

Equities

19 July 2011 | 9 pages

Packaging Corp of America (PKG)

Energy Project Risks Receding, Rewards in Plain Sight; Reiterate Buy

- Company Update
- Target Price Change
- Estimate Change

- **Operational Risks Easing on Strong Execution** – PKG posted a strong 2Q based on higher volume growth (+3.2% Y/Y) and positive price mix, as average containerboard prices rose \$52/ton sequentially. Operational risks associated with the energy projects at Valdosta and Counce are receding as PKG is hitting its milestones on plan. The projects could add \$0.40 to 2012 EPS and give PKG a powerful lever to offset input cost inflation, which is the biggest threat to containerboard producer margins in 2H.
- **2012 Set For Free Cash Flow Step-Up** – Following the completion of the \$295mm energy projects in 4Q, FY 2012 capex will likely return to the ~\$110mm range, allowing PKG to generate 12.5% 2012 pre-dividend free cash flow yield. PKG's balance sheet flexibility, high ROC specialty sales focus, and history of disciplined capital allocation make it our favored name in containerboard.
- **Group Still Needs Cost Relief** – 3Q guidance was softer than expected (\$0.43 vs. \$0.46 cons.) as cost inflation has accelerated. PKG is controlling the controllable, but ultimately the group needs a price increase to offset rising costs. We still see a resolution of the IP-TIN situation as the key to unlocking a price hike; we model a \$60/ton hike implemented in 2Q '12 (see [Containerboard Playbook](#), pub. July 1st).
- **Box Price Erosion Less of a Concern?** – Investors have worried about reports of sporadic box price discounting and OBM's view that corrugated prices slipped 5-9% in 2Q. PKG's own realized price (\$1,098/ton) was stronger than expected, while the company cited data that average industry box prices have risen for three consecutive months. Export margins for virgin producers remain attractive with OCC up 31% Y/Y.
- **TP to \$33; Reiterate Buy** – We are adjusting 2012 EPS estimates to account for the strong 2Q and softer 3Q guidance, while our above-consensus estimates for 2012-13 increase slightly on the energy project potential. TP moves to \$33; reiterate Buy.

Buy/Medium Risk	1M
Price (19 Jul 11)	US\$27.46
Target price	US\$33.00
	from US\$32.00
Expected share price return	20.2%
Expected dividend yield	2.9%
Expected total return	23.1%
Market Cap	US\$2,799M

Price Performance (RIC: PKG.N, BB: PKG US)



EPS	Q1	Q2	Q3	Q4	FY	FC Cons
2010A	0.12A	0.38A	0.60A	0.52A	1.62A	1.62A
2011E	0.39A	0.39A	0.43E	0.49E	1.70E	1.73E
Previous	0.39A	0.35E	0.47E	0.51E	1.72E	na
2012E	0.47E	0.68E	0.68E	0.75E	2.58E	2.40E
Previous	0.47E	0.59E	0.72E	0.77E	2.55E	na
2013E	na	na	na	na	2.78E	2.62E
Previous	na	na	na	na	2.74E	na

Source: Company Reports and dataCentral, CIR. FC Cons: First Call Consensus.

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Fiscal year end 31-Dec	2009	2010	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	29.5	16.9	16.1	10.6	9.9
EV/EBITDA adjusted (x)	9.6	7.3	7.4	5.5	5.1
P/BV (x)	3.1	2.8	2.7	2.3	2.0
Dividend yield (%)	2.2	2.2	2.7	2.9	2.9
Per Share Data (US\$)					
EPS adjusted	0.93	1.62	1.70	2.58	2.78
EPS reported	2.60	2.00	1.68	2.58	2.78
BVPS	8.73	9.92	10.25	11.70	13.46
DPS	0.60	0.60	0.75	0.80	0.80
Profit & Loss (US\$M)					
Net sales	2,148	2,436	2,603	2,826	2,946
Operating expenses	-1,795	-2,250	-2,308	-2,391	-2,509
EBIT	352	185	294	435	438
Net interest expense	-35	-32	-27	-25	10
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	317	153	267	410	447
Tax	-51	52	-96	-146	-161
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	266	205	171	265	286
Adjusted earnings	95	166	174	265	286
Adjusted EBITDA	350	457	463	603	602
Growth Rates (%)					
Sales	-9.0	13.4	6.8	8.6	4.3
EBIT adjusted	45.8	-47.4	58.7	47.8	0.7
EBITDA adjusted	-13.6	30.7	1.2	30.4	-0.3
EPS adjusted	-30.7	74.0	5.2	51.4	7.7
Cash Flow (US\$M)					
Operating cash flow	306	350	329	470	485
Depreciation/amortization	151	156	156	159	152
Net working capital	18	-34	-8	0	0
Investing cash flow	-119	-321	-246	-120	-170
Capital expenditure	-114	-320	-245	-120	-120
Acquisitions/disposals	-5	-1	-2	0	-50
Financing cash flow	-75	-93	-106	-350	-315
Borrowings	-1	-1	30	-242	-222
Dividends paid	-77	-62	-77	-82	-82
Change in cash	111	-64	-24	0	0
Balance Sheet (US\$M)					
Total assets	2,153	2,224	2,345	2,339	2,390
Cash & cash equivalent	261	197	173	173	173
Accounts receivable	243	293	339	379	419
Net fixed assets	1,183	1,338	1,423	1,384	1,352
Total liabilities	1,254	1,215	1,312	1,158	1,024
Accounts payable	127	154	198	238	278
Total Debt	681	681	711	469	247
Shareholders' funds	899	1,009	1,033	1,181	1,366
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	16.3	18.8	17.8	21.3	20.4
ROE adjusted	12.0	17.4	17.0	23.9	22.5
ROIC adjusted	19.0	14.1	11.2	16.3	16.1
Net debt to equity	46.7	48.0	52.0	25.1	5.4
Total debt to capital	43.1	40.3	40.8	28.4	15.3

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Energy Project Risks Receding, Rewards in Plain Sight; Reiterate Buy

2Q Recap – PKG reported adjusted 2Q EPS of \$0.39, above consensus estimates of \$0.34 and previous company guidance of \$0.35. PKG saw better-than-expected volume growth (shipments up 3.2% Y/Y, or \$0.06) and improved price and mix (\$0.09), despite planned downtime at all four of the company's mills. PKG further announced 3Q guidance of \$0.43, below consensus estimates of \$0.46. We expect rising costs and limited price relief to challenge producer margins in 2H, but remain positive on containerboard given the compelling US virgin fiber cost advantage and favorable industry consolidation.

2Q corrugated shipments and containerboard production exceeded our estimates despite the planned outages. Corrugated shipments rose 3.2% Y/Y, while containerboard production was up 2.9%. Inventories fell 18k tons sequentially over 1Q. 2Q topline beat our estimate, rising 8.1% to \$665mm, while higher COGS crimped gross margins to 20.6%, down ~60bp sequentially. The effective tax rate of 35.9% was in-line.

Packaging Corp of America

Company description

PKG is a vertically integrated pure-play containerboard producer. The company has 2.45mm of capacity, giving it a 7% market share in the US. PKG's linerboard and corrugated production comes from four mills. The company has 68 box plants in 26 states, with the majority of those sites in the Midwest, Northeast, and Southwest. PKG is headquartered in Deerfield, IL, and has roughly 8,000 employees.

Investment strategy

We are buyers of PKG (1M) with a target price of \$33. The company's industry-leading integration rate to virgin fiber and sales emphasis on higher-value local accounts should allow it to generate superior ROC over the cycle. PKG further benefits from a lean operational model and highly focused management. In an industry plagued by value-destroying acquisitions, PKG management has been extremely judicious in capital deployment.

Valuation

We use EV/EBITDA as our primary valuation methodology, assigning a 7.5x target multiple to \$528mm estimated NTM EBITDA to derive a target price of \$33. Our target multiple of 7.5x reflects the paper sector is in a mid-cycle earnings phase, with PKG deserving a premium to other containerboard producers because of its specialty business model and excellent history of capital allocation.

Risks

We rate Packaging Corp of America Medium Risk (1M) due to the following factors:

Containerboard Supply/Demand - North American containerboard supply/demand has been well-balanced in 2010-11, which could attract greenfield and converted tonnage to the market. If this tonnage is greater than our forecast, it could result in a weaker pricing environment and lower earnings for PKG and other containerboard producers.

Raw Material Volatility – PKG's containerboard production requires the purchase of raw materials including natural gas, OCC, and chemicals. Prices for these raw materials are volatile, and a rapid escalation of prices may cause PKG to miss its earnings estimates.

Manufacturing Exposure – Containerboard demand is correlated to manufacturing activity, which is volatile. Strengthening US industrial demand may cause PKG's earnings to improve, while declining demand may cause the company to miss earnings estimates.

Threat of Substitution – Containerboard consumers have attempted to reduce the weight and usage of containerboard in applications, while substitutes such as plastic and bleached board have made inroads. If this trend were to accelerate, it might cause PKG's end market demand to decline.

Operational Risk – In order to supply its box plants and meet merchant demand PKG runs its containerboard mills at high operating rates. Mills are subject to outages and disruptions; unplanned downtime at one of PKG's mills could cause it to miss earnings estimates.

Appendix A-1

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Packaging Corp of America (PKG)

Ratings and Target Price History

Fundamental Research

Analyst: Anthony Pettinari

Covered since December 16 2010

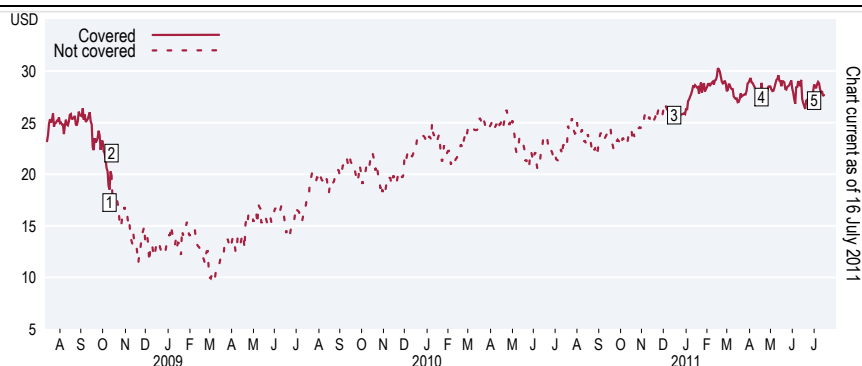


Chart current as of 16 July 2011

	Date	Rating	Target Price	Closing Price
1	10-Oct-08	1M	*29.00	18.52
2	14-Oct-08	Coverage terminated		

* Indicates change

	Date	Rating	Target Price	Closing Price
3	16-Dec-10	1M	*32.00	25.89
4	19-Apr-11	1M	*33.00	28.86

	Date	Rating	Target Price	Closing Price
5	1-Jul-11	1M	*32.00	28.70

Rating/target price changes above reflect Eastern Standard Time

Packaging Corp of America (PKG)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Anthony Pettinari

Covered since December 16 2010



Chart current as of 16 July 2011

* Indicates change

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12 Month Rating			Relative Rating		
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54%	36%	11%	10%	81%	10%
45%	41%	42%	50%	42%	44%

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