



Smurfit Kappa investors to suffer from WestRock deal

IT IS always a little odd when a share price rises on the back of poor results. In the case of Smurfit Kappa Group (SKG), whose sales fell a significant 12% last year to just over €11bn, this is exactly what happened, with the shares jumping over 10% to just on €39. This is all a little bewildering, especially when you consider the state of play in US merger candidate WestRock, where the numbers are all going south. This deal is the wrong one for SKG and its shareholders, despite the spin from CEO Tony Smurfit.

The explanation for SKG's recent price rise on foot of unimpressive results, Smurfit explained, was because "large global events like the Olympics are generally very good for consumption... At some point we will see the demand picture return to growth. Certainly, the way the year has started off would suggest it will be during 2024."

More importantly, Smurfit went on to advise analysts how "excited" he was about the pending \$20bn tie-in with WestRock.

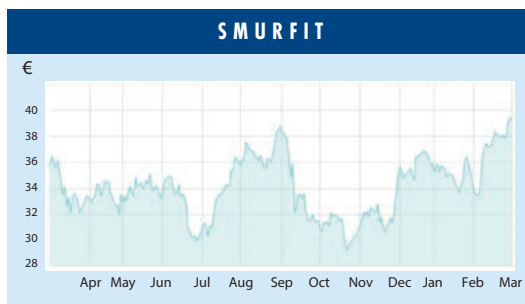
This sentiment was backed up by CFO Ken Bowles, who noted: "It's a really good footprint of assets in really good locations, very similar to what we would see in our own system. We see the opportunity as even greater now as a result of a lot of our visits and more to come."

Moneybags has expressed concern over this proposed deal, notably Smurfit's ability to manage it successfully. This is not just because he is a tax exile living in Monaco, nearly 1,000 miles from SKG's head office in Clonskeagh, D14, but rather because WestRock is a mess and it will be a real challenge to sort it out.

For example, half of WestRock's business is in packaging areas outside Smurfit's core cardboard boxes specialty. Moreover, it is an amalgamation of a number of smaller companies (ironically including the Smurfit-Stone operation Tony's Monaco-based father, Mick Smurfit, had built up in America before flogging it off in the late 1990s)

and doesn't have a good balance within the cardboard box division between the mills and corrugated plants. Another concern is the huge borrowings inside WestRock.

Recently, activist fund PrimeStone Capital – an 0.8% shareholder in SKG – expressed its



unhappiness with the WestRock deal and its terms. It has also gone on record with a letter to the SKG board pointing out what it believes is a much better alternative – "a transformational combination with International Paper (IP) to create an uncontested pure-play global leader in corrugated packaging".

IP is by far the largest cardboard box operator in North America and, on the cardboard side, almost three times the size of WestRock. Significantly, IP boasts virtually all the bigger American multinationals on its books for the very good reason that it has the best operational coverage on the whole of the continent and so can act as a single supplier to the big boys, who prefer not to have packaging discussions with a variety of cardboard box suppliers.

Mark Sutton's IP would fit in neatly with SKG's business model in Europe, where it is the largest



Tony Smurfit

player with a 20% market share (dealing with most of the larger companies), as well as in Central and South America, where the company has significant capacity.

A Smurfit-IP combination would be able to provide a full packaging service to the multinationals on both sides of the Atlantic and in South America.

Putting the two companies together was on the cards just over five years ago, when IP came knocking only to be spurned by Smurfit and his board, although the Irish CEO would have

been the most likely heir apparent at the giant combined entity, where Sutton would have been the initial CEO post-merger but only until his planned retirement this year. Maybe Tony didn't fancy having to hang around trying to prove his worth.

When announcing SKG's 2023 full-year results last month, the presentation was headlined "Consistently Delivering". This is a difficult claim to swallow in a year when group sales actually fell by a significant 12% to €11.3bn. Operating profits were down an even larger 16% to €1.4bn, while adjusted earnings per share fell a chunky 21% to €3.49.

Worst of all, the trend over the year was adverse, with the most recent second half showing sales dropping 15% and operating profit down 24%. These are concerning figures.

What is particularly worrying is that SKG's volume sales of

cardboard boxes was down only 3.5%. This means there was a price squeeze, with average prices dropping 8.5%.

The contrast with 2022 is stark. That year, SKG also suffered a 2% fall in volume but it jacked up its prices by a huge 29%, a level that could not have gone down too well with customers. While some price increase was justified by a near €600m increase in energy costs in 2022, cardboard box buyers would not have been overly pleased to see SKG increase its operating profits by €600m to a record near €1.7bn.

Far from "consistently delivering", SKG's record is notably erratic. As recently as 2020, on the back of sales falling 5%, operating profits collapsed by 38%, despite a big pandemic-linked boost to online shopping and increased demand for cardboard boxes. In 2021, sales recovered by 12% and were back to the 2019 pre-pandemic level and operating profits likewise.

Looking at the WestRock deal, it is notable that, rather than an agreed merger, SKG is the bidder, even though the underperforming US entity is the much bigger company, with sales of \$20bn in the year to September 2023.

Last September, Smurfit offered WestRock shareholders what

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Stocks & Shares

'In play' Kenmare Resources worth \$³/₄bn

ALTHOUGH NOT normally an activist shareholder, rather late in the day JO Hambro (which has a 5% stake in Kenmare Resources) has run out of patience with Mick Carvill, one of the longest-serving CEOs in the world, who has been *in situ* for 38 years. JO Hambro's move comes despite the fact that, in its last full-year report, Kenmare turned in a huge increase in sales to \$526m and a near tenfold jump in pre-tax profits from \$23m to \$222m, recording trading margins of a remarkable 42%. The most recent performance has, however, been rather less enticing.

Most of the uptick in Kenmare's 2022 outturn occurred in the second-half of the year, with pre-tax profits jumping from \$69m in the first half of 2022 to a clearly unsustainable \$153m in the second half.

While sales had held up well in the first half of last year at \$243m, pre-tax profits fell back to \$78m, little more than 50% of the second half of 2022 but, nevertheless, still very impressive in the context of Kenmare's erratic history.

There have been many issues about which JO Hambro could have complained over the years but it is not always a major issue that results in a tipping point. In this case, it looks like it was an own goal by Carvill last year when he said he would aim to distribute \$50m in dividends annually but in a subsequent tender to buy in 5.9% of the company's equity last August at a cost of €25m and a share price of €4.50 (exactly in line with the market at the time), the CEO reiterated that Kenmare's dividend policy was to distribute 20% to 40% of profits.

In December last, Carvill advised that despite this dividend policy, the absolute levels of cash paid out may decline in the coming years, particularly depending on commodity prices.

This damaging clarification appears to have been the straw that broke the camel's back for JO Hambro.

Underlying everything is the fact that, despite Kenmare's relatively high level of profitability over the last two years, its share price performed abysmally, dropping from €5.50 in April 2022 to €3.42 currently, a fall of 38%.

One of the circumstances surrounding Kenmare's small share buyback last August relates to sultan Haitham Bin Tariq and his Oman sovereign wealth fund (Oman Investment Authority), which had already reduced its near controlling 29% stake to 21% in 2021. In August, the sultan's representative on the board, Issa

al Balushi, "absented himself from deliberations relating to the proposed tender offer".

There is no reason why he should have done this for this would be the same as excusing himself from discussions on dividend policy and dividend payouts. It is possible, therefore, that the sultan was intending to fully offer up his shareholding as part of the buyback.

The directors should be acting in the best interests of the company and all of its shareholders at all times. When it comes to setting the actual dividend payout, this should be decided in the interests of all players and, likewise, any share buyback programme should



be determined in the interests of all shareholders.

On a broader note, it is significant that with net cash of \$45m as of the end of June 2023, Kenmare's new CFO, Tom Hickey (ex-Tullow Oil and PetroCeltic), should arrange a \$200m revolving credit facility for Kenmare last month to support "our planned capital programmes in the coming years".

With a healthy net cash position last June and the company generating major cash flows, the only interpretation of this is that Hickey is preparing Kenmare for a downturn in profitability and increased spending. On top of the caution expressed over dividend distributions last December, this would have been another factor taken into account by JO Hambro.

The underlying problem is that Carvill has his head deeply buried in the (heavy) sands of



Michael Carvill

Mozambique and is looking only at digging ever deeper into this sole activity.

If Kenmare has any exciting future, it should be looking for new activities to diversify from its already-developed heavy sands titanium project. Shareholders have got used to Carvill's antics, some of which have been very painful, notably the funding crisis in 2016 that led the desperate CEO to introduce the sultan of Oman as a €100m keystone investor in a \$250m rescue

plan. The existing shareholders were virtually wiped out, with the new investors ending up with 91% of the enlarged equity.

With the Oman Investment Authority clearly looking for an exit, Fidelity selling out its position from 11.14% to 8% since the Janu-

ary 17 trading update, the sultan of Oman down to 17% and JO Hambro calling for Kenmare to be sold, Carvill is in a very tricky position.

In his January trading update, the CEO confirmed that total ore production in 2023 fell 4% to almost 39 million tonnes. This is obviously not good news but worse still is that the heavy metal ore grades fell 5% to 4.38% and the price of the three titanium mineral composites that Kenmare produces all saw their market prices drop last year due to what Carvill describes as "a weakness in the global economy". This is really going to hit second-half profitability when the full-year trading figures are released on March 20.

Of some concern must be the surprising new \$200m loan facility, which is based on Carvill's ongoing desire to maximise pro-

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'What would you like to do in between checking your phone when you're older?'

Stocks & Shares

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was a 25% premium on the then \$35 share price to give WestRock shareholders virtually half of the enlarged equity with a 49.6% stake, topped up by a \$1.25bn cash bonus. (The shares have since risen to \$45.)

There are also the contrasting markets here and across the Atlantic to take into account. The European market has displayed cartel-like characteristics, with DS Smith, Mondi and SKG the only major players. The Italian competition authority went after the cartel on alleged price-fixing charges, based on information provided by DS Smith. SKG ended up being fined €124m, with the Council of State upholding most of the findings.

In the US, there are four major national players, with dozens of regional suppliers and much tougher competitive conditions. WestRock has actually been the biggest consolidator in the sector over the last decade but this has caused quite the mess, with only half of its business in cardboard boxes. Even then, WestRock is a long way from developing the ideal integrated structure of regional balance between container board mills production and the corrugated plant operations.

Tony Smurfit has finally realised he needs a big US platform to balance out

SKG but is wrong to choose WestRock, especially with so many multinationals tied into IP. Moreover, SKG is paying a hefty premium to buy this US company, seriously diluting its own shareholders in the process and, even worse, including a cash payment of \$1.25bn. Smurfit, therefore, is pushing up his own group's debt to over €4bn and will inherit the eye-watering \$8bn debt inside WestRock, leaving the combined entity with a total debt burden of nearly €12bn.

WestRock's results for the 12 months to September 2023, highlight some of the problems. Sales fell 5% to just over \$20bn and the company turned in an operating loss of \$1.5bn. There were, however, exceptional items here, so the underlying operating profit was actually \$1.3bn.

This compares with \$1.7bn the preceding year, so there has been a significant decline here of 24%. With \$8bn of net debt, this leaves WestRock in a relatively vulnerable position.

What is also concerning is that in the first quarter of its current fiscal year to December 2023, sales fell a further 6% to \$4.6bn but operating profits imploded by 25%, dropping from an underlying \$200m in the first quarter of the previous year to \$149m in the latest quarter.

This leaves WestRock on an annualised operating profit run rate of \$600m, which is less than



Mark Sutton

half the underlying run rate for the last full year. This should really worry SKG investors.

While Smurfit strikes such an optimistic note about his own group's current trading, there are warning signs. The German economy, by far the biggest in Europe, is expected to stagnate in 2024, as is the UK, so it is hard to give too much credit to the SKG boss's expectation of increasing demand over the coming year.

The only hope seems to be that when the enlarged group's flotation kicks off in New York (assuming the merger goes smoothly), the shares will attract a much higher rating than they would otherwise. While this might be true for CRH and Flutter,

which are currently enjoying significant positive earnings growth, any bad news on the enlarged Smurfit-WestRock front would be taken very badly. Also, WestRock shareholders may not like the idea of their CEO, David Sewell, handing over the reins to an Irish guy living in tax exile in Monaco.

As Carl McCann has found since he reversed Total Produce into Dole, US investors do not have much patience when it comes to underperformance and can be brutal in response. While Smurfit has finally made the right decision to get SKG into the US, the chosen strategy is the wrong one and his shareholders may live to regret it.

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duction. He plans to spend a hefty \$341m over the next four years on capital expenditure, mainly moving the well concentration plant 10 miles from Namolope to the new Nataka ore zone, with two new dredgers.

The biggest outlay will come this year, when \$179m is expected to be spent, with a further \$121m earmarked for 2025. The move will have an impact on production while the transition is taking place.

BAD NEWS

Kenmare is already the largest ilmenite titanium producing plant in the world, with an 8% market share. Carvill is pushing this up to 10% in 2027 – regardless of whether the market wants the extra production or not.

With production down, grading down and prices down, there is nothing but bad news for shareholders.

“Total cash operating costs are anticipated to increase to \$219m-\$243m in 2024 largely due to cost increases in production overheads

and power,” Carvill confirmed.

This represents a more than 5% increase in operating costs on top of lower production, lower grades and lower prices.

The ‘good news’ is that Carvill has deferred a plan to upgrade the other wet concentration plant that Kenmare is currently operating in a separate area at a cost of around \$200m to further increase production by 42%.

JO Hambro's call for a sale of Kenmare has come two years too late and should have been made in early in 2022 when profitability was going through the roof. The company ended up that year earning pre-tax profits of \$222m and could have been able to command a near \$2bn sell-out price. Today, Kenmare is capitalised at only €318m.

Although profitability has fallen significantly since 2022, Kenmare's Mozambique titanium heavy sands mine could be worth something nearer to the capital cost of the \$1.25bn invested to develop the mine, especially given its phenomenal 100 years resource.

The giant Rio Tinto, which is capitalised at \$100bn, could easily afford to pay \$1bn – three times the current share price – for



Tom Hickey

this resource but, in the current market, something closer to \$750m could be on the cards in a bidding war.

Another obvious candidate is Iluka Resources, which would only be able to do a paper deal. The question for shareholders is whether they would prefer shares in a titanium operator that is three times larger than Kenmare.

Last month, Nick Furlong's

family investment house, Pageant Holdings, was identified as a 3.28% shareholder and it looks like Pageant picked up most of the Fidelity sell-off. Furlong has been good at spotting undervalued companies and has done very well out of the likes of Donegal Investments but also lost out badly in Providence/Barryroe.

Which bet is closer to Kenmare?

A new look for Lifeline



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