27 August 2013

FY2013 Analysis & Update

Webinar 2

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.

Disclaimer:

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Welcome – opening commentary

Graham Critchley, Convenor of PIGS

- Self-funded retiree
- Actively pursuing the cause of PXUPA holders since November 2011
- Author of www.PaperlinX-Sux.com

PXUPA Investor Group Supporters

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.

Correction and clarification to Webinar 1

PIGS

This relates to Voting Thresholds covered in Webinar 1:

The following has been provided by Justin Epstein:

"Whilst the resolution for the change of a responsible entity is an extraordinary resolution as outlined on slide 28 of the first webinar, it should be noted that this only applies if the scheme is <u>not</u> listed (Corporations Act section 601FL(1)).

However, where the scheme is listed, such as with the PXUPA, the Corporations Act does not say what form of resolution is required for a listed scheme.

However for a listed scheme it can be argued that as nothing is stated, only an ordinary resolution is required.

<u>This is positive for PXUPA investors</u>

As was explained in the first webinar, an extraordinary resolution is a difficult threshold as 50% of all votes that are entitled to vote is required.

An ordinary resolution simply requires 50% of those that do vote to be in favour of the proposed resolution."

Questions from Participants:

Some questions were missed in Webinar 1 due to transmission delay, however we have posted responses on our website in the Webinar 1 post.

Participants may ask questions at any time during the webinar using the text message input box on the Citrix control panel. Participants may also submit questions via the 'contact us' section of our website.

If the issues experienced in Webinar 1 recur, we will still publish responses to all questions on our website in the days following this webinar.

Webinar Agenda

1. **Post-result Update** (Graham Critchley)

2. **FY2013 Result Analysis** (Paul Waterstone)

3. **Financial Forensics** (Simon Oaten)

4. **Potential Scrip Offer and Q&A Session**
   - *Important information on how to assess whether any scrip offer made by PaperlinX is fair and reasonable.*

1. Post-result Update

Graham Critchley, Convenor of PIGS

- Self-funded retiree
- Actively pursuing the cause of PXUPA holders since November 2011
- Author of www.PaperlinX-Sux.com

PXUPA Investor Group Supporters

1.1 Introduction & Topics

Post-result Update:

1. August 14: no response to our formal complaints to the Responsible Entity, because …
2. August 21: *"PaperlinX Hybrids 101"* issued by PaperlinX
3. *"PaperlinX Hybrids 101"* – in detail
4. Divide and conquer is the obvious Board strategy
5. Will the *"streetlight effect"* continue at PaperlinX?

1.2 Formal Complaint to RE - Status

August 14th, no response to our formal complaints:

- In response to our detailed complaint of 12 pages lodged with The Trust Co Limited, the Responsible Entity (RE), on July 4th, it advised PIGS that it is still awaiting responses from PaperlinX. No surprises here.
- Coincidently, August 14th was the last day for a response by the RE under its Complaints Procedures.
- We reasonably believe that PaperlinX and the RE would both be severely embarrassed by our complaints if they ever became public.
- More to follow in a minute…

1.3 'PaperlinX Hybrids 101'




August 21st, PaperlinX Hybrids 101:

- Concurrent with the 2013 full year results, PaperlinX issued a four page announcement to the ASX relating to the hybrids titled: *"Market Update in Relation to PaperlinX SPS (Hybrids)".*
- It's now posted on the PIGS website and is a must read for anyone seriously interested in this Board's approach to transparency versus compliance.
- A better title would have been *"PaperlinX Hybrids 101"*
- It is a truthful document, but not the whole truth.
- It tells the story from PaperlinX's perspective in contemplation of an imminent "low ball" offer.
- Shame on this Board.

1.4 ‘PaperlinX Hybrids 101’

PaperlinX Hybrids 101 – detail:

- PaperlinX announces it is in discussion with RE in relation to a potential scrip based merger between the Company (PPX) and the Hybrids (PXUPA). *“These discussions are preliminary and non-binding in nature”*. Of course, because the RE has no power to commit hybrid holders.
- The four benefits noted have already been explained in great detail by PIGS on 6 June 2013 – *“Fixing PaperlinX”.*
- *“…it has also become apparent to the PaperlinX Board that there are some misconceptions in relation to the rights of the Hybrids.”* Too right there are misconceptions.
- AND, if you want further information it suggests you contact PaperlinX. But on page 2 is the disclaimer:
  “… the board and management of PaperlinX have no fiduciary obligations in relation to PXUPA holders.”

1.5 Hark back to when PXUPA was issued

- Note the words of then Chairman Meiklejohn exactly: *"I am pleased to present you with an opportunity to invest in PaperlinX Step-up Preference Securities (PaperlinX SPS)"*
- The Product Disclosure Statement contained all the necessary disclaimers, BUT was in the PaperlinX livery of blue and gold.

Letter from the Chairman – PaperlinX Limited

22 February 2007

Dear Investor,

On behalf of the Board of PaperlinX Limited ('PaperlinX'), I am pleased to present you with an opportunity to invest in PaperlinX Step-up Preference Securities (PaperlinX SPS).

The PaperlinX SPS are preferred units in the PaperlinX SPS Trust which has been established to raise funds for the PaperlinX Group. Application will be made to list the PaperlinX SPS on the Australian Securities Exchange.

It is important that you read the Product Disclosure Statement carefully and consider particularly the risks in Section 6 before deciding whether to subscribe for PaperlinX SPS. If you have any questions in respect of the Offer, please call the PaperlinX SPS Information Line on 1300 738 908 (8.30am to 5.00pm AEDT Monday to Friday), or consult your stockbroker, solicitor, accountant or other professional adviser.

Yours sincerely

David E Meiklejohn
Chairman

1.6 Divide and Conquer Strategy

PIGS

Divide and conquer is the obvious Board strategy

- The Board knows we speak for sufficient votes to block any inequitable offer for PXUPA.
- Our Mission Statement has been constant: *"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 <u>fair and equitable</u>."
- PaperlinX SPS Trust Investor Advisory Committee (IAC) has been in existence since mid 2012. It's hosted by the RE and paid for by PaperlinX. It costs a lot of money to run.
- Hybrid investors will be aware of its inaugural open meeting on 22 November, 2012. It was a first in Australia.

1.7 The 'Streetlight Effect'




Will the "streetlight effect" continue at PaperlinX?

- The streetlight effect is a type of observational bias where people only look for whatever they are searching by looking where it is easiest.
- It's time PaperlinX ordinary shareholders (PPX) looked at its Board and Balance Sheet, specifically:
  1. Appoint a truly independent director with proven experience in managing troubled multinational industrial companies; and
  2. Clean up the capital structure once and for all, for the benefit of all; and we seriously mean ALL.
- Neither of these are easy, but they'll be more effective than "spin" of denial and hubris.

1.8 The Ethical Dilemma at PaperlinX

The ethical dilemma at PaperlinX:

- It’s now apparent that Andrew Price and his supporters made one or two commercial misjudgements. Certainly they underestimated both the:

    1. Power of the labour unions in the UK & Europe - and they wouldn’t be the first Aussie entrepreneurs to do so; or

    2. Dogged persistence of PIGS in protecting the rights of retail hybrid holders, mainly Australian, which is unusual.

- The two are unrelated but compounding. The question is how to address these mistakes. There are only two options:

    1. Let go of ego and acknowledge past misjudgements, suffer dilution by recapitalising the balance sheet, and get on with life; or

    2. Maintain denial and hubris, which means eventual disaster for almost everyone.

2. Financials & 2013 Results

Paul Waterstone

- Managing Director, Waterstone Acquisitions P/L
- Investment Analyst and Professional Investor
- Top 100 PXUPA Holder

2.1 Introduction & Topics

2013 Results Review:

1. Overview of FY2013 Result
2. FY2013 Earnings Analysis by Region
3. Between the Lines – Issues Identified:
   - Blowout in Trade Working Capital
   - Unhedged Foreign Currency & Interest Rate Risks

* Note: working capital calculations are based on second half revenue run rates and clean ‘trade’ numbers which back out deferred asset sale proceeds and provisions.

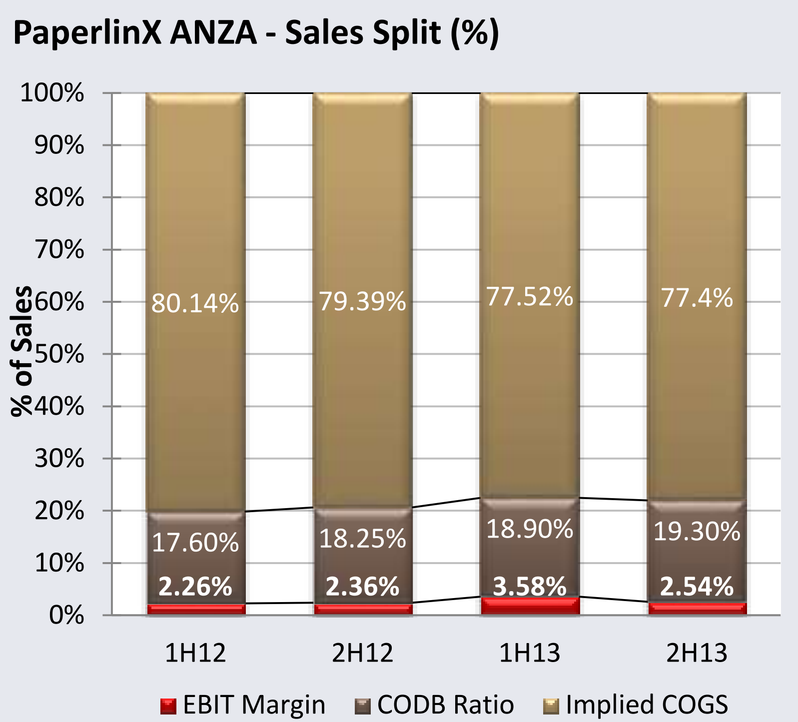
2.2 Overview of 2013 Results

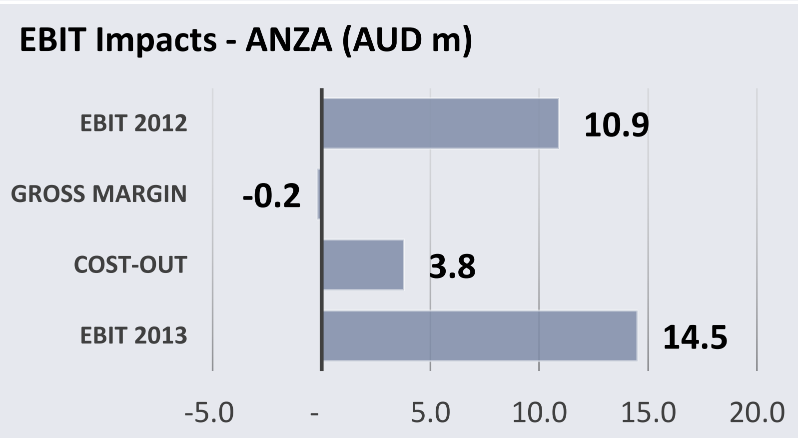
Full Year Highlights:

- Substantial decline in volumes (numbers not disclosed)
- Headcount reduced from ~4,600 to ~4,000
- Underlying loss narrowed from A$27.2m to A$21.4m
- Underling loss run rate (2H13) reduced to A$7.7m/half
- Guidance: Underlying EBIT to be marginally positive in FY14
- Significant outperformance in Canada
- ANZA rationalisation now tapering off, benefits realised
- Losses in Europe and UK continue
- **Deterioration** in *trade* working capital ('TWC'), despite company commentary working capital improved.
- Higher exposure to FX (£) risk and interest rate risk

2.3 PaperlinX ANZA Region

PIGS

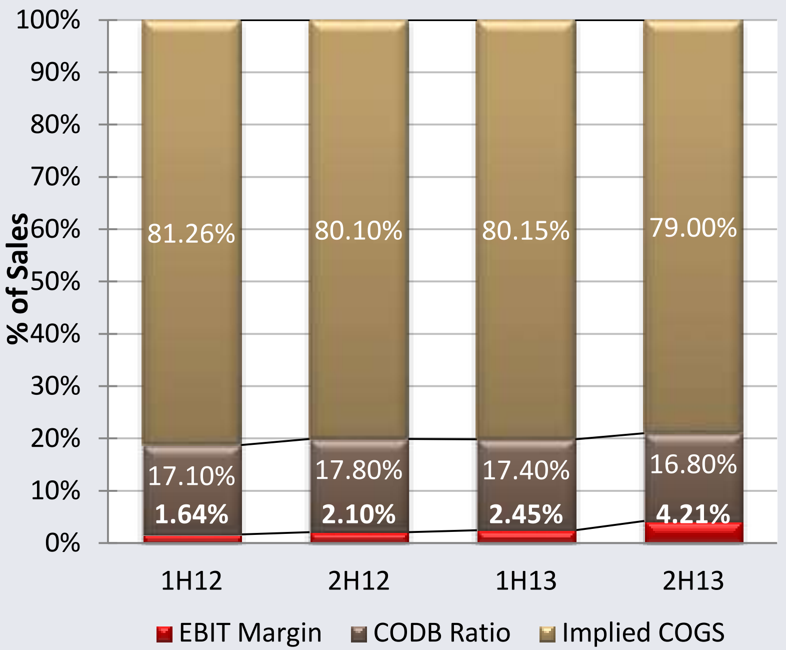




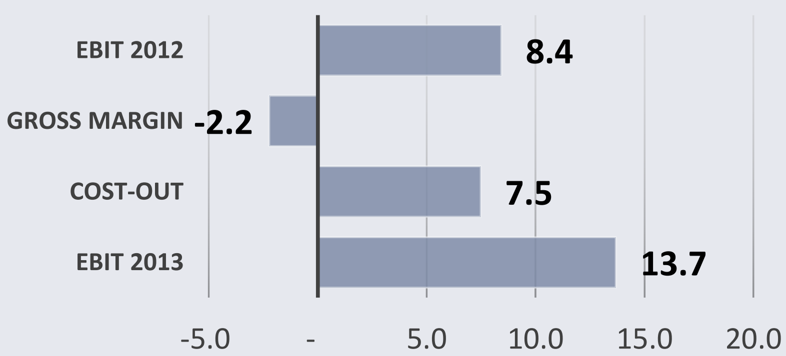
- **Estimated volume decline 12%+**
- Margin outperformance not maintained in second half FY2013.
- 199bp expansion in % gross margin versus FY2012.
- Cost-out is more than offsetting lost gross margin.
- Strong margin control and cost savings (-10% headcount) have insulated profit against volume decline.
- Now appears mix shift to high GM products has largely played out.
- Focus is now on further optimising asset utilisation and cost base.

2.4 PaperlinX Canada Region

PaperlinX Canada - Sales Split (%)



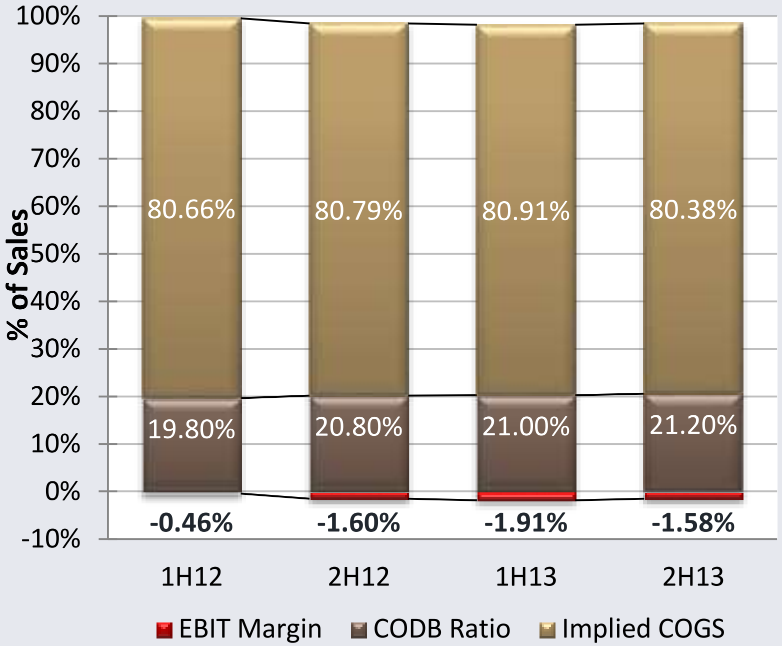
EBIT Impacts - Canada (CAD m)



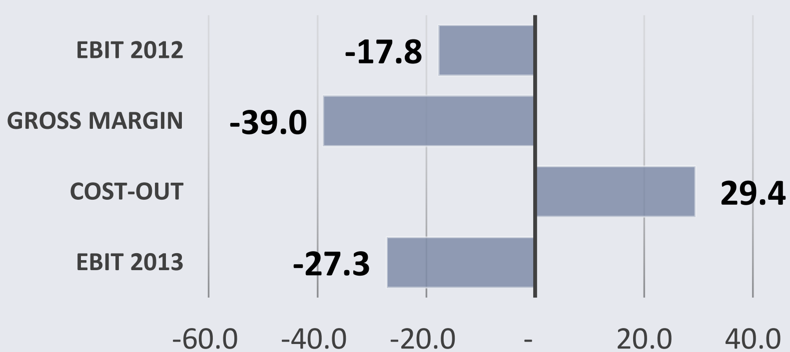
- 'Shooting the lights out.'
- **Estimated volume decline 7%+**
- Significant margin outperformance in second half versus first half.
- 115bp expansion in % gross margin versus FY2012.
- Cost-out is more than offsetting lost gross margin.
- Rationalisation strategy delivering increased profits despite declining revenues.
- If Spicers Canada were a standalone entity, even taking some debt, it would likely be worth more than PaperlinX's current market cap.

2.5 PaperlinX UK & Europe Region

PaperlinX UK & Europe - Sales Split (%)



EBIT Impacts - Europe & UK (EUR m)



- Significant restructuring ongoing.
- **Estimated volume decline 13%+**
- Marginal EBIT margin improvement in second half versus first half.
- 53bp expansion in % gross margin
- Cost-out not keeping up with losses in gross margin.
- We estimate a further 200-300 reduction (7%-10%) in staff numbers and further % GM improvement will be required to return UK/Europe to profitability.
- Further restructuring efforts could be throwing good money after bad: FY14 undertaking is to "reduce losses" as opposed to "return to profit".

2.6 Issues: Trade Working Capital

Trade Working Capital:

- Trade Working Capital (TWC) = Debtors + Inventory – Creditors.
- It measures how much cash is required to support trading.
- PaperlinX's performance on pure TWC has been **very poor.**
- **Over the past year, TWC has deteriorated, absorbing $23m of cash which could have been used to repay debt.**
- If the 2012 TWC:Sales ratio (18.6%) were maintained, **$63m** of free cash would have been released from trade funding.
- There is a significant gap between PaperlinX (TWC 21.9% of sales) and 'best practice' Amcor (TWC 9.8% of sales)
- Viewed differently, PaperlinX's cash cycle takes 80 days, over twice as long as Amcor's 36 days.
- If PaperlinX managed its working capital as well as Amcor, some **$320m** of cash could be freed-up from working capital.

2.6 Issues: Unhedged FX & Rate Risk

Unhedged bets on a higher GBP and lower rates:

- Note 31 states company policy is to target 40%-60% of debt exposed to fixed rather than floating rates (to mitigate risk.)
- As at 30th June 2013, the entire $229m debt balance is floating, leaving the PaperlinX 'naked' if interest rates move adversely.
- Company disclosure: *"the Board exempted the consolidated entity from undertaking interest rate hedging for a period of 12 months."* No explanation as to why was given.
- This is highly unusual because there is much more risk if rates move adversely rather than favourably (current average rate 4.4%)
- Further, risk to the GBP/AUD exchange rate has increase ten times. Note 31 also discloses a $71.2m exposure to the GBP, and a $10.6m profit sensitivity to a 10% move in the GBP/AUD, versus a reverse $1.0m last year.
- This unhedged FX risk appears to be currency speculation – it will pay off if the GBP rises, but magnify losses if the GBP falls.
- Both instances demonstrate risk taking behaviour.

3. Financial Forensics

Simon Oaten

- Independent Financial Analyst & Professional Investor
- Masters in Finance
- 15 years' investment experience.

PXUPA Investor Group Supporters

3.1 Introduction & Topics

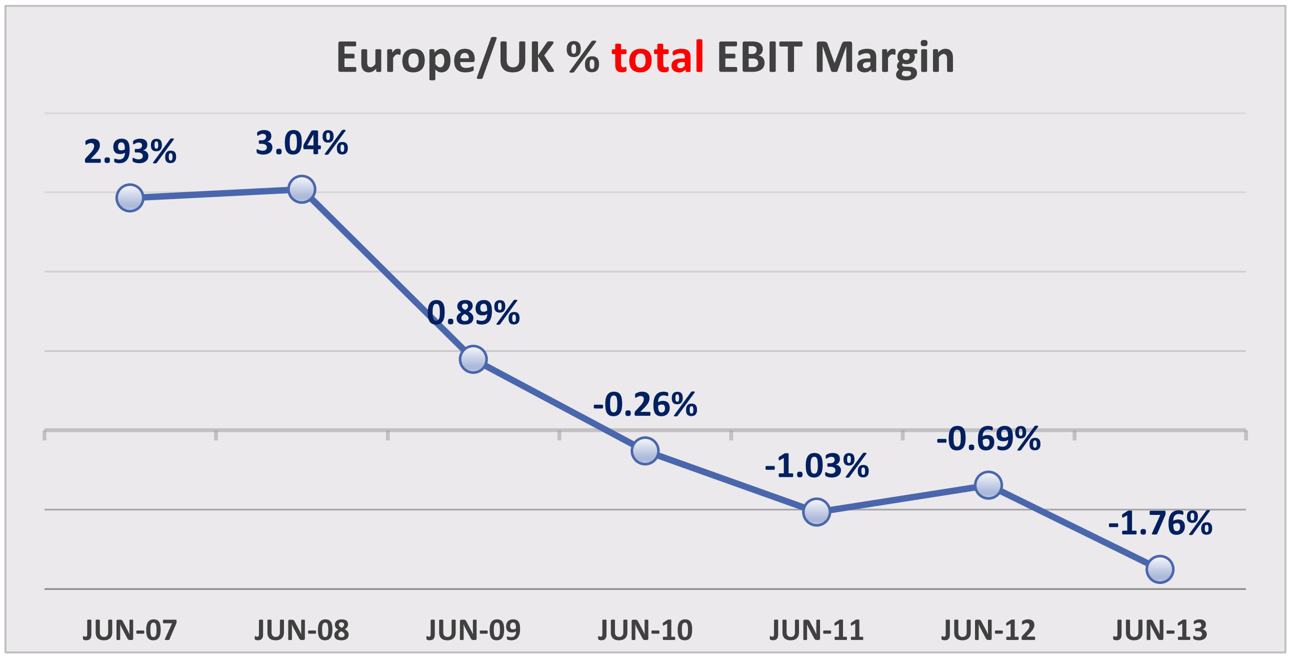
Financial Statement Forensics:

1. Margin Analysis & Core Paper Profitability
2. Credit Risk Insurance
3. Major Concerns in the FY2013 Accounts:
    - Working Capital Cycle & Credit Insurance
    - Cash drains of Restructuring and Pension Plans
4. More evidence of The Need to Recapitalise




Europe & UK - Its worse than you think:

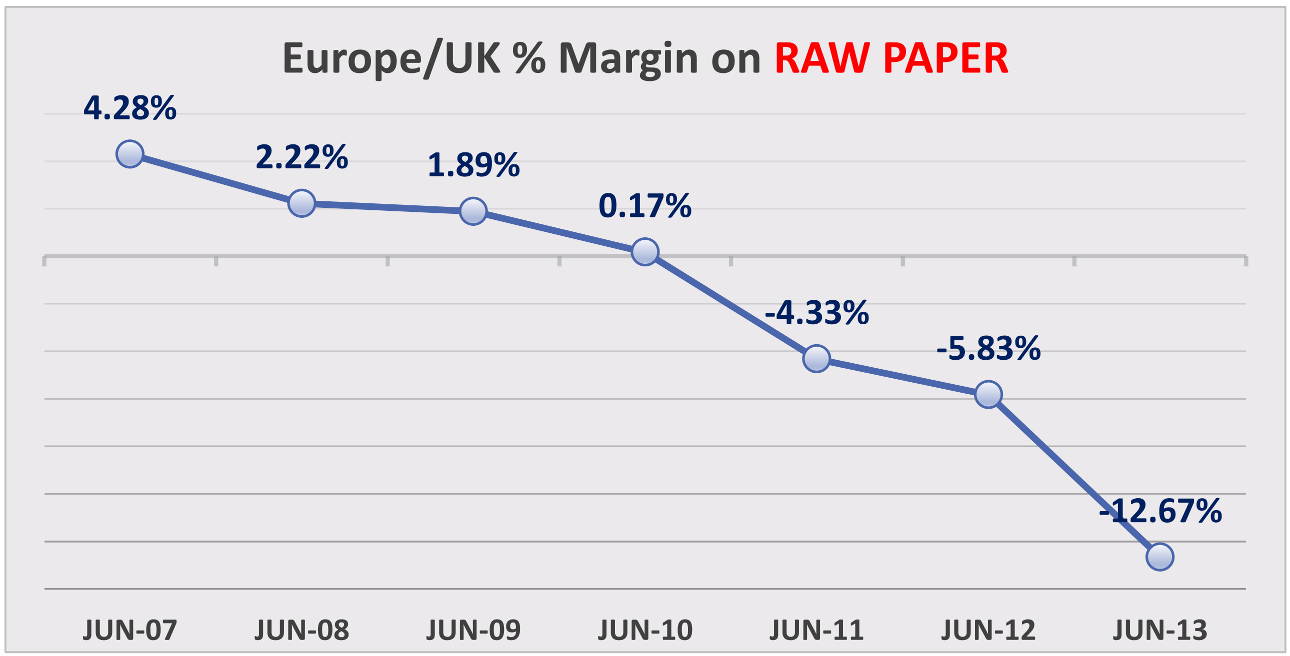
- The following charts compare total EBIT margin for all products to margin on **core paper sales** by region:






Europe & UK - Selling core paper product at a loss:

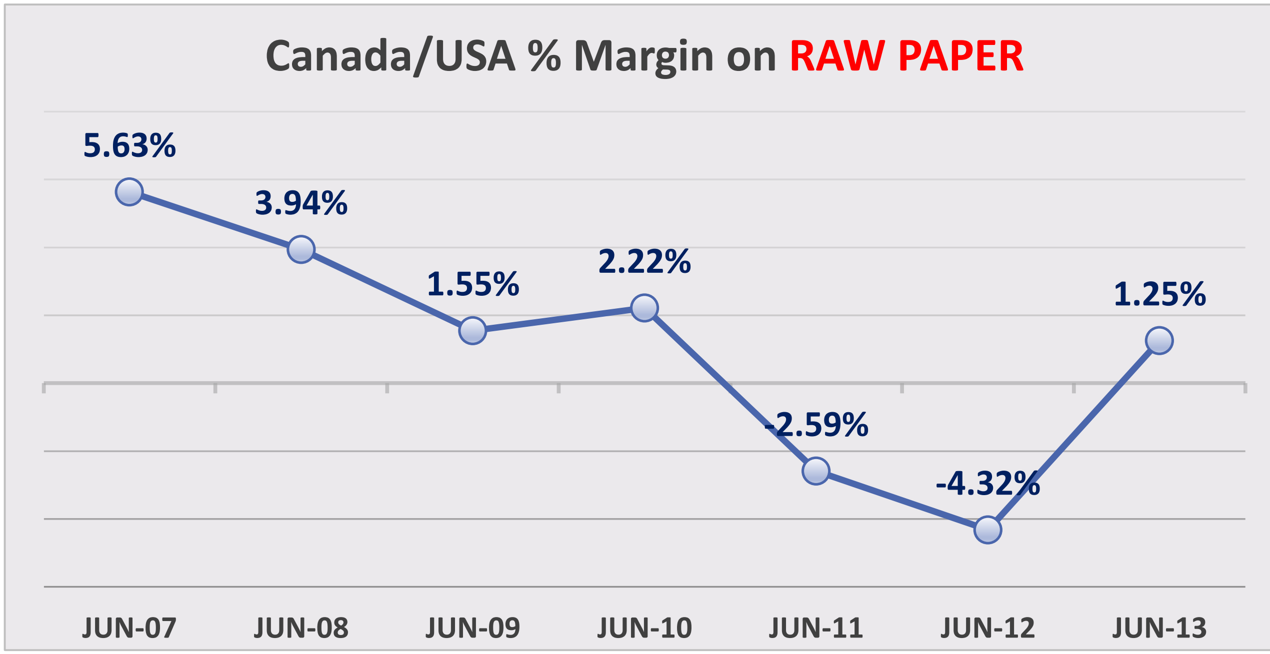
- This shows that since 2010 – PaperlinX Europe has been selling raw paper (75% of sales) for NIL margin (after stripping out sign/packaging revenues and EBITDA)



3.5 Margin Analysis: Canada/USA




Canada/USA – fixed?

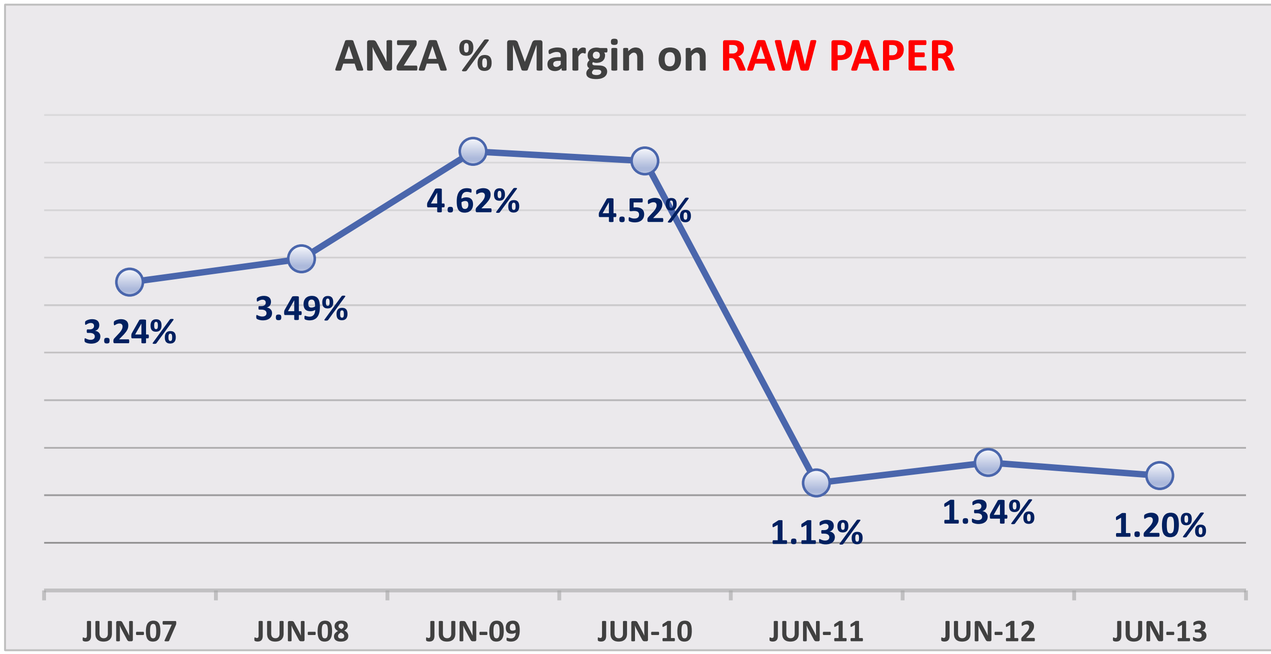


- USA division (Spicers USA & Kelly Paper) sold in FY2012.
- Supply agreement with Cascades appears to be performing.

3.6 Margin Analysis: ANZA




Australia, New Zealand & Asia:



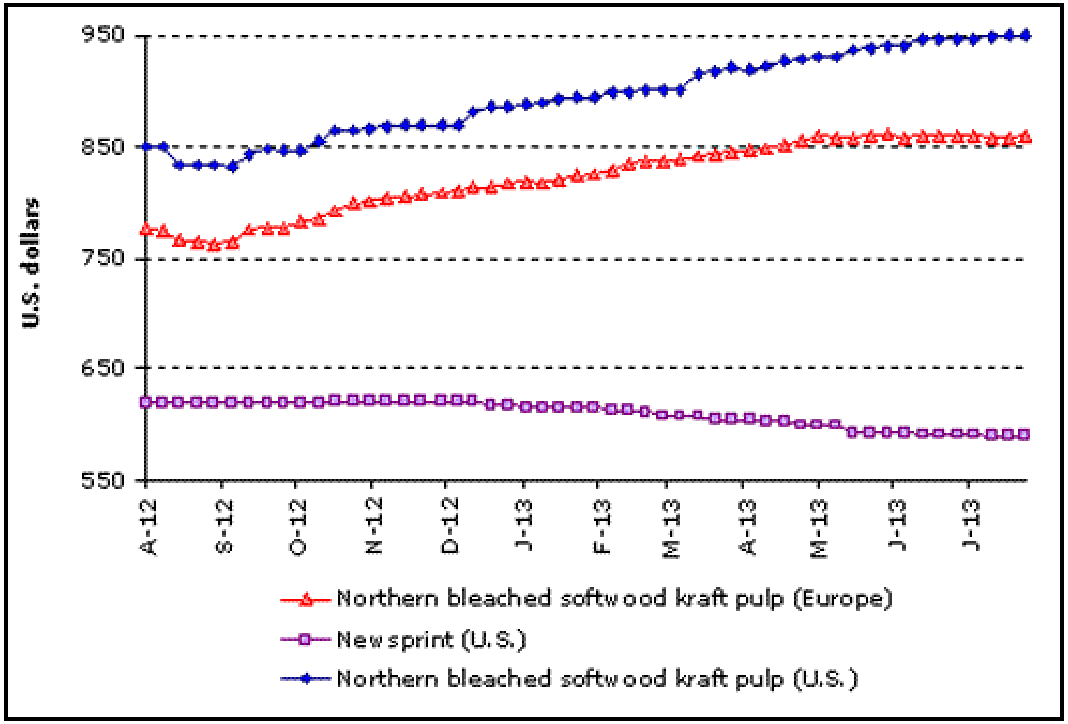
- This is what one would expect in terms of "real margins" i.e. 1.2% – 1.4% margin on a bulk commodity, +20% for value-added services (signage, packaging, etc.)
- Note that pre-2011 – PaperlinX did NOT break out margins for signage/packing parts of the business.

3.3 Market Share Loss & Disclosure




Loss of Market Share – lack of disclosure!

- Raw paper is priced off “paper pulp” – prices per tonne have INCREASED over the past 12-months – strongly suggesting PaperlinX has lost volumes and market share – WHY?



Source: Natural Resources Canada http://cfs.nrcan.gc.ca/pages/249

3.7 Major Concerns in FY13 Accounts

Major Concerns in FY13 accounts:

- Inventory Days increased from 38 days to 42 days
- Trade Debtor Days increased from 71 days to 79 days
- **Cash Cycle increased from 68 days to 80 days.**
- Nil disclosure on “growth strategy”
- Note 31 on risk disclosure:

  “In a number of jurisdictions the Consolidated Entity has credit risk insurance to mitigate its exposure to doubtful debts. Given the difficult trading conditions within the paper industry, the Consolidated Entity cannot guarantee the availability of this insurance in the future to the levels previously provided by the external insurers”.

3.8 Major Concerns in FY13 Accounts

What do these 'major concerns' this mean?

- PaperlinX sells a bulk commodity in a low-margin, high turn-over business.
- PaperlinX is REQUIRED by its suppliers to carry credit risk insurance. Should PaperlinX be unable to secure this insurance – it is possible that the major mills will stop suppling PaperlinX with its bulk commodity.
- Next, Management have NOT addressed the other areas that suggest PaperlinX will not return to profitability (namely – the cost of factoring the receivables and inventory in Europe is greater than the profit margin they make on the sale of bulk product).
- This suggests PPX will continue to "get smaller" to try and get out of the hole – that it has dug for itself……tick tick tick.

3.9 The Need to Recapitalise

Many drains on cash, but where will it come from?

- Defined benefit pensions plan deficit, primarily in the UK, increased by $20m to $126m, with the majority of the increase in 1H. Cash commitments for FY14 are largely in line with prior year's $18m.
- Established team in Shanghai, China to focus on sales and global procurement - is this a 'back-up' strategy if the major mills in Europe stop supplying PaperlinX?
- Finally – PaperlinX has announced further restructuring in Germany / UK / Netherlands and the potential restructure or sale of its "delivery company" – but given no guidance on costs or additional asset write-downs…
- Available unrestricted cash of only A$13.9m end June 2013 as most of PaperlinX's cash is restricted by its lenders:
  - *"Under certain regional asset backed loan facilities, lender approval is required to transfer cash between entities within the Consolidated Entity. Balances subject to these approvals at reporting date were $73.9 million, 2012: $71.4 million").*
- These all point to the need to remove the hybrid and recapitalise – the first two steps to Fixing PaperlinX.

4. Potential Scrip Offer

Paul Waterstone

- Managing Director, Waterstone Acquisitions P/L
- Investment Analyst and Professional Investor
- Top 100 PXUPA Holder

4.1 Introduction & Topics

Potential Scrip Offer:

1. Background to potential scrip offer
2. How to calculate value per PPX and PXUPA
3. 'Ready Reckoner' to assess offer value
4. Issues to Consider

*Note the calculation of PaperlinX's current combined market capitalisation of $68m is based on 26/08/13 closing prices:

- 609.3m PPX @ $0.065 = $39.6m
- 2.85m PXUPA @ $10 = $28.5m

Values in the 'Ready Reckoner' are also based on this data.

4.2 Potential scrip offer - Background

Background:

- August 21: PaperlinX announced that it is in negotiations with the Responsible Entity for the PaperlinX SPS Trust regarding a potential offer to exchange PXUPA units for PPX shares.
- If an offer is made, each holder will need to asses its value because the RE cannot be relied upon to act independently.
- The realised value per PXUPA depends on 3 factors:

1. **The conversion ratio offered by PaperlinX**
2. **The value of any extra 'sweeteners' offered**
3. **The resulting uplift in PaperlinX's market capitalisation**

- The following slides will show how to evaluate a scrip offer and explain using an example scenario.
- We will also consider issues to take into account in deciding whether any prospective offer is fair/reasonable, and if you should accept or reject it.

4.3 Calculating the value of a scrip offer

Step 1 – Calculate # of PPX shares post-conversion:

- Multiply the **conversion ratio** by 2.85m to get **"N"**
- Add **N** to 609.3m to get total PPX shares on issue **"SI"**
- For example, if the **conversion ratio** were **500** per PXUPA:
  - New shares issued **N = 1,425m**
  - Total PPX on issue **SI = 2,034.3m**

Step 2 – Calculate value per PXUPA based on uplift:

- Divide expected market cap **"EC"** by PPX on issue **"SI"**
- For example, if we conservatively assume removing the $285m liability will lift the value of PaperlinX $82m from $68m (current market cap) to $150m:
  - **EC** / **SI** = $150m / 2,034.3m = **$0.074** (new PPX price **"NP"**)
- Multiply **NP** by the **conversion ratio** to get the value per PXUPA:
  - **$0.074 × 500 = $36.87 = value per PXUPA "V"**

4.4 Scrip Offer Ready Reckoner

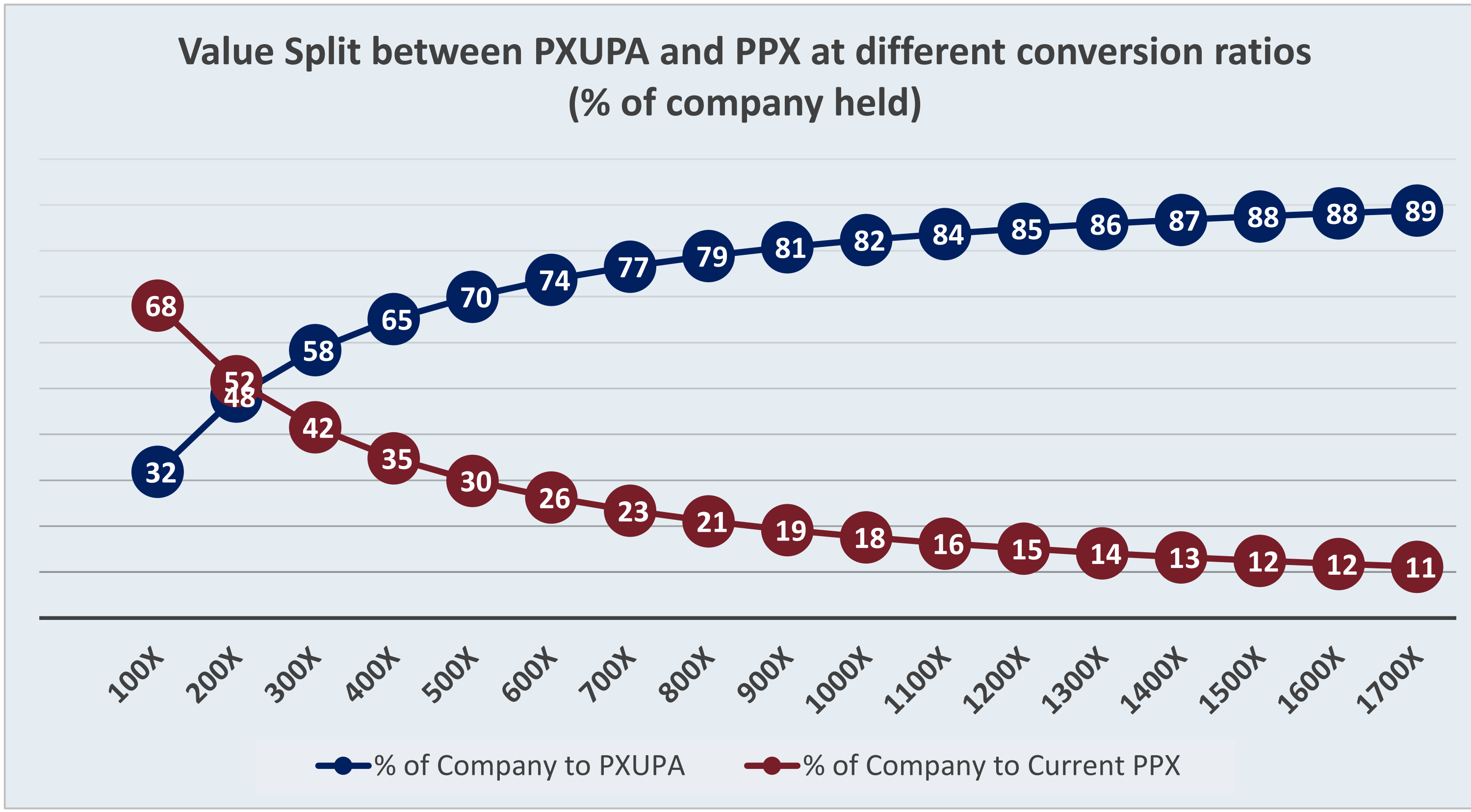
What happens to the PPX share price if all PXUPA are converted?

Conversion Ratio		200x	300x	400x	500x	600x	700x	800x
New Shares Issued (m)	"N"	570.0	855.0	1,140.0	1,425.0	1,710.0	1,995.0	2,280.0
Total PPX on Issue (m)	"SI"	1,179.3	1,464.3	1,749.3	2,034.3	2,319.3	2,604.3	2,889.3
No Uplift ($68m cap)	"NP"	$ 0.058	$ 0.047	$ 0.039	$ 0.033	$ 0.029	$ 0.026	$ 0.024
Uplift to $100m cap	"NP"	$ 0.085	$ 0.068	$ 0.057	$ 0.049	$ 0.043	$ 0.038	$ 0.035
Uplift to $150m cap	"NP"	$ 0.127	$ 0.102	$ 0.086	$ 0.074	$ 0.065	$ 0.058	$ 0.052
Uplift to $200m cap	"NP"	$ 0.170	$ 0.137	$ 0.114	$ 0.098	$ 0.086	$ 0.077	$ 0.069
Uplift to $250m cap	"NP"	$ 0.212	$ 0.171	$ 0.143	$ 0.123	$ 0.108	$ 0.096	$ 0.087

What will be the realised value per PXUPA?

Conversion Ratio		200x	300x	400x	500x	600x	700x	800x
New Shares Issued (m)	"N"	570.0	855.0	1,140.0	1,425.0	1,710.0	1,995.0	2,280.0
Total PPX on Issue (m)	"SI"	1,179.3	1,464.3	1,749.3	2,034.3	2,319.3	2,604.3	2,889.3
No Uplift ($68m cap)	"V"	$ 11.55	$ 13.95	$ 15.57	$ 16.74	$ 17.62	$ 18.31	$ 18.86
Uplift to $100m cap	"V"	$ 16.96	$ 20.49	$ 22.87	$ 24.58	$ 25.87	$ 26.88	$ 27.69
Uplift to $150m cap	"V"	$ 25.44	$ 30.73	$ 34.30	$ 36.87	$ 38.81	$ 40.32	$ 41.53
Uplift to $200m cap	"V"	$ 33.92	$ 40.98	$ 45.73	$ 49.16	$ 51.74	$ 53.76	$ 55.38
Uplift to $250m cap	"V"	$ 42.40	$ 51.22	$ 57.17	$ 61.45	$ 64.68	$ 67.20	$ 69.22
% of Company to PXUPA		48%	58%	65%	70%	74%	77%	79%

4.5 Visualising Conversion / Key Ratios



- **1578x** 'Forced Conversion' ratio at a 2.5% discount to $0.065
- **794x** 'Fair Share' ratio (PXUPA gets a % equal to its share of net assets)
- **154x** 'Market Price' ratio between PPX and PXUPA

4.6 Important Issues to Consider

Issue 1 – What is a "fair and reasonable" ratio?

- Realistically, there is very little chance an offer below **300x** would be successful because this would heavily prejudice PXUPA holders. Why?
  - Because PXUPA would take a **60%+** haircut, and give up their security and seniority; whilst ordinary shareholders benefit from a doubling of the share price (at high end of cap range below). This is **not** reasonable.
- The upper bound to the ratio is **1,578x** based on a forced conversion at $0.065 (less discount), however this is not commercially realistic.
- For PXUPA to receive a share of the company equal to their **78.8%** share of PaperlinX's net equity, the ratio would be approximately **800x**.

Issue 2 – What would be the new 'uplifted' market cap?

- It is difficult to predict what the market cap under a simplified capital structure would be, however here are some data points:
  1. The **$117m** offer made for PaperlinX in December 2011.
  2. Applying a conservative EBIT multiple (e.g. 5x) to sustainable revenues of ~$2.5b on a long term 1.5% margin = **$187.5m**
- **In the event of corporate activity, the new market cap is likely to be between (1) and (2) above, with upside given PaperlinX's earning potential if UK/Europe are fixed.**

Question & Answer Session

PXUPA Investor Group Supporters

- Volunteer Investor Action Group
- We welcome further questions at http://paperlinxpigs.wordpress.com where this presentation will be available by 8:00pm AEST today.

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Appendix: Value Uplift - The CMI Example

Comparison between CMI and PaperlinX:

- CMI Limited (ASX: CMI) had a similar deadlock between senior-ranking 'A Class' preference shares and ordinary shares.
- Although the circumstances were different (company was highly profitable, and the preference shares were redeemed for cash.
- In March 2013, CMI preference shareholders were offered 79% of face value. The special resolution required 75% of votes, and was passed with 90%+ in favour.
- Because the company paid cash (not scrip), this meant a $33.6m liability was extinguished for $26.6m, resulting in a $7m '**free kick**' to ordinary shareholders.
- From $1.90 before the proposal, CMI ordinary shares rose 28% to a peak of $2.43 in the following month, a market cap uplift of $17.8m, or 2.5 times the net liability removed.
- In PaperlinX's case, a successful full scrip offer would remove a $285m liability, but the uplift would be much less because the business is not profitable and has a weak balance sheet. The market will only rerate the equity by some % of the $285m.
- **However, it is important to note that because it is a scrip offer, hybrids would get to share the free kick if the share price of PPX re-rates.**