By **MONICA SHAW,** Editor

Packaging success

After successful integration of the Gulf States assets, Rock-Tenn CEO James Rubright says the search continues for assets that fit the company's paper and packaging business

In an era of difficult markets and rising costs, North American paper companies continue to look for ways to create growth. While some larger companies have gone into a "de-consolidation" mode, others are looking for acquisitions that open opportunities within a focused product niche.

Such is the case with Rock-Tenn Co., a $2-billion manufacturer of packaging products, merchandising displays, recycled paperboard, and, more recently, solid bleached sulfate (SBS) board and southern bleached softwood kraft (SBSK) pulp, stemming from the purchase of Gulf States' paperboard and packaging assets this past June. The company now has 12 mills, most of which produce recycled boxboard or bending chipboard, as well as 27 folding carton plants, 39 other converting facilities, and 11 paper recovery facilities.

Headquartered in Norcross, Ga., Rock-Tenn breaks down its operations into three business segments: packaging products, which includes folding cartons and solid fiber interior packaging; merchandising displays and corrugated packaging (flexographic and litho-laminated); and paperboard, including uncoated and clay-coated recycled board and SBS board.

The purchase of the Gulf States' assets, especially the low-cost Demopolis, Ala., mill, was hailed as a good move by many analysts, and Rock-Tenn has already reaped benefits in the form of a 58% increase in cash flow over last year. Rock-Tenn chairman and CEO James A. Rubright has called the assets a "terrific complement" to the company's existing ones, and is proud of the company's entry into production of the "premium paperboard substrate in the folding carton industry."

Pulp & Paper recently spoke with Rubright about Rock-Tenn's acquisition and growth strategy, as well as the challenges and opportunities facing the company's various segments. Rubright, who has served as CEO since October 1999 and chairman since January 2000, was previously an executive officer at Sonat Inc., an energy company, as well as a partner in the law firm of King & Spalding, specializing in mergers and acquisitions and corporate and partnership financings.

CORPORATE STRATEGY AND ACQUISITIONS

Rock-Tenn has seen a variety of acquistions, both large and small, since you joined the company in 1999. Has that been your major focus? Are the acquisitions focused on product mix or regional considerations?

I came to Rock-Tenn to build the company, and when I got here it seemed the best thing we could do is to focus on executing better, which we did for the first couple of years. The company cut a substantial amount of costs, particularly in our folding carton business. We also invested heavily in our recycled paperboard mills to improve product consistency and take out costs. Early on, the acquisitions were relatively small, bolt-on acquisitions, either to the display business or folding carton business.

Acquisitions have been focused on both regional and product mix considerations. One example is our 2003 acquisition of Cartem Wilco Group in Canada, which consisted of two different operations. One business was a food and consumer packaging-based folding carton business that we integrated with our Ling Industries operations in Canada, where we have a large folding carton plant in Warwick, Que.

However, we were particularly attracted to Wilco, the other business, which allowed us to expand into the higher end pharmaceutical and health and beauty products packaging categories. The high end of Wilco's business is hair coloring packaging, and we are one of two companies in the U.S. that are material suppliers. We've now integrated our other pharmaceutical and cosmetic packaging plants into a group with Wilco.

An example of a regional acquisition was the August 2004 purchase of a corrugator in Athens, Ala., from Menasha. We had a corrugator in Atlanta that had been sold out for a long time, and we wanted to capitalize on that position and expand our presence in the Southeast. Also, in 2003, Rock-Tenn purchased its first West Coast folding carton plant in Kerman, Calif.

Post-merger, Rock-Tenn is moving customers and equipment among its folding carton plants to optimize production capabilities, says Rubright.

What was the motivation behind Rock-Tenn's larger, more recent purchase of the Demopolis, Ala., bleached paperboard and SBSK mill, along with 11 folding carton plants, from Gulf States last June?

We saw Gulf States as the best fit for Rock-Tenn Company of any large potential consolidation candidate in the folding carton and paperboard sector. Before the acquisition we were one of, if not the largest independent purchasers of bleached board for folding carton markets in the U.S., purchasing about 160,000 tpy of bleached board from suppliers other than Gulf States.

On the other hand, the Demopolis mill owned by Gulf States was about half integrated with its folding carton operations, selling about half of its bleached board to independents. So by acquiring the mill and the folding carton system, the mill is effectively 100% integrated on a volume basis. Also attractive was the fact that the mill is relatively low cost due to a fairly significant amount of infrastructure investment in the 1990s.

With this higher level of integration, will you be selling less of the Demopolis mill's paperboard on the open market? Are there any plans to increase capacity at the mill?

We have not changed our purchasing practices. The mill's independent customers are very good ones and we intend to retain them, and we intend to achieve economic efficiencies at the paperboard mill by optimizing production for internal consumption.

So, we'll alter the grade mix purchased outside of Rock-Tenn to narrow the calipers we produce at Demopolis and increase mill efficiency, but we don't intend to change our practices with respect to serving independent folding carton companies that have historically been customers.

We've discussed this with our major bleached board suppliers and we think we have a plan that will work out well over time to change the mix. It's still early, but we believe it is going to work out well.

When the completion of the Gulf States acquisition was announced, Rock-Tenn said it expected around $13 million in annualized synergies in the first months and total annualized synergies of $20 million. Have those expectations been met? How has the debt-to-equity ratio been impacted?

We reached a run rate of $18.5 million by the fourth month after we owned the new assets, and we have said we would clearly get to $25 million in aggregate synergies and would look for opportunities above that. We realized a significant amount of synergies immediately, primarily of the administrative type, where we're ahead of expectations.

Now, we are focusing on operational synergies. We've closed two folding carton plants in relation to the acquisition — a former Gulf States plant in Waco, Texas, and a Rock-Tenn high-end health and beauty packaging plant in Marshville, N.C., which we consolidated into the health and beauty operations that Gulf States had in North Carolina. We achieved $5 million in synergies from those two closures. Added to the home office synergies, this puts us pretty close to our initial target, but we believe there are more opportunities.

We are at about 4.4 times debt to EBITDA as defined under our bank credit agreement. The pro forma net debt following the Gulf States acquisition was $948.5 million. As of September 30, 2005, the net debt was $72.5 million lower than the March 31, 2005, pro forma balance.

What other facility changes will result from the Gulf States' purchase? Do you anticipate more closures? What about closures within your mill system in general?

The next target for synergies is not further plant closings, because we're pretty full across our folding carton system and particularly in the plants related to acquisition synergies. Instead, we're moving customers and business among the plants to optimize production capabilities.

Some of the optimization is as simple as moving products to other facilities due to where they are shipped. Other changes are a function of press sizes and moving business to presses where products run better.

We're now in the process of actually moving printing and cutting equipment from various acquired plants to other plants to optimize the customer mix. We then move business into the plants to follow the equipment changes. So, we're in the second and third iterations of operational synergies in our folding carton system, where we believe we can ring out significant efficiencies.

Our most stressed business remains coated recycled board. We've worked very hard to develop industry cost curves and understand where our assets are in relation to the other assets in this base, and we believe that our assets are very competitive.

MILL SYSTEM AND ENERGY CONCERNS

With recent spikes in energy costs, there has been contraction in the recycled boxboard market with regard to plants not running at expected production rates. Do you think this will continue? Do you believe most North American recycled boxboard mills will be able to survive energy spikes this winter?

For Rock-Tenn, the productivity issue is mill-specific. In our specialty boxboard business where we make industrial paperboard for products like tubes, cores, laminated furniture components, interior packaging, and book and bindery products, the mills had excellent performance. However, the clay-coated boxboard business for folding cartons has suffered from decreased demand because of competing substrates and manufacturers moving offshore, and our mill operating rates have been down compared to the prior year.

Also, I think our volumes may have suffered due to our effort to increase prices to recover cost increases. In anticipation of this winter, we are probably somewhat more realistic about what natural gas costs are going to be, although we do expect to see continuing price recovery across all paperboard grades this winter.

Still, looking at publicly available data and our internal studies, over the course of the winter, a number of recycled boxboard mills will operate at or below cash cost, placing extreme stress on our sector. I've been saying for a while that I don't think the current environment is sustainable for the long term and it will be interesting to see how things play out.

Having been an executive at Sonat, an energy supply company, does this in any way provide an advantage for how your facilities deal with high energy costs?

I don't know that it creates necessarily a competitive advantage, but I probably do have more intense experience in that sector than most people in similar capacities.

Our CFO, Steven Voorhees, also came from the energy industry, as well as Erik Deadwyler, who is in charge of commodity risk management, including energy as well as fiber and interest rates. So, those managing our commodity exposures do have natural gas backgrounds, which has given us a fundamental view that hedging doesn't create value.

So, we don't adhere to the strategy that a number of our competitors have embraced of essentially averaging prices over the course of the year. We are cautious about exposure in winter, when price spikes can be dramatic, so we often manage our winter position in advance of the season. However, in terms of taking a long-term view with respect to price movements, we are of the opinion that we don't know where gas prices will go, so when we do take a position it's not because we think we know where prices are going, it's because we are pretty sure we don't know what the market will do.

What amount has been slated for capital spending this year? Is Rock-Tenn's investment strategy for its mills geared at energy efficiencies, quality, or just across-the-board improvements?

We expect capital expenditures this year of about $70 million, with depreciation around $105 million and sales of $2 billion.

As far as our recycled board mills in particular, we spent a lot of money for process controls in the early 2000 period, so they are particularly well invested at the current time with respect to quality and control systems. As a result, they're efficient in relation to mills of their type.

Our focus now is on investments that will reduce total energy costs for production, and we see good opportunities. We've made investments in the last 18 months that have reduced our purchased energy requirements for recycled paperboard by 10%. These efforts are paying larger dividends this year with what's happened to natural gas prices.

Currently, we're making a fairly significant investment in systems that will measure energy use within the mills. To manage energy consumption and control costs, you need to measure energy use at specific points throughout the process, which is difficult.

What is the primary wastepaper grade you use in the recycled board mills? How much of it do you collect through Rock-Tenn's paper recovery systems versus what you purchase on the market? Do your recovery systems bring you a cost advantage?

Across our recycled mill system, about 55% of total fiber is OCC and DLK. The remainder is a variety of grades, depending upon what we're producing.

We understand that there are those in the industry who believe that a large presence in fiber collection business is an important part of an overall recycled business, but we have not taken that position. The majority of our paper is sourced outside of our recycled fiber collection facilities.

There are local and regional differences, but having recycled fiber collection facilities is not an integral part of our mill strategy. It happens to be a business we are in, but we've reduced our exposure to the physical side of that business over the last few years, selling a number of plants that were not strategically located in connection with our own facilities.

According to Rubright, Rock-Tenn's merchandising display business "clearly has excellent growth prospects."

FUTURE GROWTH

Would Rock-Tenn consider buying more mills at this point or will you wait until the Gulf States purchase is fully integrated?

Our plan is definitely to survive as an independent entity, and part of that strategy is to look at available assets that fit with our basic business, because we want to be successful in the paperboard and paper-based packaging business.

We feel that the Gulf States acquisition is fully integrated. We acquired great people, and the business fit perfectly with ours. The systems piece is done, and we'd be prepared to do anything from an acquisition standpoint, but there isn't anything I'd want to comment on at the moment.

In the recycled paperboard space, I think there will be consolidation, but I don't know whether we will participate or not. And we've been very happy with our acquisition of the bleached board mill. I think if there were other opportunities there we would be very interested in considering them.

With regard to your different business units, which at this point do you see as having the most potential for growth?

The merchandising display business clearly has excellent growth prospects. The business grew substantially through 2003 and has been flat for the last two years, but we have stated we believe it will grow in the next year or two. I think it's an excellent business. It has typically grown more than the GDP growth that you see in the packaging businesses.

I also believe our competitive cost position in our folding cartons will support growth from existing plants, and we will continue to look at acquisitions and anticipate growth through them.

What sorts of investments have you made in the merchandising display business to help attract customers? Have you felt pressure to provide additional services in this business as a competitive differentiator?

In addition to the manufacturing capabilities required for producing displays is the design business, where we've focused very hard on having talented people and giving them freedom to create new designs for customers to help with branding. We're clearly recognized as the leader in developing theft deterrent point of purchase (POP) display systems and we're working with a number of major consumer products companies and some major retailers directly with respect to these issues.

We've significantly reduced the full program costs of PDQ (pretty darn quick) displays, which are the generic shelf-top displays, with a new design that dramatically reduces space requirements for shipping packed displays.

We also recently hired 15 people on the West Coast who are in the global brand management business and we're offering that service to customers on a fee basis for all forms of packaging, including promotional and display packaging.

I wouldn't say we've felt pressure to develop such services; the pressure in the business is on cost. Our strategy is to differentiate ourselves in two ways: by having very low costs, which we do in the display business, and by being recognized as the leader in innovation and client service, which I think we also have done a good job with.

"We acquired great people, and the business fit perfectly with ours," says Rubright of the assets purchased from Gulf States, including the Demopolis, Ala., mill.

Rock-Tenn has two converting facilities in Mexico and one each in Chile and Argentina that convert paperboard from local sources. Would you consider further expansion in South America? What about outside the Western hemisphere?

We continue to look at South American markets from the standpoint of the converting business as opposed to mills. Our South American facilities – in Mendoza, Argentina and Santiago, Chile – were greenfields that we started, but we are more likely to acquire a converting business in that region at this point.

Right now, our view is that this hemisphere provides plenty of opportunities.

Many of the statements Rock-Tenn has released comment on costs associated with Sarbanes-Oxley. Do you see this as a detriment for the U.S. industry from a cost/benefit standpoint?

For 2005, we spent $4.5 million on outside services alone for Sarbanes-Oxley compliance. You can also assume that every hour we pay a consultant is met by an hour of internal Rock-Tenn resources, so you can effectively double the cost of outside services to estimate the actual compliance cost. I view it as having been of no benefit to anyone other than potentially the accounting firms by conceivably reducing their exposure to risk, and I think this is a widely held view within our industry.

Sarbanes-Oxley was enacted in the wake of very high-level fraudulent conduct, but in actuality it is much more detailed and not directed towards high-level corporate fraud. If you really want to make sure that individual transactions are recorded with great precision, Sarbanes-Oxley is attempting to do so – at great cost. There is a massive expenditure associated with documenting controls that were already working well and then duplicative testing of all these hundreds of controls.

I think most people deeply involved with Sarbanes-Oxley compliance realize that it can't have a benefit equal to its cost. Also, this level of spending will continue unless the Public Company Accounting Oversight Board (PCAOB) changes its standard of materiality, which is far too low a threshold. I don't think investors benefit from the cost of pursuing those internal controls to that extent. **P&P**