

Sylvamo Corporation | Citi - 2024 Basic Materials Conference | December 3, 2024

Anthony Pettinari:

Good afternoon. I'm Anthony Pettinari. I'm the paper and packaging analyst here at Citigroup and for our afternoon session, we're very pleased to welcome Sylvamo. And we have John Sims, CFO. John's going to say a few kind of introductory words about Sylvamo and I'll have questions and if anyone in the room would like to jump in, please join. John, thank you.

John Sims:

Yeah, thank you, Anthony. I got a couple of slides. I know there are going to be people listening in, so I'll just call out the slide numbers. I first want to start with Sylvamo's strategy. Our strategy is to be singularly focused on uncoated freesheet. What does that mean? It means that any money that we retain, we're going to reinvest back in our business and make us stronger, increase our competitive advantages and focus on uncoated freesheet. We have two fundamental beliefs that stand behind our strategy.

First and foremost is that uncoated freesheet, the products that we produce and we supply to our customers are going to be around for a long, long time. We understand uncoated freesheet is in decline, but we believe that people are going to continue to need uncoated freesheet for a long, long time. It has the highest number of end use applications and is used across all sectors of the economy and all the regions that we operate in. This is why the demand of uncoated freesheet, as you can see from this slide, far exceeds the sum of all the other printing and writing grades combined. Uncoated freesheet is sustainable, affordable, and functional. We believe paper will remain effective vehicle for education, communication, entertainment well into the future.

The other belief in our strategy is that the markets that we operate in are hospitable to generating high returns on invested capital.

Competitors have been investing to get out of uncoated freesheet rather than investing to enter the space. However, as I said, our strategy is to continue to invest, to strengthen our competitive advantages, to generate earnings and to grow our cash flow. We're singularly focused on uncoated freesheet. We've been consistently executing that strategy since we spun from International Paper and since we've become an independent company. Our independence has allowed us to become more agile and more nimble as we work to serve our customers. We leverage our strengths, our competitive advantages with our talented teams, our iconic brands, our strategic channel partnerships, and our low cost mills and attractive regions to drive high returns on invested capitals. We're a cash flow story. So now I'm going to turn to slide six.

Since we operate in attractive markets for uncoated freesheet, and because we have inherited competitive advantages, this provides us the opportunity to create long-term value for our shareowners. Our capital allocation strategy strives to maintain a strong financial position. We invest in our business

to improve our competitive advantages and return substantial cash to our shareowners. We continue to view debt reduction and keeping a healthy balance sheet as a cornerstone of our capital allocation strategy. Having a strong balance sheet allows us to consistently reinvest in our business through the business cycle to strengthen our competitive advantages. It also allows us to return cash to our shareowners and be in position to opportunistically repurchase shares. Let's move to slide seven.

A few weeks ago on our third quarter earnings call, we shared some good encouraging news related to the Brazil goodwill tax dispute. After Brazilian Federal Regional Court ruled in our favor on a court case covering two thirds of the disputed amount, our lenders have agreed to remove the $60 million escrow requirement that we funded in 2023. As part of the amended credit agreement, our liquidity requirements did increase from 225 million to 275 million. Our liquidity includes 400 million and we have available on our revolver as well as cash on hand.

There were other standard stipulations in this amendment agreement and we're very pleased with the outcome as we can now use that cash as part of our value creation engine. I'm on slide eight. So we intend to use the $60 million release from escrow plus an additional $60 million in cash to pay down $120 million of long-term debt by the end of this year. This shows our commitment to maintain a strong financial position to allow us to operate and invest throughout the cycle. By the end of this quarter, we would've reduced our gross debt by 720 million or almost 50% since the spinoff. This healthy position allows us to retain flexibility, to address our macro conditions' downside risk, and invest in long-term high-return opportunities across the cycle.

On slide nine now. We will continue to invest in high-return projects to strengthen our business while increasing earnings and cash flow. As you can see here, how we ramped up our spending and high-return capital projects since our spinoff. Looking forward, we've developed a pipeline of greater than 200 million of high-return projects that we intend to invest over the next several years. These projects are varying in size and largely focused on our flagship mills, providing us with opportunities to grow our earnings and cash flow. As we finalize our budget for 2025, we're ramping up some high-return projects that are nearing finalization of engineering work and even preparation for board approval. Therefore, you should expect 2025 capital spending to be higher than 2024. We should be in a position to share more details in February. We expect such investments to generate well above cost of capital returns. I'll turn to the last slide.

Sylvamo is a cash flow story and we are creating shareowner value through our strong cash generation and discipline capital allocation. Our healthy financial position provides flexibility moving forward to operate as well as invest throughout the cycle. We are reducing our cost structure. We are reinvesting in our business through a great pipeline of high return capital projects, which will enable us to grow our earnings and cash flows in the coming years. We are simplifying our North America business to become leaner and more agile. We are continuing to focus on strategic initiatives to simplify the business, unlock efficiencies and drive earnings growth. We're also committed to returning at least 40% of our free cash flow to shareowners this year. Looking forward, we are encouraged by the uncoated freesheet conditions across our regions. We are confident in our future and motivated by opportunities that lie ahead. With that, Anthony, I'll turn over to you and questions. Thank you.

Anthony Pettinari:

John, thank you. Thank you. Maybe just starting off, can you talk a little bit more about uncoated freesheets supply-demand dynamics across the regions that you operate in?

John Sims:

Sure. They're improving across all the regions, first of all. So if you're starting with North America, there's been some several capacity closure announcements, of course, one being the Georgetown mill that International Paper announced. And so if you look at North America, we're expecting capacity to decrease almost, I think 10% by next year. And in Europe, there've been several capacity closures. And this is what we talked about when we talked about hospitable markets. We've also seen competitors exit the market in Europe. So in Europe we're seeing about 7% decline in capacity. And in Latin America is relatively flat, but in Latin America, balance isn't so important because you can export that.

Anthony Pettinari:

And on the demand side, how you kind of characterize current conditions, maybe going to '25.

John Sims:

Yeah, so going into 2025, so demand in North America is up around 4% this year, but we do expect that to revert back to its normal decline around three to 5%. The same thing is in Europe. Europe is actually up more, Western Europe right now. And really you're looking at 2023 was significantly down both in North America and in Western Europe because of inventory corrections. But we expect demand also decline anywhere from two to 4% in Western Europe as it also reverts back towards historical declining rate. And in Latin America, we expect it to be flat.

Anthony Pettinari:

You talked about the supply agreement at the Georgetown Mill. Can you talk a little bit more about maybe the potential earnings impact from the loss of Georgetown?

John Sims:

Yes, so we did talk about this in our third quarter earnings announcement. The net impact if all else stayed the same for 2024 in terms of cost, price and what not, would be a negative $40 million. So Georgetown's supply agreement with suppliers this year in 2024, almost 250,000 tons. We're retaining 100,000 of that. We're moving those products to other facilities, Ticonderoga in particular. But 150,000 of it we're not going to be retaining in our system. They will be probably be retained with the North America competitors.

Anthony Pettinari:

I think you also have a supply agreement at Riverdale. How do you feel about that?

John Sims:

Yeah, so we have a supply agreement at Riverdale, and as you know, International Paper is going through their strategy. And one of the things that we've been preparing for actually in day one, that International Paper would eventually convert that mill. And in fact, all indications were when they respond that they would convert that mill as soon as they could in 2023, but the market conditions didn't support that.

Now we've gotten no indication from International Paper what they have planned to do with that mill. But having said that, we've been preparing since day one to prepare for that. Now, that's a different

situation than the Georgetown mill because Georgetown was predominantly supplying specialty products where Riverdale is supplying cut size core products, products that we can supply from other regions. And in fact, our plans are such that we would backfill a lot of that volume using our global networks, particularly down in Brazil and also and in Europe. And in fact, it would actually net improve our business even though our volume would go down, our mix improvement would be such that the net impact would be zero, even maybe slightly positive. But right now we'd say near zero. If they were to tell us today it's going down. But again, as I said, we don't have any indication what their intent is.

Anthony Pettinari:

I'm just curious, when you talk about mix, can you talk about what sort of a higher mix, lower mix grade or product for you?

John Sims:

Well, when I'm talking about this particular mix, it's country mix. So it would be shipping export markets that we're serving now today in Brazil, and then supplying that volume into North America and really getting the arbitrage of the margin difference because of the pricing difference in North America versus some of our other export markets that we have. So that would be the big driver to earnings.

Anthony Pettinari:

You talked a little bit about CapEx. Can you just talk about the philosophy around capital spending next year and beyond?

John Sims:

Sure. What we said is we operate in a cyclical business. This is why it's so important for us to have a strong balance sheet because that we believe that we need to maintain our competitiveness, maintain our ability to generate cash through the cycle. We need to invest and maintain those facilities through the cycle. So even on the down cycle, we're not going to pull maintenance back. We're going to continue to make the necessary investments we have to do in terms of maintenance.

The other opportunities we have is high return projects. But when we look at it across our system and look at the options of what we have to invest back in the business for high returns or other uses of cash, whether that's opportunistically buying shares or even returning cash through dividends. But to the extent where we think that we can actually generate high returns and grow our earnings, this is a fundamental belief that we have that even though the volume potentially could come down like in Georgetown or even if IP decides to convert Riverdale, that we can grow our earnings and cash flow by reinvesting back in our business. We can make up for those earning losses and actually we can be a earnings growth and cash growth story.

So what we are investing in, so when we spun, we said we had $100 million of high return projects. We'll have actually have made all those investments by the end of next year, 2025. On average, those projects are returning 35 to 40% return. So they're generating the returns that we expect and we believe it's a low risk investments because we know the business, we know the assets that we're in, and so these are very high returns.

Anthony Pettinari:

That 200 million, can you give us an example of some of the projects or-

John Sims:

Sure. So one that we made and we're seeing a lot of returns off is at our Eastover mill. And if you think about it, the digital transformation of our paper machines. So it gives us the capability to do sophisticated data analytics because the controls are now digitized on our paper machines and you can deploy AI technologies and things like that. So what we've seen is reduced chemical uses, better machine efficiencies, lower chemical uses, less web breaks.

Another example we did, and we talked about this one, is we took an opportunity for... There was a mill in Charleston that closed, they used a lot of chips. We added an investment, our added investment in our capability to process chips in our Eastover mill. So then we were able to use a much lower cost source of fiber. Another example is in Brazil we added the turbine generator, brand new turbine generator that increased our energy self-sufficiency, reduced our energy costs. Some of these projects can be in 15, 20 million. Some of them could be a million dollar project. Now, the ones I gave you examples were larger examples, but we have, I think of the 100 million, it's around 25 to, actually maybe higher than that, 40% return projects.

Anthony Pettinari:

You talked a little bit about this, but in terms of thoughts around capital allocation going forward into next year, how do you balance those CapEx investments with other uses of cash.

John Sims:

Yeah, so we're always been pretty clear with our priorities. First, the strong balance sheet that we already have. Two is a dividend that we can sustain through the cycle. We just recently increased our dividend by 50%. Then we look at reinvesting back in the business because we really are committed to uncoated freesheet. We believe that we can grow our earnings and cashflow by reinvesting smartly back into the business high return projects, and we'll do that because we could get much higher returns than we think we can with other uses of it. And then we'll also repurchase our shares opportunistically anytime we believe that our share price doesn't reflect the value of the Company.

Anthony Pettinari:

Can you talk a little bit more about your balance sheet fixed versus floating, debt profile, maturities? How are you structured?

John Sims:

Well, we have some interest rate hedges in place right now, and when we pay off this 120 million, we'll actually only have about 15 to, let's say less than 20% will be floating. It'll all be fixed. But then we have some amortizations that we'll need to pay off, and when we do that next year, that'll increase. So some of those hedges will come off. We typically like to be 50/50, so we're a little bit more because we're paying off this debt, going to be a little bit unbalanced than that. Going to be more on the fixed, less variable.

Anthony Pettinari:

Can you give us an update on Project Horizon?

John Sims:

Yes. So Project Horizon was our cost reduction effort. It was a one-year effort. Our targeted run rate was $110 million. It's really in three categories. One is an S&A, two was in supply chain, three was in our mill operations. Reported in our third quarter earnings that we now expect to exceed that run rate target by $10 million. So $120 million run rate. We're getting more now than we expected. When we first rolled out the program, we said about 10 to 15 million, and we would've realized in this year, probably about double that this year, but we're going to get total run rate of $120 million. And we're seeing more of that. S&A came in on target. It's in the supply chain and the manufacturing area where we've been able to exceed our target.

Anthony Pettinari:

Can you talk about maybe potential tariff impacts for uncoated freesheet as you look at your global network and impact on the industry and maybe impact on Sylvamo specifically?

John Sims:

Yeah, that's a tough question. I get that a lot. I even get that from employees and I also push this back because it's a really difficult one to say because you got to say what's going to be the size of the tariffs? Who's it going to be on? And what are they going to be the counter tariffs where they're at? Yeah, we believe, and our philosophy is, we believe in equitable free trade.

Tariffs can be impactful in different ways. It can be both plus and minuses depending upon where. And you have to look at each of the markets, but in terms of North America, tariffs on Brazil could be hurtful to us if it impacts our ability or reduces our margins in terms of what we can ship in from Brazil in here. Maybe even to... [inaudible 00:20:41] because of the Riverdale decision, counteract that. It could help us if it's on imports that are coming into North America. For example, Mexico put in tariffs on cut size from Brazil. That gave us opportunities to ship down into Mexico from North America. So we move things around. That can happen. We can move things around too because of our global network based upon how the capacity or how the tariffs are being applied. That is some of the advantages of us being global on nature. But it's hard to really definitively answer that until we see what those tariffs are going to be.

Anthony Pettinari:

Right. And you talked about the supply demand environment across the regions. In terms of pricing, the pricing that you've seen in '24, and not talking about forward pricing, but just can you talk generally about the pricing environment for uncoated freesheet?

John Sims:

Yeah, so we'll start in Europe. Europe pricing has been going down. So pulp prices as well as uncoated freesheet prices have been declining in Europe. And I think it's steadying out, but we don't expect it to go down any further. And North America, pricings have been stable. And same thing is in terms of Latin America, it's been stable. And also in Brazil there's been some price announcements. And we've announced to our customers price announcements.

Yeah, so what we've seen in North America is they're strongly correlated. So when operating rates do improve or when they're strong, that typically you'll see prices increase and the reverse is true. Having said that, when you look at 2023, we had the most significant decrease in uncoated freesheet in my

history of 20 years of uncoated freesheet. So demand was down in North America about 23%. Operating rates were in the low 80s for 12 months, and pricing didn't move more than $40. So this also speaks to the two basic premises we talked about in terms of our strategy being based on uncoated freesheet is going to be around a long time, and two, the markets are attractive, hospitable. And that's an example of North America. So I share that because historically you would've expected a strong correlation between operating rates and price, but you didn't see that. Right? So I'm not going to predict what pricing is going to do next year in terms of that. But historically you've seen a correlation between the two.

Anthony Pettinari:

And I guess it's been just over three years since the spin and the creation of the company. What has the kind of response been from maybe first your customers in the marketplace, but also investors?

John Sims:

I think with customers it's been very positive, and I think it's mostly because of our strategy. They, like everybody, didn't know what this meant for us, but now they see that our strategy is not only be singularly focused on uncoated freesheet, but that also means we're singly focused on their business. We're singly focused on serving their needs, helping them be successful in their business, and we're committed to it. And that gives them... We've seen that that has been an advantage in the marketplace because customers that depend upon uncoated freesheet for their business and product lines that they can depend on us. So that's been a very positive.

I think from an investor perspective, I think you will see... From the time we spun, we've gone through quite a few transitions in our investment base. I think now that we're three years in, we've got an investment base of some long-term holders that believe in our strategy, believe that we will generate a significant amount of cash, that we have the potential to reinvest back in the business, grow our earnings. And so they like our strategy because it's focused and because we're saying what we're not going to do. We're not going to take their money and invest it in high risky businesses, businesses we don't know. We're not going to convert our mills into product lines that we're not operating in that are really risky. They know that if we do invest, it's going to be in low-risk, high-return projects.

Well, you asked a lot of questions with that. So we think that the market will continue to consolidate, and it is,we're seeing that today. As I said, and competitors are leaving the uncoated freesheet. They're investing to get out of it. We're seeing that, and I say that, we see that in North America, and we're also seeing it in Europe. And that will continue to happen. I think the Department of Justice I think will continue. I don't think they'll change their stance if there's a consolidation move. So it may change a little bit in terms of maybe the new administration, but generally, when you start to do consolidations that make moves greater than 30, 40%, DOJs probably not going to not support that. However, it can happen naturally. This is what happens in declining industry. That does happen naturally.

And it happens naturally, one, because there are a number of mills that are getting to the point where their paper machines or their mills are at a time of life where the cost to stay in is getting higher than the cost to exit because of major capital costs. And we've seen that. So over times, the barriers to exit start to become a little bit less because the cost to stay in becomes even greater. So naturally, and we see this not just in uncoated freesheet, but generally across a lot of declining industries that are capital intensive, companies are going to exit. And so it just naturally consolidates over time. That's our bet on Europe, and that's what we've seen here in North America.

You asked how we feel about our mills system. We have seven. So six of them are integrated mills. One's a non-integrated mill down in Brazil. So non-integrated means just a paper machine. We believe that the

assets that we have are low cost because of the low cost quartile they have. We have several mills that we call our flagship mills. These are the ones that are really generating a significant amount of our cash. These are the ones that we're going to put most of our investments in. There's actually three of them when we talk about it. So it's our Eastover mill, here in North America. Luiz Antonio down in Brazil, and Tres Lagoas, which is just a paper machine, but it's a non-integrated machine. It has very little capital required to it, so it generates tremendous amount of cash. The next tier mills are the ones that are the next four mills that we have.

Anthony Pettinari:

John, maybe one last kind of catch-all. What do you think is sort of misunderstood or underappreciated about Sylvamo?

John Sims:

I think the biggest thing is that even though we're focused on a declining market, we still have the capability to grow our earnings and grow our cash flow, even in light of declining revenues. That's probably the biggest misunderstanding about Sylvamo.

Anthony Pettinari:

All right, John, thank you.

John Sims:

Thank you. Thank you for having me.