

Fernando Bernad: Smurfit Kappa

Fernando Bernad is fund manager with Bestinver Asset Management S.A. As one of Bestinver's current stock ideas he presented Smurfit Kappa, the leading producer of packaging paper in Western Europe. Knowing the packaging paper sector for years, the IPO of Smurfit Kappa caught Bestinver's eyes.

EVI: Mr. Bernad, how did you come aware of Smurfit Kappa (ISIN: IE00B1RR8406)?

Bernad: We know the packaging paper sector for years already, and looked at Smurfit Kappa soon after the IPO in March 2007. We became interested in the company as we saw the stock price fall from an IPO price of EUR 16.5 per share and a peak in May 07 of EUR 20 per share to just above EUR 10 per

share by the end of last year.

EVI: Why do you see potential in just this stock

Bernad: We value cyclical stocks based on normalised ("mid-cycle") earnings. We normalise earnings based on the estimated per ton profit at which the marginal producer makes a modest return on capital employed. In case of Smurfit Kappa we assume that profit per ton of Kraftliner

– a particular packaging paper made out of wood, as opposed to using recycled paper - gives a return below the cost of capital of the marginal producer. This has been the case for long, due to endemic overcapacity in the US and, lately, very unfavourable exchange rate in Europe. Should this situation change to improve, this would increase our fair value of Smurfit Kappa. At EUR 4.2 per share, the stock is trading below 3 times our estimated normalised earnings.

EVI: How do you see the market situation and the competition situation?

Bernad: We are facing a challenging situation going forward, as demand is weakening precisely at a time when several capacity expansion projects are under way to be commissioned by end 2008 and 2009. This will exert strong pressure on paper prices. In our view, however, capacity additions will be partially compensated with shut-downs of inefficient sites. This is even more likely in a scenario of paper prices being (temporarily) low. We believe in rational business behaviour, and expect that producers will not invest in those assets under-earning its cost of capital. The industry, today still fragmented, is gradually consolidating, and leading producers like Smurfit Kappa, Mondi (ISIN: GB00B1CRLC47), DS Smith (ISIN: GB0008220112), SCA (ISIN: DE0006889801) and International Paper (ISIN: US4601461035) already account for more than 50% share of the Western European market. These companies have undertaken permanent closure of sites in the past few years, and we expect will continue to manage their capacity plans prudently for the shake of overall industry profitability.

EVI: What competitive advantages does Smurfit Kappa have?

Bernad: Smurfit Kappa is by far the leading producer in Western Europe, with



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Fernando Bernad joined the team of Bestinver along Francisco García Paramés and Álvaro Guzmán de Lazaro in February 2007

Following full-time internships at Price Waterhouse (Madrid, 1994), BBVA (Madrid, 1996), and DG Bank (Frankfurt, 1997), he started his professional career in 1998 in Frankfurt, where he worked alongside Álvaro Guzmán de Lazaro at the same asset management company, Value Management & Research. It was here that he began to gain in-depth knowledge of the theories of value investing.

He then worked in the Spanish private equity sector as an Associate at BNP Paribas Leveraged Finance. Subsequently he joined the analysis team at Banesto as a cyclicals analyst (steel and oil sectors) and later formed and led the analysis team at Interdin, whose strategy was focused on investment

ideas based on the theory of value. In 2005 he joined the Vetusta Group as investment director, leading a three-person team specialising in the value-style management of portfolios and funds. In his two years in charge at Vetusta he achieved average annual returns of around 30% on equities, always beating benchmark indices. He joined Bestinver in February 2007 along with Francisco García Paramés and Álvaro Guzmán, whom he considered the leading lights in the Spanish value school.

He has a Bachelor in Business Administration (summa cum laude, awarded jointly by ICADE, Madrid and Northeastern University, Boston) and is a CFA charter holder. He is fluent in English and reads German and French. ■

24% market share. In fact, market shares in some individual European countries are as high as 40%. Smurfit also commands leading market shares in some Latin American countries, where the company has slightly more than 10% of the business. Smurfit Kappa is 100% integrated from papermaking to box manufacturing. This makes its earnings more stable, as box prices are mostly negotiated with clients annually, unlike paper which prices are adjusted more frequently. In terms of efficiency, Smurfit used to be the lowest cost producer. Admittedly, after some years of high leverage (the company went through an LBO before going public last year) and of some underinvestment, this is not the case anymore, but we are still in a relatively good position, with margins above industry average.

EVI: What are reasons for the under-valuation?

Bernad: The market believes that cyclical headwinds will erode company’s earnings significantly. We believe this is probably true, but we look at it as if a period of poor results is the “price” we are paying for investing in the long term at an extremely attractive valuation. Also, the market is worried about high leverage, as Smurfit Kappa net debt to trailing 12-month EBITDA was 3.15 times as of the end of March 2008. However, we believe that the company will meet covenants even under quite unfavourable scenarios in the current year and next. And the good side of this, debt reduction is the absolute number one priority of the company, so equity holders can be certain that all free cash flow accrues to them. In sum, we believe that temporary poor earnings and current high leverage are not going to produce a permanent impairment in our investment at the current stock price even under the worst case scenarios.

EVI: Where do you see the fair value?

Bernad: We think the stock is worth a little more than EUR 21 per share. This is based on 15x our calculated normalised earnings. Another way to look at the valuation of Smurfit is that the replacement value of its tangible assets is EUR 8.2 bn, compared to a current enterprise

value of EUR 4.3 bn, of which net debt is the biggest part.

EVI: What are the risks with Smurfit Kappa?

Bernad: The company’s current leverage is high. Should the economic crisis last very long and the industry behaved irrationally for long also (for example, in the event of governments bailing out some companies and preventing inefficient producers from going out of business and restore supply demand balance) we could be subject to a severely dilutive capital increase. However, at current stock prices, we believe we would still make a

nice profit even under such unfavourable and rather remote scenario.

EVI: Thank you! ■

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Remark: The disclaimer note published on the last page of this edition is applicable to the entire content of this article.

SMURFIT KAPPA

ISIN IE00B1RR8406

Business: The leading producer of paper packaging in Western Europe, with 24% market share.

Stock Information (08/19/2008)
Price: € 4.00
 52 Week Range: € 16.70 - € 3.02
 Dividend Yield: 0.8 %
 Market Cap: € 871.9 m

Financials:
 Revenue: € 7.27 bn (2007)
 EBITDA Margin: 14.6% (2007)
 Operating Margin: 7.73% (2007)

Valuation Metrics:

	Smurfit Kappa	MSCI World
P/E	3.8x	15.67
P/B	0.4x	

Institutional Investors:
 1) Madison Diarborn 21.50%
 2) CVC & Cinven 24.00%

Free Float: 54.50%

Fair Value: € 21.00

SMURFIT KAPPA STOCK PRICE



INVESTMENT THESIS

Smurfit Kappa is by far the leading packaging paper producer in Western Europe, with 24% market share. It also has important market shares in some Latin American countries. Its 100% integration from papermaking to box manufacturing makes its earnings more stable. The temporary poor earnings and currently high leverage are not going to produce a permanent impairment on the stock.