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Paper and packaging industry
Back to basics: Cost restructuring for the future

Introduction

In an industry already challenged with consistently covering its cost of capital, the current credit crisis has added pressure to the balance sheets of many paper and packaging companies. The era of available and inexpensive credit for all is over, this much we know. Tapping the capital markets without addressing underlying business issues is no longer an option.

Collectively, the industry lost sight of the fundamentals of lowest cost production as a key driver to a sustainable and profitable enterprise. Growth by acquisition has given some groups strong market positions but left them with parallel structures that needlessly duplicate many functions. Where divestiture was the strategy, companies have been left with cost bases originally built for larger enterprises but are no longer necessary for the leaner organization.

The convergence of these two challenges makes a new look at cost reduction imperative for survival. Companies that have borrowed to merge, acquire, or invest in capital equipment need to deliver the synergies from those deals, and they need to deliver them sooner rather than later. The lending world has changed; it should not be assumed that lenders will tolerate underperformance without corresponding compensation (or marking to market).

The approach must be holistic. Operational performance and balance sheet management cannot be viewed separately. In fact, no part of the company can be spared careful scrutiny. Each can play an important role in reducing costs, preserving cash, adding shareholder value, and contributing to the long-term health of the company.

How did we get here?

By now, the story is familiar. It all started with easy credit and grand ambition.

When the cost of money is cheap, the temptation is to take advantage and borrow. Companies borrow to buy new mills, plants, and equipment. They borrow or restructure debt to merge (e.g., Abitibi Bowater) and to acquire (e.g., West Fraser Timber's acquisition of International Paper's U.S. lumber business and International Paper buying Weyerhaeuser's containerboard unit). They borrow to meet their obligations in volatile times. The paper and packaging industry was no exception.

Expansion or restructuring using low-cost capital is not a bad decision. However, top-line growth and dramatic market change leave managers with less time to focus on managing costs in SG&A (sales, general, and administrative) and associated inefficiencies. In good times, discipline on costs takes a back seat. In an economic slowdown, any inefficiencies can begin to erode financial performance and ultimately the very viability of the business.

At the end of 2008, a cross-section of 10 global paper companies had $50 billion plus debt outstanding, a median debt/EBITDA ratio of 6.3 times, demonstrating the lofty leverage that has been made available to the sector.

Right now, the lenders who supplied low-cost capital are re-examining the business plans and commitments these loans were based on. It is no secret that the banking industry is under duress, and the cost of most loans made from 2006 to mid 2008 falls substantially

below today's market value. The result is that any cost redundancies will have an impact on operating performance and could lead to the breach of lending covenants or commitments. To survive this recession, costs need to be reduced.

Of course, many companies have entered this recession in a stronger balance sheet position. These companies will have opportunities to make strategic acquisitions and to offer others a solution to balance sheet issues by acquiring noncore assets or their entire company. Nevertheless, even relatively healthy companies must focus their attention on sustained cost reduction to remain competitive.

Six strategies that will help companies thrive through a downturn

Following is a list of six proven strategies that help provide a road map for the successful navigation of the current economic crisis by suggesting areas where costs can be cut from the business. It is also a guide to taking advantage of the opportunities that cost cutting provides. Certainly, not every suggestion will apply, but in listing several, we aim to demonstrate that solutions can be finely tailored for almost every situation.

Figure 1: Six cost reduction strategies that promote growth and sustainability

Cost focus

"Lean-out" operations

- Optimize manufacturing and supply chain networks globally
- Leverage scale to improve service delivery of "back office"
- Reduce material costs through sourcing strategies
- Reduce asset intensity through strategic alliance and JVs
- Compress cash conversion cycle
- Reduce effective tax rate by leveraging new incentives

Shift fixed costs to variable costs

- Variable cost structure through tolling outsourcing
- Pursue contract labor in functions with highly variable loading
- Increase variable pay component in compensation models
- Overhaul shared service model to reduce internal demand for business services

Simplify business Model

- Calibrate SG&A cost burden to business unit gross margin potential
- Challenge value contribution of each business unit and divest accordingly
- Rethink the operating model to reduce cost business complexity

Growth and sustainability

Grow "smart"

- Revise pricing strategies based on less price elastic products and services
- Emphasize growth in geographies that offer counter cyclical demand (or currency fluctuations)
- Innovate to differentiate customer experience and drive into new channels and accounts
- Develop acquisition strategies to take advantage of favorable multiples
- Understand customer behavior and the cost to serve

Proactively manage talent

- Identify top talent to be retaining through downturn
- Accelerate out-counseling of underperforming employees
- Rebalance mix of monetary and nonmonetary incentives

Bolster planning disciplines

- Develop early warning systems and contingency planning capabilities
- Rebalance and prioritize the investment portfolio
- Tighten alignment among strategy, operation plans, and management rewards
- Improve balance sheet flexibility by de-levering and identifying alternate funding mechanisms
- Improve/ realign tax planning for new environment

Source: Deloitte Consulting LLP

Applying the right strategy: Three case studies

While the strategies outlined in Figure 1 cover a wide range of situations, the application will be tailored to the particular company and the realities it is facing.

In one example, a $2 billion company faced shrinking margins due to decreasing market share and increasing costs. Shareholder value had eroded during the two previous years, prompting the need for strategic cost reduction. With a whole-company approach, the firm was able to cut wasteful expenditures by sharing services, rationalizing capacity, streamlining customer service, and creating better tools to provide greater visibility for measuring and tracking projected savings. In the end, financial performance was greatly improved with a run-rate savings of approximately $50 million and a one-time cash infusion of about $27 million. Moreover, the savings were made sustainable and scalable for future growth by transforming the business model from a holding company to one of strategic control.

Another company, an $8.9 billion concern, found itself fighting to control costs in a rapidly shifting industry. A structural overhaul brought cost reductions to the operations and distribution, sales and marketing, and general and administrative functions. Indirect spending was reduced and the company implemented a "best cost" initiative across the organization to focus on keeping costs in check. The result was savings of approximately $200 million on a cost baseline of $1.1 billion and a three-fold improvement in operating earnings.

Finally, a $7.9 billion institution needed to find cost savings in the wake of a major divestiture. Employing key levers (e.g., business model integration, service delivery model, strategic sourcing, and demand management) they were able to realize savings of about $124 million and developed a roadmap to capture and implement further savings opportunities to put the company in a better financial position going forward.

Keys to success

While every company will be challenged by the global recession, no two companies will have precisely the same issues. As evidenced by the three summary case studies presented, the approach will be different depending on the company. However, any solution to drive out cost must be aligned with the overall strategic vision for the company.

Cost discipline is not consigned to operations. Many balance sheets in the sector will not survive underperformance even through a moderate downturn in the sector. Those who demonstrate they can deliver on synergies and maintain lowest cost benchmarks will have the opportunity and the capital to make bold moves during this downturn.

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