An Industry View on Irrational Pricing & Trading Terms

Paul Xavier Waterstone 11 September, 2013

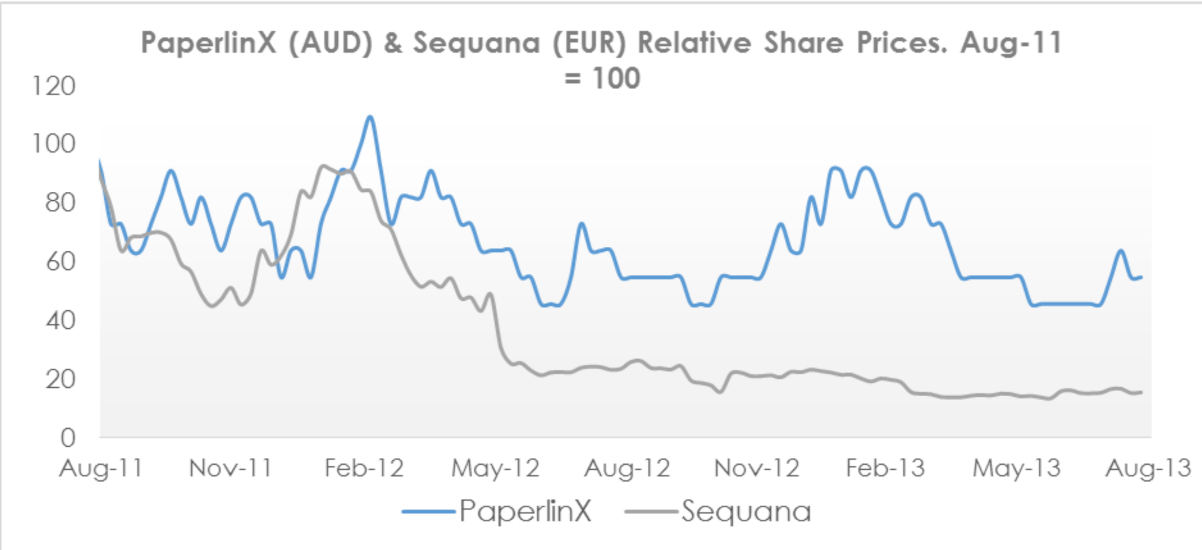
Maintaining a healthy and rational paper merchanting 'link' in the value chain is important to preserve the profit pool of the paper and printing industries as a whole.

This information piece explains the problems of irrational pricing and trading terms in the context of game theory between different parts of the value chain, and shows why there needs to be a repatriation of profits back to paper merchants from paper mills and commercial printers to keep the whole industry sustainable in the long term.

*

Due to the current climate of excess capacity and resultant irrational pricing, particularly in Europe, suppliers and customers can play long-suffering paper merchants such as PaperlinX and Antalis off against each other, leading to depressed profit margins and uneconomic returns on capital.

Paper merchants cannot continue to earn uneconomic returns for their shareholders indefinitely. Eventually, their owners will walk away and allow the businesses to fold, resulting in more concentration and perhaps only one or two surviving. These survivors would then use their pricing power to extract better returns from both mills and printers, in the knowledge that the mills' only alternatives would be to invest substantial capital in their own distribution, or to pay the step-up higher prices charged by general logistics operators such as a Toll or DHL. Part of these additional costs would then be passed on to commercial printing customers, reducing profits to both mills upstream and commercial printers downstream.



The financial results and share price performance of two major global paper merchanting businesses, PaperlinX and Antalis (Sequana) – both down over 95% since 2008, reflect an industry which must restructure its sharing of the profit pool to ensure the whole value chain does not collapse. The gravity of the situation was shown in July 2012, when Sequana needed a €150m recapitalisation including an apparent €45m 'bailout' from the French Government to enable it to refinance.

Paper merchanting companies are currently bearing a disproportionate share of the pain caused by industry contraction; subsidising both paper mills and commercial printers by enduring compressed margins, and being put on the rack (stretched at both ends) with trading terms, often having to pay suppliers within three to four weeks, whilst giving their own customers six to eight weeks to pay.

The underlying story parallels how farmers' and food companies' profits and returns are arrogated by the supermarket duopoly (Coles and Woolworths) in Australia. First, the large supermarket chains award contracts to small and medium suppliers, and encourage them to invest in new capacity by giving them volume. Then when it is time for contract renewal, the supermarkets demand price reductions which barely allow the suppliers to make an economic return on their capital. They can do this because of their market power, and because they know the capital investment in new capacity is already a sunk cost.

Because the contract volumes of Coles and Woolworths are so large, if the supplier lost such a significant contract, it would be traumatic for the business because it is almost impossible to find another buyer for what often amounts to over 30% of production volume; traumatic to the point of not being able to cover fixed costs, and in some cases, triggering insolvency.

So, for the supplier, who is faced with a choice between (A) having their operating margins and returns cut down to the bone (continuing to scrape by in survival mode) and (B) going out of business, the only rational choice is the former.

This 'appropriation' of margin occurs because the buyers (Coles and Woolworths) have significant market power concentrated in a duopoly. Further, this duopoly has distribution infrastructure which is extraordinarily difficult for any new entrant to replicate for a cost which allows them to make an economic profit. The supermarket's distribution proposition (convenience of access to large 'one-stop' destinations for millions of people who all need groceries) is something that thousands of small, medium and large producers of food and grocery products cannot replicate, which is why they need the supermarkets. The suppliers do not *own their distribution*, so the supermarkets act as a middle-man or intermediary between grocery producers (suppliers) and grocery consumers (customers). In exchange for providing this distribution 'service', they clip the ticket with a very lucrative profit margin and return on capital, and "pass on some savings" back to customers in the form of lower prices. The table below shows a snapshot of the industry's dynamics:

The Grocery/Supermarket Industry in Australia			
	SUPPLIERS	**INTERMEDIARIES**	**END CONSUMERS**
Who?	Farmers, food manufacturers	Major supermarkets (80%+ of market)	Anyone who buys groceries
Examples	Patties, Tassal	Coles, Woolworths	You and me
Market	Fragmented (000's)	Concentrated (few)	Fragmented
Market/Pricing Power	**Low-medium**	**High**	**Low**
Economic Profitability (ROIC)	**Tends to be low (<12%)**	**Tends to be high (>14%)**	N/A

In the commercial paper and printing industries, the model has the same three parts/groups (suppliers – the mills, intermediaries – merchants such as PaperlinX and Antalis, and customers – thousands of commercial printers), but the power dynamics are very different:

The Paper and Printing Industry			
	SUPPLIERS	INTERMEDIARIES	END CONSUMERS
Who?	Paper Mills	Paper Merchants	Commercial Printers
Examples	Sappi, Nippon Paper	PaperlinX, Antalis	PMP, HannanPrint
Market	Concentrated (few)	Concentrated (few)	Fragmented (000's)
Market/ Power	**Medium**	**Very low**	**Low-medium**
Economic Profitability (ROIC)	**Tends to be low (<12%)**	**Uneconomic (<8%)**	**Tends to be low (<12%)**

Although the mills don't own their distribution either, significant excess capacity means that merchant intermediaries have little or no pricing power and act irrationally, leading to their profits subsidising mills and printers. Two key points which need to be addressed are examined below:

Irrational Pricing

Paper merchants operate in a market which is irrational due to excess capacity. This means they will sell contract volumes at a loss, so long as they recover their variable costs and make a contribution to covering fixed costs. For example, if a marginal tonne of paper is bought for $1,000 and the sale price needed to break even on total costs is $1,250 (i.e. a gross margin of 20%).

Let's assume that the $1,000 buy price for the paper is the only variable cost, and the rest (the other $250) is all fixed costs, such as the warehouse lease and wages for the delivery driver.

If the merchant is running at 60% of capacity, and its warehouse and truck is almost half empty, then it will still sell the paper for $1,050 because the $50 it gets above the marginal variable cost of the extra tonne of paper ($1,000) offsets or defrays some of its fixed costs.

When many players in an industry have significant excess capacity (i.e. paper merchanting), they will compete on price in order to secure volume to offset their fixed cost burden, even though this means they may be selling at an uneconomic price. This is called *irrational pricing* and it is one of the key reasons paper merchants currently earn uneconomic returns on investment below their cost of capital.

Put another way, paper merchants will be loath to invest (they actually need to *divest* to reduce capacity) until pricing rationality returns to the market, and they can earn an economic return.

Unfavourable Terms

There is a second major issue of poor trading terms, by which the paper merchants are notoriously afflicted. If your suppliers (mills) demand payment from you in four weeks, and you give your customers (printers) six to eight weeks to pay for their purchases, then you have to make up that difference by tying up your cash in working capital – which has a real cost.

The simplest way to understand this is to imagine a business with an average annual working capital balance (trade debtors + inventory - trade creditors) of $600m which could get 3% interest if it put the cash in the bank. That's a real $18m opportunity cost per year for the business – i.e. encumbered cash. If that business' cash cycle or 'timing gap' was 70 days, and they managed to reduce it by just one week to 63 days, this would represent a release of $60m in cash, which could be deployed riskfree in a bank deposit to earn $1.8m a year, used to invest in the business, pay off debt, or returned to shareholders.

The wide trade working capital gap that paper merchants sustain improves the liquidity and profitability of both their suppliers and their customers. The suppliers (mills) because they are getting paid more quickly, and the customers (printers) because they are being given longer to pay.

In effect, the paper merchants use their own balance sheets, liquidity and profits to subsidise both paper mills and commercial printers, which means paper merchants earn lower profits and economic returns than they otherwise should in a rational industry.

This cannot continue indefinitely, and unless the split of profit across the value chain is made more sustainable, the merchants will either consolidate or be replaced by logistics companies. Under both scenarios, mills and printers will lose profit margin as the price of distribution rises to a level where there's an economic return.

(Paul Xavier Waterstone is a Financial Analyst and MBA Candidate based in Oxford, UK)