

UPM Stock Analysis – Investing in The Paper Industry

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Summary

A good company with conservative management that will probably deliver a 10% return over the long term. However, it is also cyclical so I am happy to put it on the watch list and wait for returns of 15% or even 20%.

I still have to look at some businesses in the sector and then I'll probably add two or three to the watch list. I feel that over the next 20 years, this could be a good sector to find bargains as the cycles evolve.

Investing in the paper industry

I have spent the last few days looking into the global paper industry. I gave a quick look to approximately 30 stocks and of those I have picked a few that I will research in depth. Those are Klabin, Nine Dragons Paper, Finnish and Portuguese paper stocks plus probably two North American stocks.

Part of my stocks list:

West Fraser Timber tsx: WFT-5B	THESE GUYS DON'T OWN THE LAND and the trees :-(((
Canfor forest products- TSX: CFP	tariffs of 20% to usa
Western forest products	
Klabin	to look into, complex, 4 types of shares
Youtube input	
Smurfit Kappa	5% FCF yield on slow growth
RYAM and OSB	A lot going on but high debt not for growth, just there.
OSB	cyclical and high investments - interesting, not much debt, 5%
Mayr-Melnhof Karton (recycling carton and packaging)	No debt - good company, on the expensive side:-(
RFP	cyclical with negative outlook
UPM	stable company, single digit returns
Altri and Navigator (altri, perhaps a 10% yielder, but pulp prices are really high
Navigator	dividend stock
stora enso	looks good like the other finnish, good margins
LSE:MNDI	similar
Billerudkorsnäs, Stora Enso R, SCA B, Holmen B.	
01626 HK	small, stable,
WSE:KPD	low margin
SEHK:3363	Zhengye International Holdings Co Ltd
TSX:CFP	canada owns the land
TSX:SJ	expensive
ASX:ORA	
ASX:MWY	
ASX:BRI	low margin
Conclusion - find those with the best margins and long term competitive advantages.	

From the paper sector analysis, I can conclude that there are some positive trends as the global middle class is growing but that there aren't really moats as anybody can buy or build a paper mill and make paper. Therefore, the only safety one can find is with integrated producers that can access their own pulp cheaply, thus Latin America, Finland and Portugal. In the US the timber land is owned by REITs, that are great businesses but also valued like great businesses while in Canada it is mostly the government that owns the land.

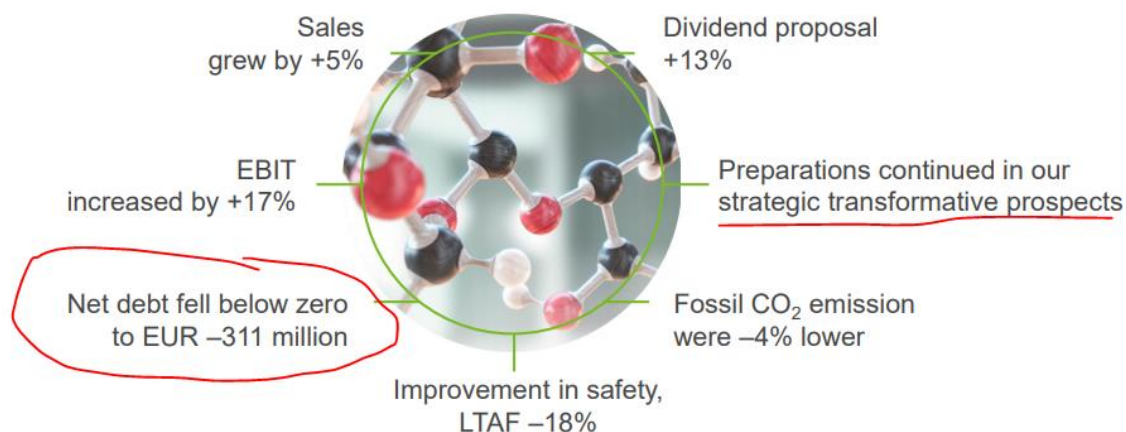
What am I looking for? I am looking for businesses that give me a margin of safety through value, be it business value, growth, sector tailwinds and when I find that, I put them on my watch list and buy only when the probable long-term return is 15%. Given the cycles in some industries like paper, mining or countries, it is not that rare that a stock price hits my buying range. Let's see at what price would UPM give us a 15% business return.

UPM Company Overview

The first two things that strike me positively with UPM is that they have zero net debt and that they are planning on transformative prospects. Usually the market doesn't value at all something that might happen in 5 years but with such boring companies as paper businesses, it often happens and you see good things later when the market recognizes them.



Record earnings and value creation in 2018



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Source: [UPM Investor Relations](#)

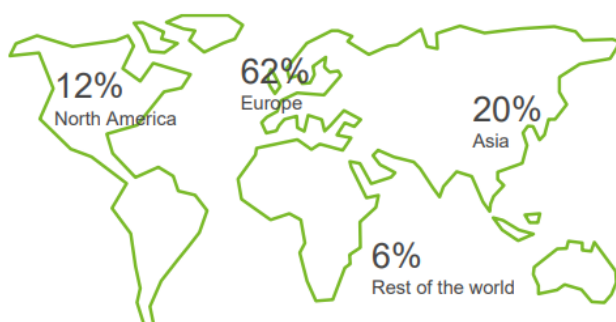
The second important thing is that 2018 was a year of record earnings. In a cyclical industry it makes me very cautious and I prefer using 5 or 10 year averages when it comes to valuing the past.

UPM is mostly focused on Europe which means I have to look at the European market for paper and pulp.



Global businesses – local presence

UPM's sales by market
EUR 10,483 million



54 production plants in	12 countries
19,000 employees in	46 countries
12,600 customers in	110 countries
99,600 shareholders in	32 countries
24,000 b-to-b-suppliers in	75 countries

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Their products are diversified which is good but the majority of EBIT comes from biorefining.

Operating on healthily growing markets



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A company's guidance usually gives you a good indication of what you have to look for.



The global economic growth is estimated to continue in 2019, albeit at a slower pace than in 2018. There are, however, significant uncertainties related to this, including trade negotiations between China and the US, growth in China, the undefined nature of Brexit and political uncertainties in several countries. These issues may have an impact on the global economic growth and on UPM's product and raw material markets during 2019.

UPM reached record earnings in 2018. UPM's business performance is expected to continue at a good level in 2019.

In 2019, favorable demand is expected to continue for most UPM businesses.

Demand decline is expected to continue for UPM Communication Papers.

In the beginning of the year 2019, pulp prices are expected to be lower and graphic paper prices in Europe are expected to be higher than in Q4 2018.

Input costs are expected to stabilise after the significant increases seen in 2018.

UPM will continue measures to reduce both variable and fixed costs.

Fair value increases of forest assets are not expected to contribute meaningfully to comparable EBIT in 2019.

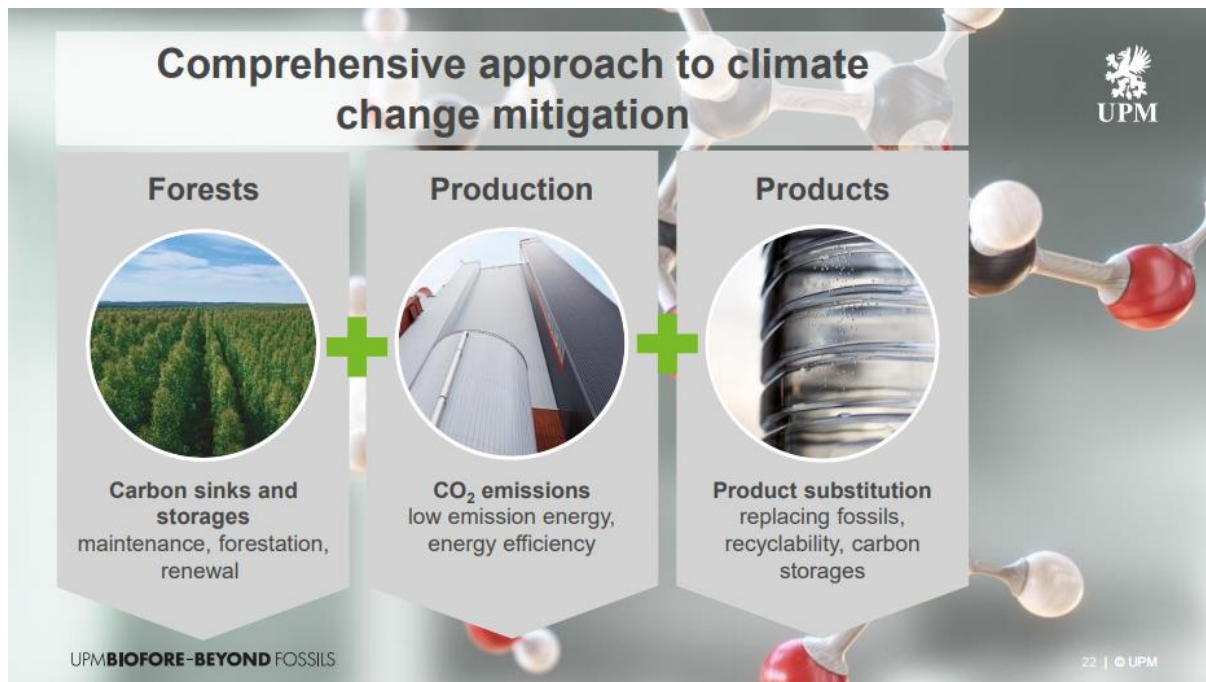
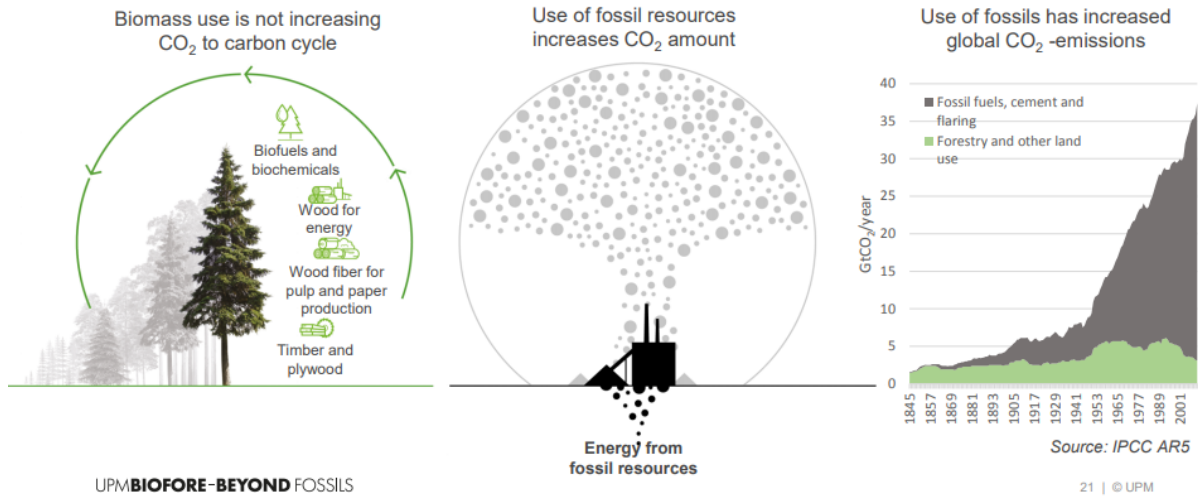
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In this case, UPM's performance will always be linked to global economic growth as it sets the prices for their products. Secondly, input costs, as we will see later in the financial overview are also meaningful and thirdly, we have to see about those fair values of forest assets as that is a tricky thing and can skew EBIT significantly depending on how the management is approaching it.

For those interested in investing into sustainable businesses, UPM is trying its best to lower CO2 emissions and their message is that forestry can provide the same products as fossil fuels but with lower emissions.

Bioeconomy offers a sustainable alternative to fossil-based economy



Talking about forests, they own 512k hectares in Finland and plant 100 trees per minute.

UPM's forest ownership and carbon sequestration in Finland



- UPM owns 512,000 hectares of land in Finland and is the second biggest private forest owner in Finland
- UPM owned forests in Finland are carbon sinks of 0.5 million tonnes CO₂, equivalent to yearly average emissions of 170 000 cars
- UPM owned forests are a carbon storage of 360 million tonnes of CO₂, which represents over six years' emissions from Finland

20 million seedlings yearly

360 million tons CO₂ storage

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Business strategy

Their main future development plan is to build a pulp mill in Uruguay. The mill would produce 2 million tons of eucalyptus pulp and cost about 2 billion EUR.

Renewal creates growth potential in Uruguay – pulp is the raw material for the future



Potential new pulp mill

- 2 million tonnes of eucalyptus pulp
- The estimate for a pulp mill investment approximately EUR 2 billion

Competitive advantage

- High barriers to entry: sustainable and competitive wood supply, location, infrastructure and capital
- Stable transparent democracy

Outcomes

- Sustainable products for growing consumer demand
- Positive impacts on local society

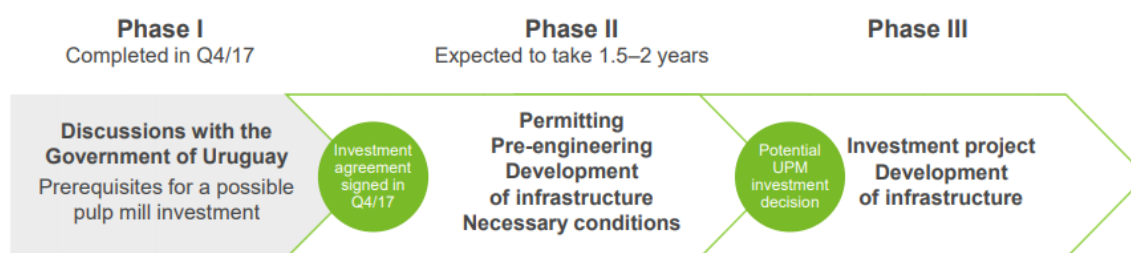


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However, it will take a few years before that happens but if they can get a 10% return on capital and be highly competitive globally, it could be a really good plan. Klabin, a Brazilian competitor just decided to go on with its Puma mills so I wonder if that might change UPM's plans in Uruguay.

Second preparation phase for the potential new pulp mill in Uruguay proceeding



Main items in preparation phase II:

- Mill permitting, pre-engineering
- Rail permitting, tendering, start construction
- Port permitting, tendering, concession
- Roads
- Labour protocols, regulation
- Investment regimes
- Regional planning and development
- Energy and complementary items

I have found a nice article on [ResearchGate on eucalyptus](#) production in Uruguay. I have requested the full text to see what is going on there and will update when I get it. The abstract says how it all boils down to the demand of two integrated paper producers. One will probably be UPM.

The fact that UPM owns [230k hectares](#) of land there already makes things easier to grasp and lowers the risk. They already own a mill there (Fray Bentos) and the mill covers 9% of Uruguay's energy demand apart from making 1.3 million tons of pulp.

Sustainability aside, there are also [negative consequences](#) of producing eucalyptus monocultures.

Further on the strategy, they are also investing in R&D and significantly when compared to profits.

We innovate for a future beyond fossils

200	370	106
Researchers globally	Patents filed in 2018	EURm Spend on research and development in 2018

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Remember, even Nokia was a paper business at first.

The key is that they maintain their cost competitiveness.

Consistent performance and cash flow in paper, maintaining strong competitiveness

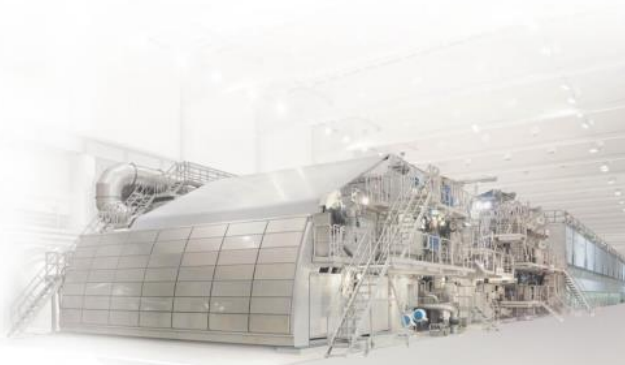


Strategy

- Customer-driven development of business and product portfolio
- Maintaining a strong, profitable market position
- Capacity management and increasing the efficiency of operations

Competitive advantage

- Maintain and improve cost competitiveness in all market situations
- Trusted long-term paper supplier
- High product and service quality



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If they can do that, all will be well. Now that we know the story, let's look at the financial aspects of the same story.

[UPM – Financial Overview](#)

The 2018 financials look really good but given it is a cyclical industry we have to be careful when looking at numbers. We also have to keep in mind the currency as UPM reports in Euros.

UPM delivered record earnings in 2018, in a strong position for 2019



2018 vs. 2017:

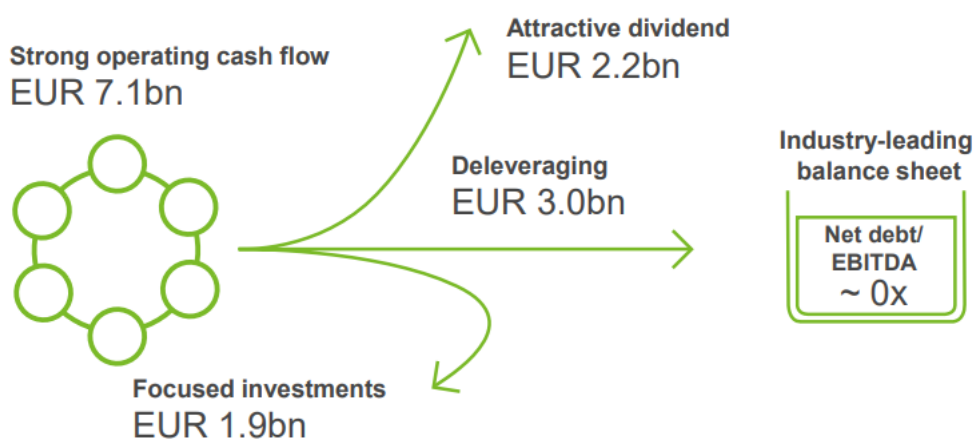
Sales EUR 10,483m	▲ 5%	Comparable ROE 12.9%	▲ +1.0pp
EBITDA EUR 1,823m	▲ +192m	Operating cash flow EUR 1,391m	▼ -167m
Comparable EBIT EUR 1,513m	▲ +221m	Net debt EUR -311m	▼ -485m
Comparable EPS EUR 2.24	▲ +0.36	Net debt / EBITDA -0.17x	▼ -0.28x

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Over the last 5 years the company has created EUR 7 billion in operating cash flows, of which 3 billion went for deleveraging, 2.2 for the dividend and 1.9 billion for investments. Now they are debt free and ready perhaps to develop the new mill in Uruguay.

5-year cumulative cash flow (2014–2018) – efficient capital allocation in action



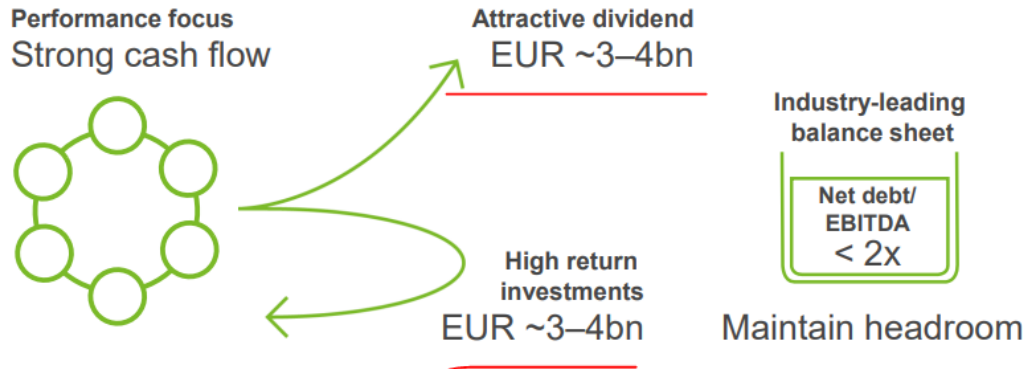
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Operating cash flows of 7 billion lead to 1.4 billion per year.

As the deleveraging is done, they will have more money for dividends and they will take a bit of debt to build the mill in Uruguay.

Illustrative capital allocation *) for the next 5 years, assuming the Uruguay pulp mill investment



*) This is not a forecast

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In any case, the dividend over the next 5 years should be 50% to 100% higher than in the past 5 years, depending on market forces of course. I must say that I am impressed to see how the company lowered its debt by 4 billion over the last 10 years.

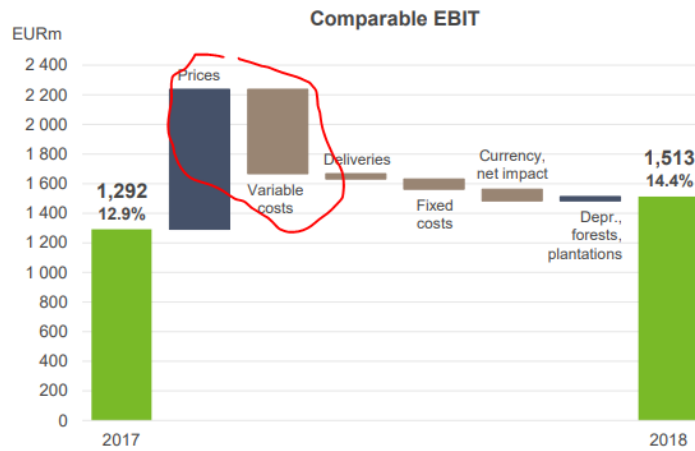
UPM transformation, performance and efficient capital allocation are reflected in shareholder value



Consequently the market capitalisation expanded significantly too.

The increase in prices created a nice increase in EBIT, and I must say that it is nice they are not using EBITDA like all others are.

Sales prices increased in all business areas, outweighing the impact of higher input costs

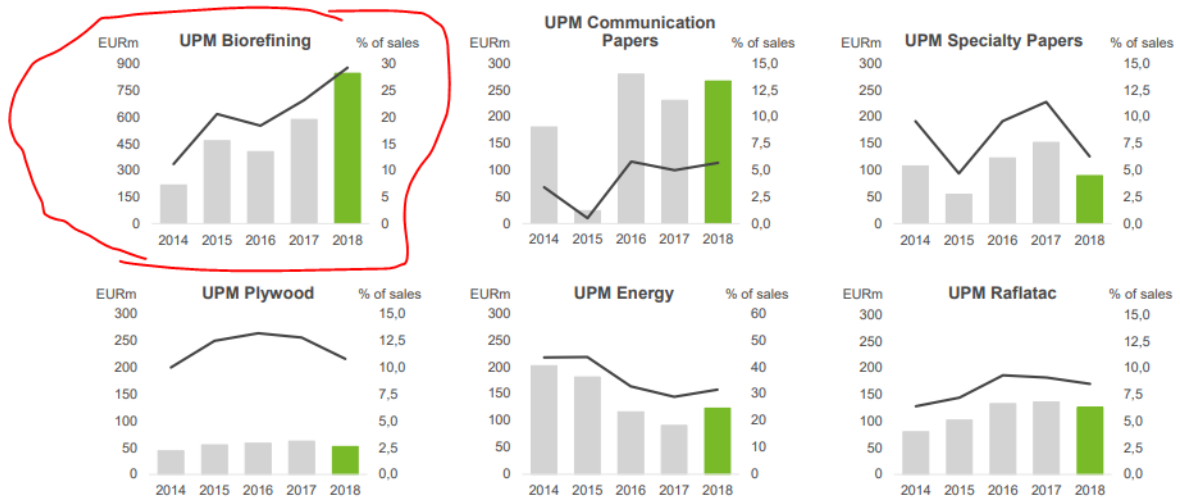


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The largest contributors to EBIT is biorefining. What is important to see is how all these sectors balance out over time.

Comparable EBIT by business area



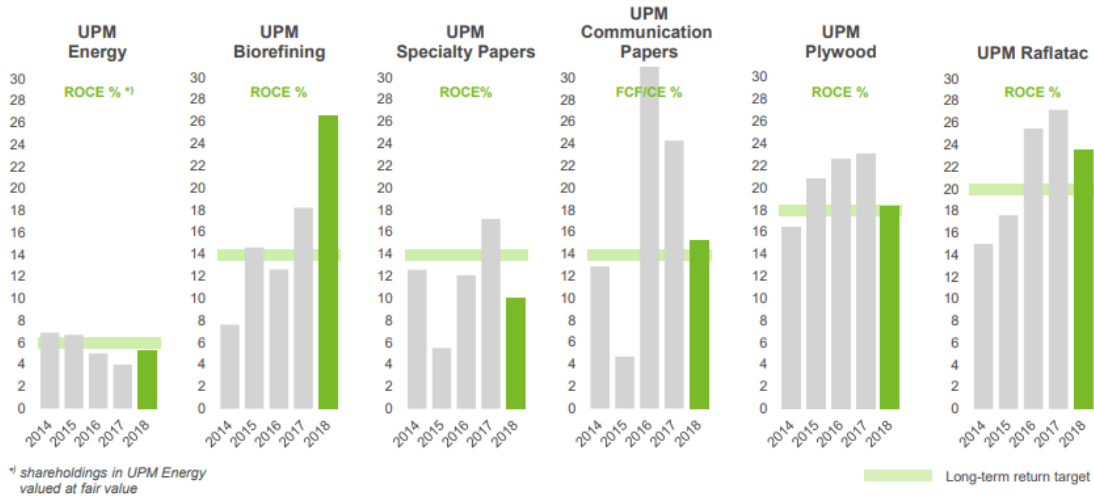
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The business returns look excellent and a high ROCE is what you want when looking at good businesses.



Business area returns and long-term targets



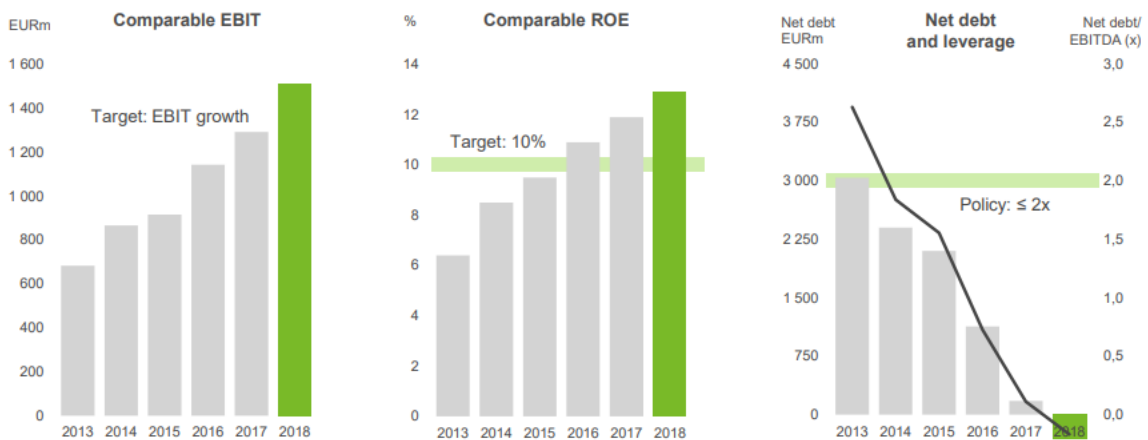
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Given that in 2018 the ROCE was above expected we could say we are in a positive cycle part for the industry.



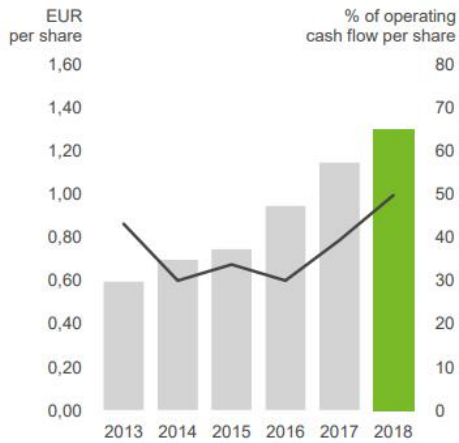
Group financial performance



The policy 2x net debt to EBITDA means these guys can take about 3 to 4 billion in debt easily in Europe, probably at very low interest rates. We should take them over, pay huge dividends and leverage them to the hilt. We can't lose but we could make huge returns if we win.

They have a good dividend policy.

Dividend proposal: 13% increase



Long term dividend policy

- UPM aims to pay an attractive dividend, 30–40% of operating cash flow per share

Dividend proposal for 2018

- EUR 1.30 (1.15) per share, totalling EUR 693m
- 50% of 2018 operating cash flow

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And it will probably stay high if things continue to be good on their market.

A look at the 10year financials shows something happened in 2012 but also that the company has been constantly profitable no matter the cycles.

UPM-Kymmene Oyj UPMKF

Income Statement Balance Sheet Cash Flow

Statement Type	Data Type	Period	Show Report Dates	Data Scroll	View	Rounding	Export				
Annual	As of Reported	10 Years	Ascending		\$ % 1.0	▼.0 ▲.0					
Fiscal year ends in December											
EUR in Million except per share data											
		2009-12	2010-12	2011-12	2012-12	2013-12	2014-12	2015-12	2016-12	2017-12	2018-12
Revenue		7,766	9,000	10,068	10,438	10,054	9,868	10,138	9,812	10,010	10,483
Cost of revenue		4,682	5,475	9,013	6,847	6,731	6,454	6,547	6,235	5,471	5,723
Gross profit		3,084	3,525	1,055	3,591	3,323	3,414	3,591	3,577	4,539	4,760
▼ Operating expenses											
Sales, General and adm...		309	282	—	—	—	—	—	—	888	891
Other operating expens...		2,640	2,488	742	3,173	2,853	2,680	2,684	2,640	2,551	2,469
Total operating expens...		2,949	2,770	742	3,173	2,853	2,680	2,684	2,640	3,439	3,360
Operating income		135	755	313	418	470	734	907	937	1,100	1,400
Interest Expense		—	207	—	168	146	148	122	111	76	44
Other income (expense)		52	87	104	(1,656)	151	81	290	254	162	483
Income before taxes		187	635	417	(1,406)	475	667	1,075	1,080	1,186	1,839
Provision for income t...		18	74	(40)	(152)	140	155	159	200	212	342
Net income from contin...		169	561	457	(1,254)	335	512	916	880	974	1,497
Other		—	—	—	—	—	—	—	(1)	(1)	(2)
Net income		169	561	457	(1,254)	335	512	916	879	973	1,495
Net income available t...		169	561	457	(1,254)	335	512	916	879	973	1,495
Earnings per share											
Basic		0.33	1.08	0.88	(2.39)	0.63	0.96	1.72	1.65	1.82	2.80
Diluted		0.33	1.08	0.87	(2.39)	0.63	0.96	1.72	1.65	1.82	2.80
Weighted average share...											
Basic		520	520	522	525	528	532	534	534	533	533
Diluted		520	521	524	526	528	532	534	534	533	533
EBITDA		966	1,607	1,141	1,349	1,166	1,473	1,721	1,736	1,712	2,305

Source: [Morningstar – UPM stock](#)

I would say that the business, as it is now can deliver 700 million in profits per year no matter the cycles in the industry. Plus, there is the growth and there is the margin of safety in the land, who doesn't like to own forests. If you can't get a good price for the wood, you simply let it grow and get a return later.

From the balance sheet I can see that the cost of building what they have is 20 billion, but it is on the book for just 4 billion. They don't have much goodwill and it looks like the 2012 impairment is related to some past acquisition.

UPM-Kymmene Oyj UPMKF

Income Statement Balance Sheet Cash Flow

Statement Type	Data Type	Period	Show Report Dates	Data Scroll	View	Rounding	Export										
Annual	As of Reported	10 Years	Ascending		\$ % 1.0	▼.0 ▲.0											
Fiscal year ends in December								2009-12	2010-12	2011-12	2012-12	2013-12	2014-12	2015-12	2016-12	2017-12	2018-12
▼ Assets																	
▼ Current assets																	
▼ Cash																	
Cash and cash equivale...		438	269	495	468	787	700	626	992	716	888						
Short-term investments		—	—	—	—	—	—	—	109	—	—						
Total cash		438	269	495	468	787	700	626	1,101	716	888						
Receivables		1,446	1,661	2,003	1,432	1,398	1,412	1,436	1,360	1,447	1,476						
Inventories		1,112	1,299	1,429	1,338	1,288	1,316	1,342	1,324	1,292	1,609						
Prepaid expenses		—	—	—	165	193	183	168	157	88	114						
Other current assets		28	26	50	447	446	315	362	253	380	408						
Total current assets		3,024	3,255	3,977	3,850	4,112	3,926	3,934	4,195	3,923	4,495						
▼ Non-current assets																	
▼ Property, plant and eq...																	
Gross property, plant ...		17,354	17,774	21,520	19,920	19,776	20,180	20,217	19,769	19,456	19,638						
Accumulated Depreciati...		(11,140)	(11,892)	(15,278)	(15,074)	(15,019)	(15,473)	(15,322)	(15,112)	(15,175)	(15,452)						
Net property, plant an...		6,214	5,882	6,242	4,846	4,757	4,707	4,895	4,657	4,281	4,186						
Goodwill		1,017	1,022	—	222	219	230	241	245	231	236						
Intangible assets		423	424	1,480	357	342	340	329	299	295	296						
Deferred income taxes		287	359	508	686	564	532	466	446	423	397						
Prepaid pension benefi...		—	—	—	194	88	40	93	71	84	38						
Other long-term assets		2,640	2,870	3,182	2,738	4,517	4,420	4,235	3,997	3,830	4,348						
Total non-current asse...		10,581	10,557	11,412	9,043	10,487	10,269	10,259	9,715	9,144	9,501						
Total assets		13,605	13,812	15,389	12,893	14,599	14,195	14,193	13,910	13,067	13,996						

The cash flows have been used in investments, about 400 million per year and debt repayment. You cannot not like these guys.

Statement Type	Data Type	Period	Show Report Dates	Data Scroll	Rounding	Export								
Annual	As of Reported	10 Years	Ascending		▼.0 ▲.0									
Fiscal year ends in December														
EUR in Million except per share data														
		2009-12	2010-12	2011-12	2012-12	2013-12	2014-12	2015-12	2016-12	2017-12	2018-12			
▼ Cash Flows From Operat...														
Net income		169	561	457	(1,254)	335	512	916	880	974	1,496			
Depreciation & amortiz...		779	—	—	2,587	545	658	524	545	450	422			
Investments losses (ga...		—	—	37	—	—	—	—	—	—	—			
Deferred income taxes		—	—	(94)	(152)	140	155	159	200	212	342			
Change in working capi...		532	(139)	(73)	(1)	(196)	(5)	(360)	151	24	(682)			
Inventory		400	(145)	13	50	33	18	15	41	(26)	(317)			
Other working capital		132	6	(86)	(51)	(229)	(23)	(375)	110	50	(365)			
Other non-cash items		(221)	560	714	(166)	(89)	(79)	(54)	(90)	(102)	(187)			
Net cash provided by o...		1,259	982	1,041	1,014	735	1,241	1,185	1,686	1,558	1,391			
▼ Cash Flows From Invest...														
Investments in propert...		(236)	(241)	(286)	(374)	(337)	(378)	(432)	(351)	(305)	(303)			
Property, plant, and e...		46	55	32	100	33	89	26	—	106	—			
Acquisitions, net		(21)	(4)	(14)	(14)	(3)	—	7	6	2	—			
Purchases of investmen...		—	—	—	—	(31)	(31)	(33)	(8)	(28)	—			
Sales/Maturities of in...		—	1	141	150	1	68	35	—	1	17			
Other investing activi...		(3)	(6)	(4)	73	40	5	5	91	2	26			
Net cash used for inve...		(214)	(195)	(131)	(65)	(297)	(247)	(392)	(262)	(222)	(260)			
▼ Cash Flows From Financ...														
Debt issued		325	167	801	126	553	—	22	1	1	—			
Debt repayment		(1,057)	(878)	(1,156)	(910)	(323)	(836)	(519)	(540)	(964)	(331)			
Common stock issued		—	—	—	8	19	47	—	—	—	—			
Dividend paid		(208)	(234)	(286)	(315)	(317)	(319)	(373)	(400)	(507)	(613)			
Other financing activi...		—	(21)	(30)	115	(64)	12	2	(118)	(134)	(15)			
Net cash provided by (...)		(940)	(966)	(671)	(976)	(132)	(1,096)	(868)	(1,057)	(1,604)	(959)			
Effect of exchange rat...		3	10	(13)	—	(5)	15	1	(1)	(7)	—			
Net change in cash		108	(169)	226	(27)	301	(87)	(74)	366	(275)	172			
Cash at beginning of p...		330	438	269	495	486	787	700	626	992	716			
Cash at end of period		438	269	495	468	787	700	626	992	717	888			
Free Cash Flow														
Operating cash flow		1,259	982	1,041	1,014	735	1,241	1,185	1,686	1,558	1,391			
Capital expenditure		(236)	(241)	(286)	(374)	(337)	(378)	(432)	(351)	(305)	(303)			
Free cash flow		1,023	741	755	640	398	863	753	1,335	1,253	1,088			

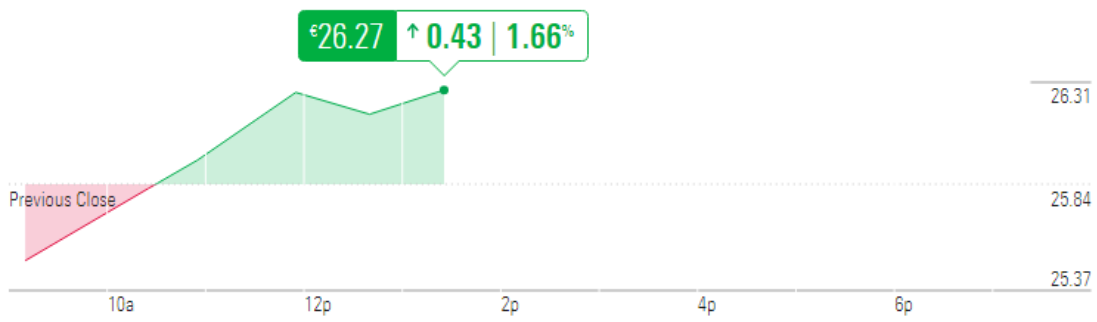
On a 700 million value added per year, from the financial and current business perspective, requiring a 15% I come go a 4.6 billion EUR valuation for this part.

Further, given the potential to borrow more, the available investment capital from cash flows and the target return on equity of 10%, one could assume that the 3 billion they might assume in debt, in combination with 3 billion added by themselves, could lead to another 300 million to 600 million in yearly returns in the future. Also, those trees keep growing whatever happens. This would add another 4 billion to the valuation.

Over the next 10 years, the average return to shareholders could be 1.4 billion per year, in line with current EBIT. That would justify a valuation of between 10 and 14 billion.

A look at the stock price suggests we are at the high end of the valuation.

Show Full Chart >



EUR | Boerse Frankfurt | Prices updated as of Apr 25, 2019, 1:25 PM CET

Quote	Key Ratios	Short Interest	News
Bid/Size 26.25×1,905	Ask/Size 26.47×1,889	Day Range 25.49 – 26.27	Volume / Avg — / —
Year Range 13.25 – 34.64	Forward Div Yield 5.04%	Market Cap 14.0104 Bil	Investment Style Large Value
Price/Sales 1.31	Price/Earnings 12.57	Consensus Forward P/E 14.08	Price/Book 1.41

However, we must keep in mind that this is a cyclical industry and that you might get much better entry opportunities.

UPM-Kymmene Corporation

HEL: UPM

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25 Apr, 15:18 EEST · Disclaimer

1 day 5 days 1 month 6 months YTD 1 year 5 years **Max**

Open	25,80	Div yield	4,36%
High	26,40	Prev close	25,72
Low	25,34	52-wk high	34,70
Mkt cap	14,09B	52-wk low	21,60
P/E ratio	9,42		

All in all, for now, investors can expect a 10% return from UPM over the long term. Something actually very, very good. As for me personally, I still have to look at the other Finnish paper stocks, the Brazilian Klabin, two Portuguese, two North Americans and the Chinese Nine Dragons.

This will give me a good overview of what is going on in the sector and I might pick one or two to cover. By covering a stock over a few years, you really learn about the sector, the business, the management and about how the market breathes in relation to the stock. Consequently, you can buy when the risk is the lowest and the returns the highest like it was the case between 2009 and 2015 with the best time to buy being 2014.

I like the tailwinds of the sector in the form of demand for tissue that gives a long-term margin of safety.