention of coming back to you, our investors, and asking you to fund it, right? We're not going to say and therefore we're going to lower our expected profitability to fund these investments. My view of, when you think about 80/20, what is it? It is around understanding where profit pools are long-term, where returns can be driven long-term and moving people and investment towards those things very aggressively. One of my favorite sayings of all times is if nothing changes, nothing changes. And so, fundamentally, you have to aggressively move resources, people and money towards those things that you want to inflect. And we'll do that. And the idea behind it is we will fund that. We'll both improve profitability and fund expense and capital through those changes. In my point of view, there are a number, I'm going to put the big inflection points into three big buckets, two are commercial. One is – [ph] excuse me, (00:07:40) one is commercial; second is a hybrid, and the third is pure cost. And let me start with the cost side. Because ultimately, right, we have to reset our cost structure. That that growth of $1.7 billion in total operating costs over the last few years is unacceptable. And we have control over that. And so our ability to understand where we are overcapacitized, where our matrix organization doesn't function for us, it doesn't drive value for us and resetting that is step one, right? That's how you fund all of that and that's how you start the journey toward a profit reset.

The second one that is a hybrid is starting to think about investments around driving capability, both to drive productivity but then driving capability long-term. And I'll give you an example. So, if you think about economic downtime, so economic downtime is a fancy word for we have too much cost. That's what it is. And the ability to eliminate that economic downtime and move that volume to assets that are far more capable has three benefits.

The first one I already talked about, which is to kind of taking out structural cost. The second one is actually with the assets that have the potential to be at full performance. The assets that we have run really, really, really well when you're kind of plus 90% utilization, right? They run very well. That's what they're designed for. They're actually designed for that, whether it's a mill or a box plant, they're designed to run in those utilization ranges. And kind of like a guitar string, if it's too tight, it breaks. And if it's too loose, it goes dung, right? And so, as you move volume and you can find that tightness, those assets start to perform much better, right, which drives reliability into the field and that's why I say it's a hybrid. So, it's just to drive reliability of supply into – towards customers.

And then the third piece is that culture of continuous improvement, so, as you free up capital and you're able to really drive capital spending into continuous improvement. So, what's very different about IP versus my time at IDEX is the nature of the capital cycle, right? We're dealing with half-decade capital cycles generally. So, from start to finish, where I was dealing with kind of two- and three-year capital cycles before. And why that's important is that that engine of productivity has to be fed consistently with investment. It absolutely has, specifically around maintenance investment and around overall productivity. And so those are those three parts. And that's kind of the hybrid piece that I was talking about.

The third one is really around commercial excellence. And I think around commercial excellence, I'll break that into an A and a B. The first one is getting coverage, right? So, getting the right kind of coverage in the right geographies, which we have – we are – we're not covered appropriately. We have work to do. We need to expand our sales capability in terms of coverage, in terms of the type of coverage, meaning as we segment different types of customers, they need and deserve different types of coverage, and the same thing on sales and on service capability. That's really important.

The other one is really around pricing intelligence. So, our industry is not very good at pricing. Bottom line. For as big as we are and as important is pricing is in our industry, if you look at us compared to, say, other businesses that are similar, so I'll use the chemical industry as an example. And even to some degree, I don't want to

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compare us to it. But just because they're so good at actually intelligence of pricing, the airline industry around the intelligence of pricing, we need to get much better at understanding that.

And why is that so important? It's so important because in my old world, when a highly – in a really highly engineered, highly differentiated product, when you were the market leader, you got 10%, 20%, 30% price premiums versus the middle-tier players. That's just not the way that works in this world. You're at a 3% to 5% premium if you're high-performing and you're established. But that 3% to 5% is a huge difference between being really profitable and having great returns and being okay. And we need to continue to invest in the tools and the intelligence to price to value in the marketplace.

Philip Ng
Analyst, Jefferies LLC

Q

Okay. On that note, on price, you pine on price to value maybe 3 to 5 points. And then we had a good conversation the last time about pricing umbrellas in the past. Maybe the industry would, at times, get a little bit too greedy and that would solicit more capacity. And then you talked a little bit about price to real costs rather than the mills. Can you kind of unpack all those elements from a pricing standpoint, how you're thinking about it perhaps a little differently than the old IP?

Andrew K. Silvernail
Chief Executive Officer & Director, International Paper Co.

A

Yeah. So, as I've studied this both in my diligence and since I joined the company on the 1st of May, one of the questions I had was how much of the market volatility is driven by self-inflicted wounds and how much of it is – is – can be – where you can bring discipline to that. And I think part of the self-inflicted wounds is as things cycle in and out, how dramatically we respond, I'm not going to speak about the rest of the industry, but how dramatically we tend to respond to things drives a lot of behaviors internally and I think drives a lot of market behaviors. What do I mean by that? When things are good and pricing is high, the industry tends to get pretty darn greedy. And what do I mean by that? We get greedy and we extend and we ride price for as long as we possibly can, which really starts to invite what I'll call relatively undisciplined capital. And if you think of it from a perspective of where it's attractive to come in or not, my best estimate is in the mid-teens, it's probably relatively unattractive for somebody who's a marginal producer to enter the marketplace. When you start talking about things that are in the 20s, the risk, just the – the risk that you have, right, the margin of safety that's out there tends to attract kind of crazy behaviors, even though you know that the downside of that, right, is one where the cash returns, over time, don't pay off. And so I think really being disciplined around that and not getting too excited when things are tough and not getting too excited when things are good and really understanding the long-term is what matters in creating value over the long-term and bringing that discipline in the marketplace, even if that means you're making some tough choices.

Like we're making some tough choices right now around price and volume because we have been undisciplined and because we have been pricing below reasonable returns. And so I think that's really important. Now, to get that right and to drive really good returns over time, that balance between pricing to value, so pricing to market, not pricing to cost. And this, our industry, from what I can tell, is a cost-based pricing industry, right? That's how we think about it and that's completely wrong from my perspective. You have to be able to compete kind of at that intersection of customers and competitors and then you got to drive the heck out of productivity. That's how you drive long-term returns.

Philip Ng
Analyst, Jefferies LLC

Q

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Okay. And I think the perception out there in terms of think about the corrugated containerboard producers that have delivered higher returns and margins consistently, we often point to higher vertical integration, the mix in smaller regional customers, which I think is important. But I think in your 80/20 presentation, you talked about how the profit pools you're looking to attack and it's actually not necessarily that profile. But kind of help us think through which profit pools that you're looking at and why that's going to unlock value?

Andrew K. Silvernail
Chief Executive Officer & Director, International Paper Co.

A

Yeah. Look, I think there's a bit of a – it's a fallacy, a bit of a fallacy that the only place that money is made in this industry is in the small local customers. I think that's a fallacy. And what do I mean by that? When you look at the national accounts or the larger customers, when you look at those businesses, if you behave in a way like we have, which is a very complex, relatively undisciplined cost structure, yes, it's very hard to compete and win and make sustainable returns when you're playing in the very large pieces of the market. If you are disciplined and you do have the right cost structure, it can be very attractive, and you can offer a superior solution to those customers. But that requires you to drive like heck to be the low-cost producer, not the low-price player. To be very clear, that's not what I mean. But to be the low-cost producer.

And when you subsegment the market between what I'll call national and local or regional accounts, they both have very attractive profit pools but you have to approach them differently. How you go about doing business is different. And one of the mistakes that we have made is we have treated them, in many ways, the same in terms of the cost structure and in terms of the intensity of how we service them. And when you do that, you basically are managing to the mean. And when you manage to the mean, you're kind of not good for anybody. And so that segmentation and organizing yourself around those customer segments and that's really what 80/20 is all about, is going to be a big key to can we access those profit pools.

Philip Ng
Analyst, Jefferies LLC

Q

Super. I think probably a lot of investors in this room, if there's any pushback that we've done on our bullishness on the IP call is how does DS Smith fit in the equation going forward? IP has had a mixed track record being international. Why is it important being international? And then you're obviously looking to lead a transformational change in culture and how you're running business in US. How does – executing all of that? Is there any risk around integrating DS Smith and doing what you're trying to accomplish in the US, so, help us kind of think through that?

Andrew K. Silvernail
Chief Executive Officer & Director, International Paper Co.

A

Yeah. Well, look – yeah. I would be disingenuous if I said there was no risk, right? That would be – it'd be crazy to say. And ideally, right, if we could do this deal a year or two from now, that would be better. But we can't, right? That's not reality. And from a strategic perspective and from a financial perspective, this is a very good deal, right? It is structurally a very good business in that marketplace in Europe and we become a clear leader in the European marketplace. But that's really an investment decision around the European theater.

The reason I say that is that there's very little overlap. When we talk about cross-border deals, when we talk about international deals, the fact that they are in Europe is the only thing that's really of interest there. How the businesses operate, there's very little overlap and there will be very little overlap between the businesses besides a handful of places that will drive a bunch of cost benefits. So, how we purchase chemicals, us being long paper,

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them being short paper are examples, the overhead structure, the combined overhead structure that exists in Europe. Those things are things that are shared in our – we can go get from being together.

The reality is, is that what this is, is really three different integrations and we have to treat it that way. And I think by treating it that way, we can derisk the transaction very substantially. And, by the way, I think the capital structure and I think the price paid derisked the transaction substantially already. But the three different integrations, how we're thinking of that is in the US, they have two small mills and eight box plants. It's pretty darn small. That really gets absorbed into our North American packaging footprint and it's a relatively small integration. It does not worry me substantially.

On the corporate side, what we've said is we're going to make this very simple. We're going to close the books and we're going to be compliant and that's it. We're going to close the books and we are going to be compliant. We are not going to do systems integrations. We're not going to do policies and procedures integrations. We're not going to do all that administrivia and bureaucracy that tend to go with large deals. There's really no point in that. It's not to say that there won't be benefits at some point in the future of finding those things, but they are nowhere near coming to the top of the list. The top of the list is what's happening in Europe. So – and what's happening in Europe is effectively DS Smith acquiring our European footprint, right?

We are really strong in the Iberian Peninsula. We're very, very strong there. And they are strong throughout the rest of Europe. The way we can actually think about our box plant network, the way we can think about how we link our mills to our box plant network, the way we can leverage their strengths commercially, DS Smith is very good commercially, much better than we are. And what we can do to help bring operating discipline in terms of manufacturing to them, I think of that. So, completely different teams of people. Tim Nicholls, our CFO, is going to lead the overall integration. We have a very strong finance team and so that's going to become the bulk of his time. That's going to become his 80, so to speak. And so making sure that we do no harm with the core of DS Smith, making sure we go get the $514 million-plus of integration benefits. And that's kind of the start. And the fact of the -again, the price we paid in the capital structure puts it in a pretty good position to derisk it.

Philip Ng
Analyst, Jefferies LLC

Q

Okay. You going through it, I mean, I think everyone in this room appreciates that you're trying to unlock long-term value but to, call it, the next few quarters. There's a adjustment period whether it's your go-to-market strategy from a pricing standpoint where there's going to be some volume leakage and then you're stepping up costs in terms of improving the performance of the business over the long-term.

On the commercial front, can you remind us where you are kind of in that negotiation process for some of these below market contracts? And when you expect that is flushed out and you could see your volumes stabilize [indiscernible] (00:22:03)?

Andrew K. Silvernail
Chief Executive Officer & Director, International Paper Co.

A

Yeah. So, the vast majority of things that we're going to negotiate have been negotiated. And now what it is, is a matter of kind of when they flow through. And our expectation is as – kind of the bottom of that was last quarter and over the next two quarters. And we believe that by the end of next year, we start to get to some kind of equilibrium, right? So, it should get sequentially better as we get into the second quarter of next year. That's kind of how I would think about that; first, second quarter of next year. And then, hopefully, by the end of next year, we're starting to get to some level of parity. That's really the goal. And how do I – what gives me any level of confidence around that. So, if we kind of freeze the economic outlook, right? So, I'll just say let's just kind of

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freeze that because I don't control that and that's going to go up and down. We know when expected volume is going to fall off from things that have been negotiated. And so we can look at that pipeline. I'm personally spending a lot of time looking at the pipeline, trying to understand how the pipeline flows. Customers in, customers out, customers that we think are out but actually are coming back to us, which we're seeing a little bit of that, which is good. And so, – so that's what gives me confidence that we can get there. That being said and we talked about this last night, ultimately, right, for the investment thesis to work past the reset, we have to inflect from being a net share loser, right, to getting to parity to winning, right, if I just kind of think about that over time. And that's what we're focused in on. And that's why when you think about commercial excellence around having the right kind of coverage, having the right kind of service and support, having the right kind of pricing models, those sorts of things are going to be really key as I think about multiple years forward.

Philip Ng
Analyst, Jefferies LLC

Q

And I guess we have time for one last one. The investments you're making, just to make sure you have the right coverage, the sales force, when do you think you're going to have that in place? I'm not asking you when you're going to see results. But in terms of hiring the people, having the infrastructure, kind of walk us through the next few steps?

Andrew K. Silvernail
Chief Executive Officer & Director, International Paper Co.

A

I think it's kind of 12 to 18 months to have it structurally right. And why does it take that long? Look, you got to hire people. You're hiring people who aren't necessarily in the industry, and so there's a training cycle. There's a pipeline cycle, right? So, when – if someone comes in, if you think of their training, their onboarding, their development, that early stages, then you're building their pipeline to ultimately that turn into new volume. I think that's kind of an 18-month outlook.

Philip Ng
Analyst, Jefferies LLC

Okay. Well, Andy, I think that's all the time we have. Really appreciate all the great insights. Thank you very much.

Andrew K. Silvernail
Chief Executive Officer & Director, International Paper Co.

You bet. Thanks, everybody.

Philip Ng
Analyst, Jefferies LLC

All right.

Andrew K. Silvernail
Chief Executive Officer & Director, International Paper Co.

Take care.

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