6 June 2013

How to Fix PaperlinX

PXUPA Investor Group Supporters

PIGS

Important Information

PIGS is a committed group of volunteers formed in early 2012 specifically to protect the rights of PaperlinX hybrid investors - particularly those who cannot speak for themselves.

Our objective is to ensure that every vote counts; and that any outcome for PXUPA holders is fair and equitable.

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How to Fix PaperlinX: Contents

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- All realisation values are provided to illustrate examples, and are not indicative of PIGS' views on the value of PXUPA.

1. Background

- In the seven months since being appointed, the new board has not made any effort to "address" the PXUPA hybrid as promised, let alone provide hybrid-holders with important documents requested by PIGS.
- Distributions continue to be withheld, and PaperlinX continues to be capital constrained in the face of challenging conditions.
- Press speculation that PaperlinX has appointed an investment bank (Moelis & Co) to assess funding options.
- This presentation outlines a number of potential solutions to PaperlinX's capital structure, publicly tabled by PIGS.

1. Background

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- The core of PaperlinX's operational dilemma is volume decline and inability to reduce fixed costs fast enough to mitigate losses.
- Organic growth in diversified product lines is not enough to offset lost volume and contribution margin in core paper lines.
- PaperlinX is thus making small acquisitions to improve fixed cost cover; boost throughput and asset (sales force, trucks, warehouses) utilisation.
- Given capital constraints of high gearing and overhang of hybrid equity, PaperlinX cannot execute on its 'pipeline' strategy optimally because it does not have enough cash to make accretive acquisitions.
- For this reason, the resolution of PaperlinX's capital structure is intimately tied to the **probability**, **extent** and **speed** of a successful 'fixing' of PaperlinX.
- **If capital structure is not addressed, there is less margin for error. An overleveraged PaperlinX is more vulnerable to enter receivership – banks and suppliers will likely withdraw support if it continues to sustain losses.**

2. Option A: Capital Raising

- Substantial capital raising with funds used to reduce debt, repay PXUPA and support working capital. Example:
- 8:1 non-renouncable rights issue at $0.045 (~25% discount) to raise ~$219m:
  - $13m (~6%) for issue costs and underwriting fees (estimated)
  - $71m to pay down debt and fund working capital
  - $135m to repurchase PXUPA hybrids for ~$47.50 each
- Removes $356m in liabilities, assume market value of PaperlinX increases from $56m currently, by ~60% of this amount (+$214m)
- New market value of company is now $270m, or ~$0.05 per PPX share
  - **PXUPA takes a ~53% 'haircut', but are redeemed at $47.50**
  - **Existing PPX takes a ~15% 'haircut', but**
  - **Each new PPX makes an ~11% profit on $0.045 subscription price**
  - **Net outcome to existing PPX holders in this scenario would be ~7 %.**

2.1 Capital Raising: Discussion

- Solves structural issues (outstanding hybrid, capital constraint, dividend block, gearing level, liquidity).
- Reduces financial risk and creates more 'breathing room'
- Offers an incentive to take up new equity – post raising, NTA per ordinary share increases to **positive** $0.04 from **negative** $0.02.
- Provides liquidity to fund restructuring and pursue value-accretive opportunities.
- Frees PaperlinX to clean up its share register (44,000+ shareholders, 30,000+ of which hold <$500 worth of PPX shares); cost savings.
- Enables PaperlinX to recommence payment of ordinary dividends.
- Dilutes non-participating shareholders.
- High transaction costs, likely material shortfall if not underwritten.
- Sheer scale of required raising would discourage uptake.

3. Option B: Break-up

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- Split PaperlinX into two companies, (high risk ‘**linx**’ and low risk ‘**Spicers**’), and spin-out the latter to PXUPA holders.
- ‘**linx**’ holds Europe and UK, ‘**Spicers**’ holds Canada and ANZA.
- Similar principle underpinned Macquarie Infrastructure’s split into **Intoll** (low risk, stable assets), and **Atlas Roads (**high risk, high option value assets). Both **significantly outperformed** post the split.
- ‘**Spicers**’ allocated a higher % of debt, but with sufficient free cash-flow to pay dividends to ex PXUPA hybrid-holders.
- ‘**linx**’ allocated a lower % of debt, and left with sufficient cash to support current restructuring programme.
- Risk to PaperlinX’s banks reduced due to bulk of debt exposure being transferred to less risky ‘**Spicers**’ and likely subsequent recapitalisation of ‘**linx**’.

3.1 Break-up: New Operating Companies

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Spicers (ANZA & Canada)

- Spun out to hybrid holders
- ~$700m Revenue (2013e)
- $22m EBIT
- $80m Debt
- $115m EV (@ 7.5x)
- **~$40 per PXUPA**
- Capacity to pay equivalent of $3-$4 in dividends

linx (UK & Europe)

- Retained by PaperlinX
- ~$1,900m Revenue (2013e)
- EBIT loss
- *Potential EBIT $14m-$33m
- $60m Debt
- $31m-$155m EV (@ 6.5x *)
- **~$0.051 - $0.255 per PPX**

3.2 Break-up: Discussion

- Solves structural issues (outstanding hybrid, capital constraint, dividend block).
- More closely aligns operating assets with risk and return profiles of different classes of equity holders.
- Promotes more regionally-specialised management focus.
- Opens both companies to potential takeover bids.
- Requires dissolution of corporate structure (unknown cost).
- Requires lender approval and input.

4. Option C: Rationalisation

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GeldVerliezen

- PaperlinX on public record stating chronically underperforming operations in Germany/Netherlands were either 'fix' or 'sell'.
- Neither have been 'fixed' – however the recent investment in Sweden* indicates PaperlinX is committed to Continental Europe (throwing good money after bad?)
- **Benelux has been restructuring for 7 years**, since 2006 (Project Mercure), and is **still unprofitable**.
- A commercially-minded operator would have cut their losses and sold these business units by now.
- *Note that PaperlinX divested its Swedish business in 2006 due to inadequate "in-market scale." See slide 12 here: http://www.paperlinx.com.au/_literature_48920/060420-PPX_Retail_Broker_Presentation

4.1 Rationalisation: Discussion

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- Despite the merits of rationalising the business and cutting loss-making regions, PaperlinX has demonstrated a preference otherwise (further investment in Continental Europe).
- The board's assessment of risk/return is distorted due to the presence of free funding (PXUPA's $285m of captive finance).
- Divestment of loss-making operations would improve profits, free-up capital and enable clearer management focus.
- May have to accept significantly less than fair value for assets.
- Rationalisation does not fix the capital structure issue.
- However, it would reduce risk, enhance profitability, and therefore the ability to pay distributions.
- This would materially lift the market value of both PPX and PXUPA.

5. Option D: Cornerstone Investor

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- A large financial (private equity) or commercial investor (mill, logistics operator) takes a substantial stake in equity and/or convertible notes, in exchange for cash to retire debt, recapitalise the business and pay out the PXUPA liability.
- 'Cornerstone' investment would likely be conditional upon PXUPA hybrid-holders approving a scheme of arrangement to cancel or repurchase their units at less than face value.
- Transpacific (ASX: TPI, hybrid: TPAPA) was recapitalised by a $800m cornerstone investment from Warburg Pincus in 2009, leading to a favourable outcome for both shareholder classes – the alternative was bankruptcy.
- Palatable option if a commercial agreement can be reached.
- Complexity and duration may be disruptive to management.

6. Option E: Staged Conversion

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- PaperlinX invites PXUPA unitholders to convert their units into ordinary PPX shares at a ratio the board offers. The ratio would be between the '**market ratio**' of **119:1** and the '**entitlement**' ratio of **1,695:1,** represented by [$100 ÷ PPX market price].
- Condition of a minimum holding conversion, e.g. the first 150 units tendered), then subject to a pro-rata scale-back to reduce the $285m to the desired amount.
- Each tranche of PXUPA converted to PPX at lower than the '**entitlement**' ratio of 1,695:1 (represented by [$100 ÷ PPX market price]) sterilises the potential dilution against the ordinary equity.
- In theory, each successive conversion increases the PPX price and reduces the conversion ratio because a potential $100 liability is being extinguished for significantly less than face value.
- Note the critical influence of price relativity between PXUPA and PPX and the disparity between the '**market**' ratio and '**entitlement**' ratio.
- **The lower the conversion ratio, the more value is transferred from PXUPA to PPX.**

*represents the market price ratio as at 05/06/13, i.e. $7.00 PXUPA price ÷ $0.059 PPX price = 119 ratio

6.1 Staged Conversion – Example

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- **Scenario:** PaperlinX invites PXUPA unitholders to convert their PXUPA units into ordinary PPX shares at a ratio of 200:1, delivering ~$12.60 of value for each PXUPA unit (i.e. a 80% premium to $7.00 market price).
  - Estimate 40% of holders holding <1,000 by number accept
  - Estimate 25% of holders holding 1000-2000 by number accept
  - Estimate 15% of holders holding 2000-3000 by number accept
- **Outcome:**
- 973 PXUPA holders and ~348,500 (~12.5%) PXUPA units 'taken out'
- ~69.7m new PPX shares issued (~11.4% of current ~690.3m on issue)

Holder Categories						
Holding	**Limit L**	**Limit H**	**Category**	**Names**	**Units**	**% Units**
0 to 499 Units	-	499	1	1,398	278,448	9.8%
500 to 999 Units	500	999	2	349	216,864	7.6%
1000 to 1999 Units	1,000	1,999	3	206	245,783	8.6%
2000 to 2999 Units	2,000	2,999	4	88	197,032	6.9%
3000+ Units	3,000	1,000,000	5	149	1,914,273	67.1%
				2,190	**2,852,400**	**100.0%**

6.2 Staged Conversion: Discussion

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- An proposal involving staged or partial conversion may be more palatable for the board given it does not require cash, significant fee leakage, or operational separation.
- However, the resulting dilution (value and control) of existing shareholders would encourage the board to minimise the conversion ratio (and hence value to PXUPA).
- In such a scenario, the Responsible Entity would commission an Independent Expert's Report (IER), to legitimise the offer as being in 'the best interests' of hybrid-holders.
- The IER valuation would be materially closer the RE's $14 valuation than the $100 face value in order to avoid embarrassment.
- A staged or partial conversion reduces the hybrid liability and provides a mechanism for hybrid-holders to realise some value.
- Does not fully solve the problem: so long as a meaningful amount (over 25%) of PXUPA remain on issue, and distributions aren't paid:
  - The dividend stop on ordinary shares will remain.
  - Ordinary shareholders will be unlikely to support any subsequent capital raising.

7. Option F: Forced Conversion

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- Forced conversion of PXUPA hybrids into PaperlinX ordinary shares is a potential resolution to the capital structure that may be sought by way of a court order to remedy oppression.
- This would be a non-commercial outcome for PaperlinX as a whole.
- As illustrated on the next slide, conversion at full entitlement could dilute existing PPX shareholders down to $0.01, assuming no market uplift from resolving the capital structure and removing the impost on a takeover.
- In such a worst case scenario, **PXUPA would own 88.8% of PaperlinX** and realise approximately **$17.42 per hybrid**.
- If the market re-valued PaperlinX's total equity from $56m (current) to $200m (i.e. by half the liability removed), existing PPX shareholders would only be diluted down to $0.037, and each PXUPA would receive a value of approximately **$62.34 per hybrid.**

7.1 Forced Conversion: Outcome Table

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- Forced conversion of PXUPA to PPX at full entitlement value would result in **1,695** PPX shares issued per PXUPA. **The break of the deadlock would cause an increase in market capitalisation due to the removal of a $285m liability.**
- The table below shows the resulting prices/outcomes for both PPX and PXUPA at different conversion ratios and higher market capitalisation scenarios.

PPX - Price (@ hypothetical Market Cap)						Conversion	PXUPA - Realised value (@ hypothetical Market Cap)					
Base*	100m	150m	200m	250m	300m	Ratio	Base	100m	150m	200m	250m	300m
$ 0.063	$ 0.112	$ 0.168	$ 0.224	$ 0.280	$ 0.335	**100**	$ 6.25	$ 11.18	$ 16.77	$ 22.36	$ 27.96	$ 33.55
$ 0.047	$ 0.085	$ 0.127	$ 0.170	$ 0.212	$ 0.254	**200**	$ 9.48	$ 16.96	$ 25.44	$ 33.92	$ 42.40	$ 50.88
$ 0.038	$ 0.068	$ 0.102	$ 0.137	$ 0.171	$ 0.205	**300**	$ 11.45	$ 20.49	$ 30.73	$ 40.98	$ 51.22	$ 61.46
$ 0.032	$ 0.057	$ 0.086	$ 0.114	$ 0.143	$ 0.171	**400**	$ 12.78	$ 22.87	$ 34.30	$ 45.73	$ 57.17	$ 68.60
$ 0.027	$ 0.049	$ 0.074	$ 0.098	$ 0.123	$ 0.147	**500**	$ 13.74	$ 24.58	$ 36.87	$ 49.16	$ 61.45	$ 73.74
$ 0.024	$ 0.043	$ 0.065	$ 0.086	$ 0.108	$ 0.129	**600**	$ 14.46	$ 25.87	$ 38.81	$ 51.74	$ 64.68	$ 77.61
$ 0.021	$ 0.038	$ 0.058	$ 0.077	$ 0.096	$ 0.115	**700**	$ 15.02	$ 26.88	$ 40.32	$ 53.76	$ 67.20	$ 80.64
$ 0.019	$ 0.035	$ 0.052	$ 0.069	$ 0.087	$ 0.104	**800**	$ 15.48	$ 27.69	$ 41.53	$ 55.38	$ 69.22	$ 83.07
$ 0.018	$ 0.032	$ 0.047	$ 0.063	$ 0.079	$ 0.095	**900**	$ 15.85	$ 28.35	$ 42.53	$ 56.71	$ 70.88	$ 85.06
$ 0.016	$ 0.029	$ 0.043	$ 0.058	$ 0.072	$ 0.087	**1000**	$ 16.16	$ 28.91	$ 43.36	$ 57.82	$ 72.27	$ 86.72
$ 0.015	$ 0.027	$ 0.040	$ 0.053	$ 0.067	$ 0.080	**1100**	$ 16.42	$ 29.38	$ 44.07	$ 58.76	$ 73.45	$ 88.13
$ 0.014	$ 0.025	$ 0.037	$ 0.050	$ 0.062	$ 0.074	**1200**	$ 16.65	$ 29.78	$ 44.67	$ 59.56	$ 74.45	$ 89.35
$ 0.013	$ 0.023	$ 0.035	$ 0.046	$ 0.058	$ 0.070	**1300**	$ 16.84	$ 30.13	$ 45.20	$ 60.26	$ 75.33	$ 90.40
$ 0.012	$ 0.022	$ 0.033	$ 0.043	$ 0.054	$ 0.065	**1400**	$ 17.01	$ 30.44	$ 45.66	$ 60.88	$ 76.10	$ 91.32
$ 0.011	$ 0.020	$ 0.031	$ 0.041	$ 0.051	$ 0.061	**1500**	$ 17.17	$ 30.71	$ 46.07	$ 61.42	$ 76.78	$ 92.13
$ 0.011	$ 0.019	$ 0.029	$ 0.039	$ 0.048	$ 0.058	**1600**	$ 17.30	$ 30.95	$ 46.43	$ 61.90	$ 77.38	$ 92.86
$ 0.010	$ 0.018	$ 0.028	$ 0.037	$ 0.046	$ 0.055	**1700**	$ 17.42	$ 31.17	$ 46.75	$ 62.34	$ 77.92	$ 93.50

8. Option G: Exchange for Notes

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- PaperlinX offer hybrid holders a scheme whereby they are able to exchange their existing PXUPA hybrid for a better quality instrument.
- The new instrument could take the form of a high-yield convertible note with a mandatory distribution/coupon , which automatically converts into ordinary shares if the distribution is not paid.
- For example: $50 face value, paying a ~10% fixed coupon quarterly, comparable to the ASX-listed IMFG note which pays 10.25% quarterly.
- Significant take up of such an offer would materially reduce the $285m liability, thereby increasing PaperlinX's attractiveness as a takeover target.
- Hybrid holders get a more certain investment.
- Not dilutive to existing PPX ordinary shareholders as long as PaperlinX makes scheduled distributions.
- Distributions on lower face value would be more manageable.
- Would require lender approval.

9. Option H: Do Nothing

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- Continue to leave capital structure unresolved.
- High leverage and undercapitalisation exposes **all stakeholders** (employees, pensions, suppliers, bankers, hybrid holders and shareholders) to increased risk:
  - Prolonged European recession, increasing bad debts
  - Restructuring taking longer and costing more to execute
  - Continued market and volume deterioration
  - Withdrawal of major players from the credit insurance market (**meaning PaperlinX would no longer be able to buy or sell paper**)
  - Downturn in global equity markets
- **The 'do nothing' option is not consistent with the representations made by the new board.**

10. Summary

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- Any positive action by the board to address PaperlinX's capital structure removes material uncertainty (solvency risk, litigation risk)
- This leads to increasing comfort in the business as a 'going concern'
- Operationally, a stronger balance sheet has a number of benefits:
  - Lower cost of debt
  - Higher valuation ascribed by market (lower financial/leverage risk)
  - More favourable terms with suppliers
  - Improved employee morale/productivity (greater security and certainty)
- Any proposal to hybrid holders has the potential to benefit all stakeholders, but it must be **fair** and **reasonable**.
- **We are now approaching seven months since the AGM, and it is high time PaperlinX to make good on its undertaking to 'address the hybrid.'**

Conversion: Then (November 2012)

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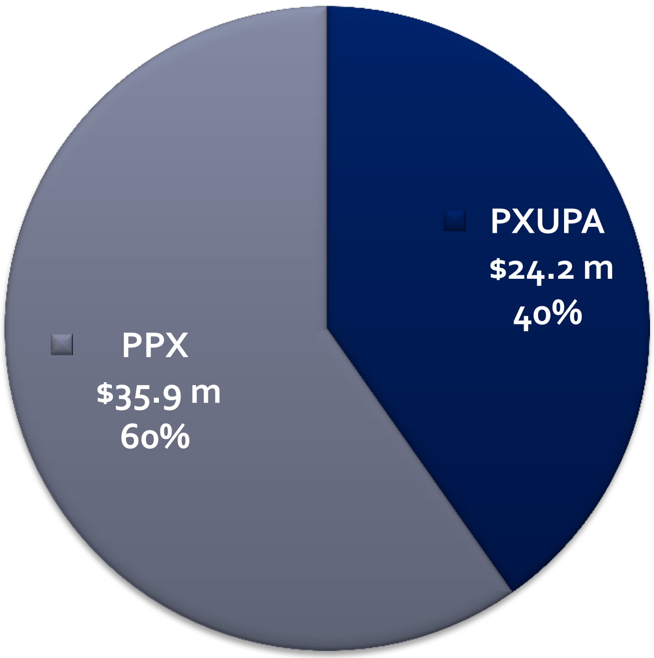
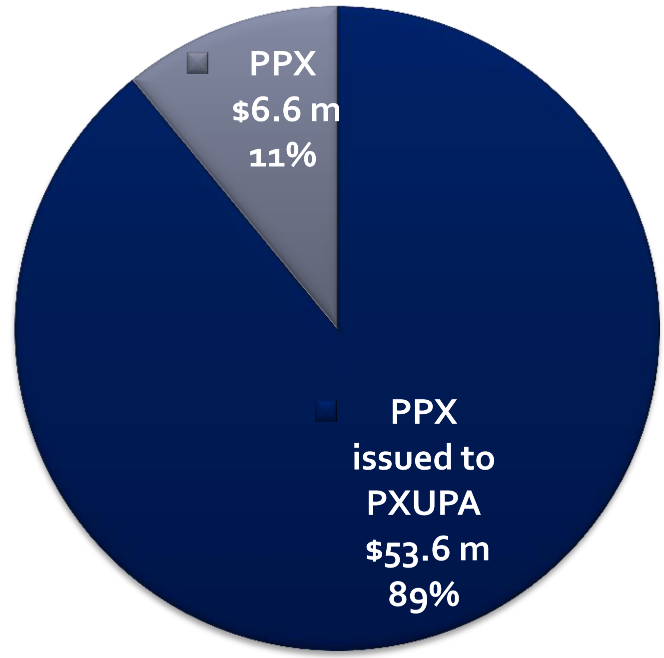
Pie Split (on Market Prices)



Pie Split (on Conversion)



- If the $285m of PXUPA hybrids were converted to ordinary shares at entitled face value, PXUPA holders would own 89%* of the PaperlinX entity.
- The PPX share price would fall to ~$0.011 due to the dilution.
- Each PXUPA unit would receive ~$18.80 worth of PPX shares (versus $8.50 market price).
- Further upside potential due to simplification of capital structure.

*** Based on prices as at 20th November 2012 (PPX $0.059, PXUPA $8.50)**

Conversion: Now (June 2013)

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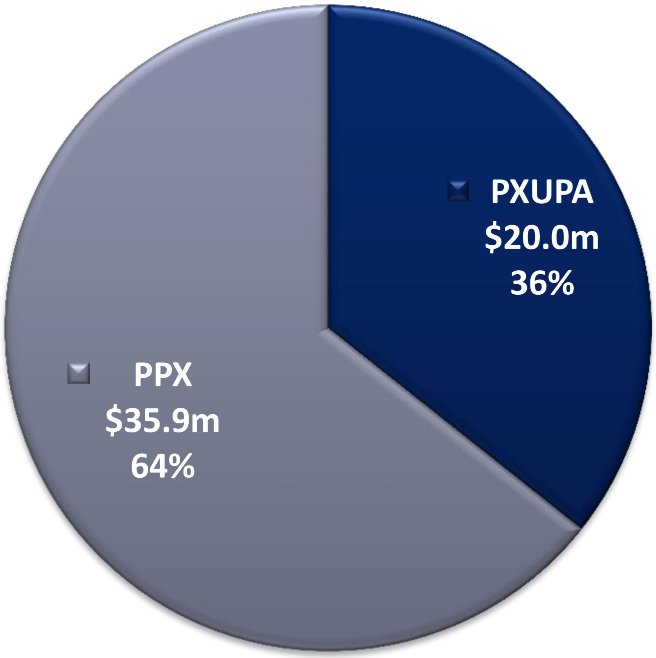
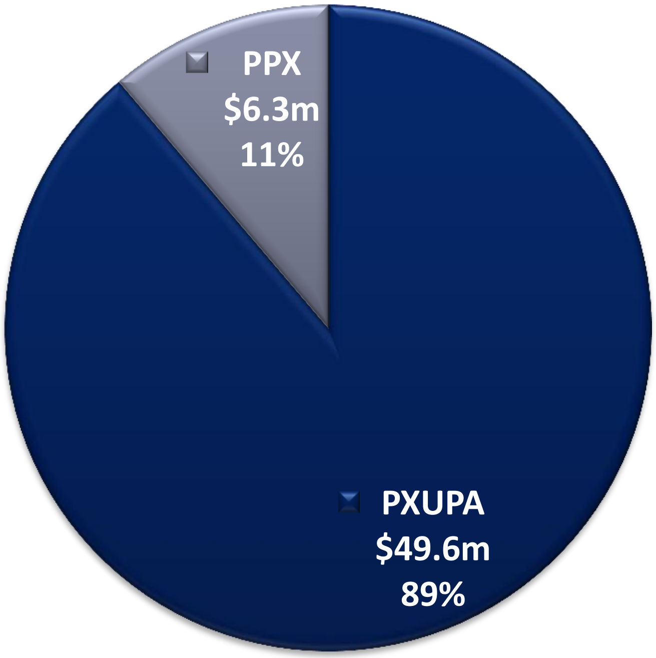
Pie Split (Market Prices)



Pie Split (on Conversion)



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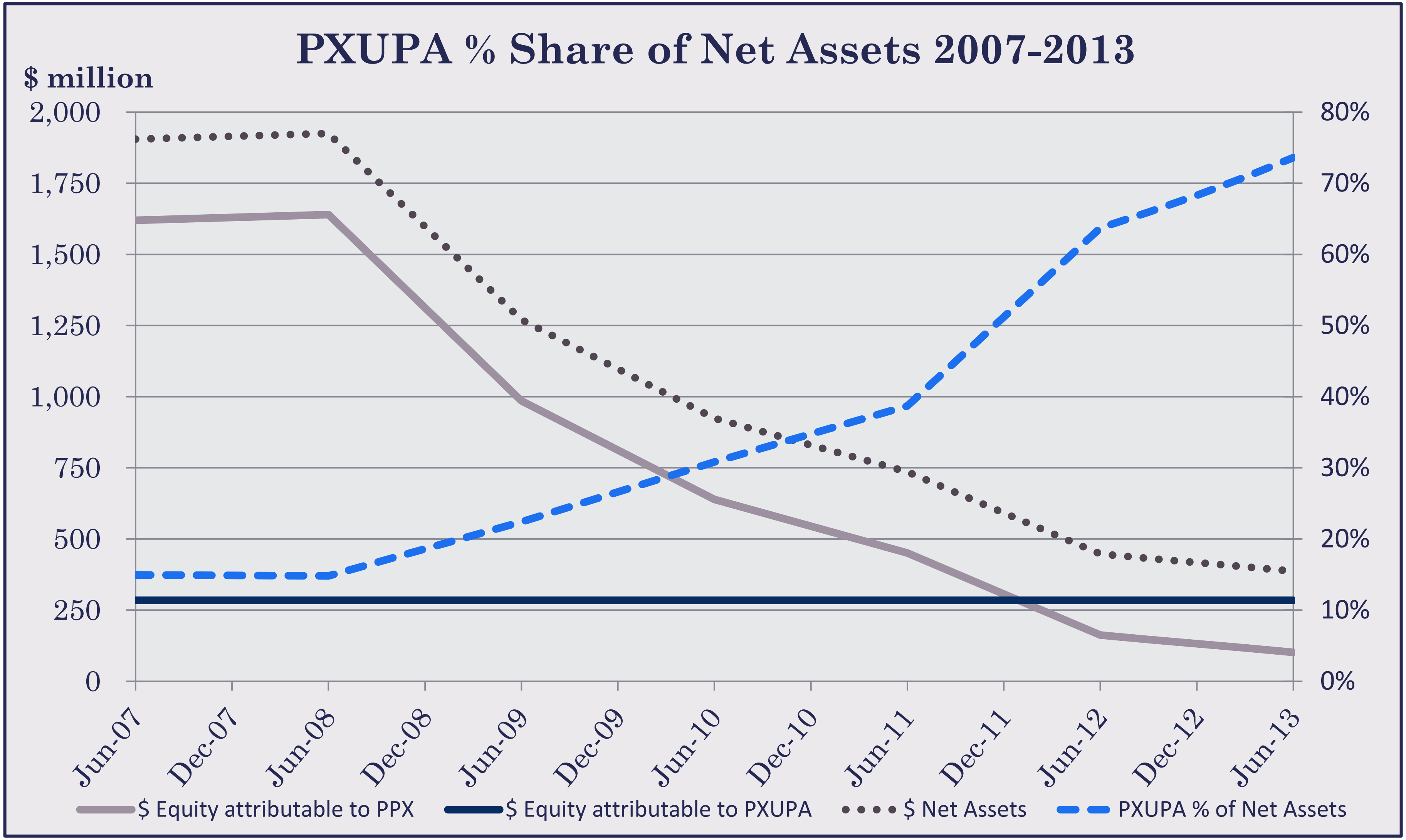
- The PPX share price would fall to ~$0.011 due to the dilution.
- Each PXUPA unit would receive ~$18.00 worth of PPX shares (versus $7.00 market price).
- Further upside potential due to simplification of capital structure.

*** Based on prices as at 5th June 2013 (PPX $0.059, PXUPA $7.00)**

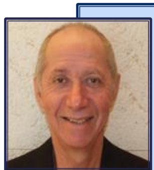
Importance of PXUPA Capital



PIGS: Team Structure & Key Roles

- The PIGS Committee comprises 5 volunteer fellow investors in PXUPA.
- The team has combined industry and financial experience of over 100 years.
- The team has a broad base of skills encompassing negotiation, financial analysis, valuation, strategy, and business management.
- We are committed to attaining the best possible outcome for all investors in PXUPA hybrids.

PIGS Committee Profiles



Gaby Berger

Gaby is an experienced businessman who founded and ran an IT company for 30 years. He holds a BE, MBA, and Graduate Diploma in Applied Finance and Investment. He has been a professional investor sine 2003.

Graham Critchley

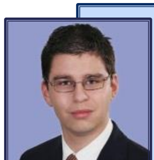
Graham is a self-funded retiree. In 2000 he founded Australia's first GST reclaim business for non-resident entities. Prior to that he was a self-employed financier for many years.

Justin Epstein

Justin is a founder and executive director at One Investment Group (OIG). OIG is the responsible entity/trustee for in excess of 100 trusts with more than $2bn under administration.

Simon Oaten

Simon has over 15 years experience in researching companies as an independent research provider, and for various broking houses. He is a Geologist by training, has worked in the field for 7 years and has a Masters Degree in Finance. Simon is passionate about markets, and characterises himself as a deep-value investor.



Paul Waterstone

Paul is an industrial research analyst specialising in financial analysis and modelling. His prior experience includes institutional funds management, business consulting and equities research. He runs a private investment company and has been an equities investor for 13 years.

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http://paperlinxpigs.wordpress.com

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