



Thursday, 5 September 2013

## **Position Paper on Potential Conversion of PXUPA into PPX Ordinary Shares**

*This position paper is intended as a public document to provide information on the position of the PIGS committee on any prospective conversion, along with key issues which have factored into and influenced our assessment.*

A preliminary copy of this position paper was provided to PaperlinX and Moelis & Co. prior to a recent meeting with members of the PIGS committee. It soon became apparent that the contemplation of PaperlinX's tentative offer would have resulted in an unconscionable outcome to hybrid holders. As a result of this, the PIGS committee has withdrawn its support for the 78.8% equity ratio stated in this document.

### **EXECUTIVE SUMMARY**

1. The PIGS committee would favourably consider a 'clean' conversion of their PXUPA hybrid units into PPX ordinary shares at a ratio which results in an equity share outcome proportional to the balance sheet, i.e. 78.8% of the equity in PaperlinX, which translates into a conversion ratio of approximately 800 ordinary shares per hybrid security. (This position has been withdrawn).
2. The PIGS committee notes that under a forced conversion, the exchange ratio based on market prices as at 5<sup>th</sup> September 2013 would be **1972** ordinary shares per hybrid, which would result in PXUPA controlling 90.2% of PaperlinX's equity.
3. Any conversion would be conditional upon:
  - a. The appointment of at least one additional independent director. We note PaperlinX's major competitor, Sequana, has ten directors, five of which are independent, and two whom are shareholder representatives;
  - b. An undertaking by PaperlinX not to play any 'tricks' with rights issues;
  - c. The release of important documents related to the investment, entitlements and rights of hybrid unitholders which are currently being withheld.
4. The proposition of conversion has material impacts for hybrid unitholders, as they will give up valuable rights and entitlements. The conversion ratio offered must adequately compensate them for:
  - a. The loss of their security of a fixed \$100 entitlement value which is 'enshrined' in the terms, and despite being perpetual, is nevertheless a contractual obligation upon PaperlinX.
  - b. The loss of their seniority in a winding up ahead of ordinary shareholders (and to income and capital before ordinary shareholders)
  - c. The exposure to risk and dilution from a potential capital raising (as we have seen with Elders and Transpacific, this can be extremely dilutive for pure equity)
  - d. Their surrender of their 'other rights' under the terms – information about which is being withheld.
5. The Responsible Entity is in a conflicted position and has demonstrated a failure to act with an appropriate degree of independence and accountability – it should therefore not be relied upon to negotiate or advise what is in the best interests of unitholders.
6. In the event of a material deterioration in PaperlinX's financial situation, the holders of senior equity (PXUPA hybrids) will hold the upper hand.
7. The equity of PXUPA can be appropriately valued as a residual claim on PaperlinX's total enterprise value after deducting debt.



## 1 BACKGROUND - WHY OFFER TO CONVERT NOW?

Concurrent with its 2013 financial year results release on August 21<sup>st</sup>, 2013, PaperlinX announced it was in preliminary, non-binding discussions with the Responsible Entity of the PaperlinX SPS Trust to consider a potential scrip conversion of the PXUPA hybrid units into PaperlinX ordinary shares.

The key reason given was the need to simplify PaperlinX's capital structure by removing the \$285m hybrid equity and moving to an equity structure with a single class of share (i.e. ordinary). The simplified capital structure would remove the obstruction to corporate activity, enable the company to conduct a capital raising to accelerate its turnaround plan, and increase confidence in the business generally.

According to management commentary in PaperlinX's 2013 Full Year results, the company's need for liquidity is not yet critical:

**“We have the liquidity in place to continue our current business plan.”**

(PaperlinX CFO Joost Smallembroek, August 21<sup>st</sup>, 2013)

However, a miscellany of recent transactions which provide small amounts of liquidity, indicate that there is increasing strain on cash, and that a more permanent solution to liquidity problems, via recapitalisation is now necessary. It is for this reason that PIGS has released a series of documents highlighting the need to fix the business by first addressing its balance sheet and removing the hybrid.

We note that a company “selling its soul” typically begins with the sale and leaseback of hard assets, particularly land and buildings. PaperlinX conducted a significant sale and leaseback program to release cash in 2008/2009.

The second step is the liquidation, sale or closing-out of peripheral and core assets which realise cash (for example a regional business, or a financial instrument or hedge which shows an unrealised gain). PaperlinX's sale of its US operations and closing out of its foreign currency option in June 2012 may be relevant in this regard.

The third step is the securitisation/factoring of receivables which converts a company's trade debtors to cash, but comes at a cost. PaperlinX has had securitised receivables for many years, and has in early August 2013 announced a further ~\$30m securitisation of the receivables within its German operating company.

It is important to note that the cost of (a) debt, (b) credit insurance, and (c) receivables factoring, depend on the financial risk of the company, i.e. how highly leveraged it is. For a company whose balance sheet is in the state of PaperlinX's, these costs can be prohibitively high, and actually impede the turnaround of the business. **By way of example, the cost of securitising receivables in some cases completely absorbs the profit made on those sales.**

The unwinding of such extortionate structures is a necessary step in fixing PaperlinX and more liquidity will be required to effect this unwinding, hence the consideration of converting PXUPA into PPX and the likely capital raising which would be assumed to follow conversion.

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## 2 CAN THE COMPANY KEEP GOING WITHOUT CONVERSION?

For the time being, the answer is yes. The maturity on the company's major debt facility has been extended, and supplier credit insurance continues to be provided at present. Furthermore, if faced with a desperate need for cash, there are still saleable assets such as The Delivery Company and Spicers Canada which the company would likely consider letting go if it were forced to deleverage by its banks, irrespective of whether their retention would make more sense from a commercial point of view.

So, if a fair conversion is not achieved, PaperlinX can continue to operate, albeit with a heavy constraint on its liquidity and flexibility with its restructuring program. In this scenario, PXUPA retains its senior standing to ordinary equity, the dividend-stopper remains in place, and the company cannot raise capital or entertain any takeover/merger proposals.

In the event the financial situation of the company becomes critical, the board, faced with the prospect of administration, would be obliged to convert the PXUPA hybrid into PPX ordinary shares at their full entitlement value of \$100 to enable the company to conduct a capital raising. Such a conversion would be in the best interests of ordinary shareholders because the alternative would be PaperlinX entering into administration, and likely zero return for ordinary equity after crystallising all contingent liabilities and the full \$285m senior claim of the hybrid.

In considering a 'fair' conversion, **Section 3** of this document provides detail on what the offer must compensate hybrid-holders for. **Section 4** gives the position of the PIGS committee.

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## 3 WHAT HYBRID HOLDERS MUST BE COMPENSATED FOR

Any prospective offer to convert the PXUPA hybrid units (which rank above ordinary equity with preference to income and capital in the event of a winding up) into PPX shares (ordinary equity) must take into account that conversion results in PXUPA hybrid holders giving up a number of important entitlements and protections – and exposing themselves to full equity risk.

The offer ratio (PPX shares per PXUPA hybrid), and therefore, the % of the equity of the group to hybrid-holders must take into account these significant concessions:

1. The loss of their security of a fixed \$100 entitlement value which is 'enshrined' in the terms, and despite being perpetual, is nevertheless a contractual obligation upon PaperlinX.
2. The loss of their seniority in a winding up ahead of ordinary shareholders (and to income and capital before ordinary shareholders)
3. The exposure to risk and dilution from a potential capital raising (as we have seen with Elders and Transpacific, this can be extremely dilutive for pure equity)
4. Their surrender of their 'other rights' under the terms – information about which is being withheld.

We reiterate that as at the June 2013 accounts, the \$276.5m of hybrid capital which appears as equity in PaperlinX's statutory accounts, constitutes 76.4% of the net assets of the company. Writing back the issue costs, this percentage rises to 78.8%.

**As presented on Slide 40 of PIGS' post-results webinar (available [here](#)), this 'fair-share' conversion ratio would be in the vicinity of 800 PPX ordinary shares per PXUPA hybrid unit.**

Any offer to convert which leaves hybrid-holders with less than this percentage represents an unearned dividend to ordinary shareholders, whose position on the pecking order should not warrant such an entitlement.

**We reiterate that contemplation of any conversion ratio based on comparing market prices and values of the two securities is nonsense and demonstrates a lack of understanding with regard to the nature and entitlements of the PXUPA instrument.**

By the same token, the most recent valuation of \$7 published by the Responsible Entity is simply a ‘circular reference’ back to the market price which cannot be relied upon to make an informed investment (or divestment) decision. To the extent the \$7 figure provides a buffer below the current trading price, it fulfils the objective of affording the Responsible Entity protection from being accused of overvaluation.

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#### 4 POSITION OF THE PIGS COMMITTEE

As documented in our recent publication [Fixing PaperlinX](#), we are of the view that there is an increasing urgency to fix PaperlinX’s capital structure – because there is a not insignificant risk that soon there will be no ‘share of the pie’ to fight over.

In forming our views, the PIGS committee has done extensive analysis, consulted widely with hybrid-holders, and obtained input from a range of experts:

1. [A ratio based on market prices is totally unacceptable to PXUPA investors, and similarly a ratio based on the forced conversion of PXUPA to PPX would be unpalatable to PPX investors. Our position is as follows:](#)

The PIGS committee would accept a conversion compromise based on PaperlinX’s latest balance sheet, which shows total equity of \$361.7m, comprised of \$76.7m junior equity (ordinary shares) and \$285m senior equity (PXUPA hybrids). We would favourably consider a ‘clean’ exchange which results in a proportional outcome of 78.8% equity in the new single-class structure.

Further, if there is an agreed conversion ratio, then we would require ‘iron-clad’ undertakings that there would be no ‘tricks’ in issuing PaperlinX shares before the conversion, and any rights issues after the conversion would be on a renounceable basis for the first 12 months.

Any agreement would include an undertaking by PaperlinX to appoint at least one additional independent director to the board to improve breath, expertise, governance and transparency. This condition precedent is not negotiable. We would also seek appropriate performance option packages to retain and incentivise key management personnel.

2. [PaperlinX’s announcement that it “has been in preliminary discussions with the The Trust Company” is reprehensible – we have identified lack of independence and information asymmetry as being major issues, in addition to the conflicted position of the Responsible Entity, as detailed in Section 6 of this document . This announcement effectively says that PaperlinX is having “discussions” with itself on how to deal with the PXUPA securities.](#)

We have lodged a formal complaint with the Responsible Entity, which has not been adequately addressed, and are actively considering various options include the removal of the Responsible Entity, changing the Constitution, a forced conversion, class action, etc. We consider that it is not possible for the current Responsible Entity to be a truly independent party, nor adequately represent the interests of hybrid unitholders in these negotiations.

3. We also require full disclosure of all documentation that we have previously requested relating to how the \$285m of PXUPA subscription funds were passed over to PaperlinX, to the identity and nature of the investments currently held by PaperlinX SPS LLC, and those which detail the ‘other rights’ of PaperlinX SPS LLC preference shareholders.

Closing the information asymmetry gap is essential before any legitimate negotiation to occur. The negotiating positions are not on equal footing so long as PaperlinX continues to withhold important information from hybrid-holders concerning their investment and their rights.

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## 5 UNDERSTANDING HOW TO VALUE PXUPA

In this section, we will explain the structural flaw in the Responsible Entity’s valuation approach, and suggest why it is more appropriate to value PXUPA as a residual claim on the enterprise value of PaperlinX, after debt, and ahead of ordinary equity.

The Corporations Act (2001) requires investments to be marked to market, in the case of unlisted investments; a choice is given to the valuer (Responsible Entity). The Responsible Entity has already stated it “relied upon” information from PaperlinX for two separate valuations.

Given the Responsible Entity has a legal obligation to unitholders; it does not appear that “reasonable investigations” have been made to determine the underlying value of trust assets (the PaperlinX LLC preference shares).

PIGS has requisitioned income statements, balance sheets and other relevant financial information for the vast majority of PaperlinX’s operating entities from public sources, which has enabled the development of a detailed enterprise valuation of PaperlinX which is far more robust and informative than any of the techniques employed by the Responsible Entity.

**Whilst we acknowledge the fact PaperlinX SPS Trust is not a direct investment in PaperlinX *per se*, it is however, effectively a contingent preference share which may be crystallised above ordinary equity in certain circumstances - for example, subsequent to the removal of the Responsible Entity if a replacement is not appointed. On this basis, the hybrid units may be valued as a senior claim on PaperlinX’s residual operating enterprise value after deducting debt.**

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## 6 RESPONSIBLE ENTITY: CONFLICTS OF INTEREST

The Responsible Entity has demonstrated poor initiative with regard to material concerns of unitholders in the PaperlinX SPS Trust:

- It has not challenged the representations made by PaperlinX and pursued evidence;
- It has not actively sought information regarding the security and performance of the trust’s investments;
- It has not provided any meaningful information regarding the trust’s investments which would enable an investor to evaluate their holding in the trust with any degree of confidence;
- It has been *reactive* rather than *proactive* in its dealings and communications with unitholders;



- It has not undertaken to inform unitholders of their rights under a potential receivership of PaperlinX, nor investigated options to realise the SPS Trust's investment;
- It has produced hollow valuations founded on baseless and highly subjective assumptions (for example the application of excessive discount rates);
- It has behaved broadly in a manner which is consistent with the interests of itself as opposed to unitholders; and
- **It is conflicted between a fiduciary duty to unitholders (its primary obligation) and a contractual obligation to PaperlinX, under subjection of confidentiality.**

Given the points raised above, it is seriously questionable whether the primary concern of the Responsible Entity Company is its fiduciary duty to unitholders or its own self-interest.

Unitholders could be forgiven for wondering if the Responsible Entity fees are a rather expensive silence bought by PaperlinX, or whether the continued failure to disclose material information to unitholders is a mutual contrivance by PaperlinX and the Responsible Entity to avoid potential exposure to legal liability arising from information contained within undisclosed documents.

Information tends to be withheld when it its contents are untoward, and when it is not in the best interests of the disclosing party to reveal it.

**This is a conflict of interest between unitholders and the Responsible Entity; and we have requested in our letter of complaint that the Responsible Entity clearly establishes how its commissions and omissions with regard to the matters raised in the letter demonstrate that it has put the interests of unitholders above its own, in accordance with its legal obligations.**

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PXUPA Investor Group Supporters

*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.*

**A1 DIAGRAM: EQUITY STRUCTURE OF PAPERLINX**

The diagram below shows the structure and relationships between the two classes of equity, PaperlinX and the Responsible Entity:

