

Paper - ALERT: Resurgence in N.A. Uncoated Freesheet Market Continues; Containerboard Supply Additions Keep on Coming

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RISI's *Pulp & Paper Week* reported that N.A. uncoated freesheet industry conditions remain quite healthy, and that the third price increase of 2018 is being paid with no apparent resistance. Industry conditions have gone from lousy last year to exceedingly favorable this year, largely thanks to a 5% reduction in 2018 capacity (along with just a modest YTD demand decline, compared to much more significant declines in years past). In containerboard, RISI noted McKinley Paper's announcement last week that it will add 250,000 tons/yr. of containerboard capacity by September 2019 from converting two machines at its mill in Port Angeles, WA and that McKinley Paper's conversion will be one of eight U.S. containerboard capacity additions totaling 2.4 million tons in 2018 and 2019. In addition, RISI said that there could be two more announced projects and potentially a third unannounced project in 2020-2021, which if these transpire could lead to U.S. containerboard capacity growth of 9.5% over the four-year period from 2018-2021 (~2.4%/yr. capacity growth over that period). RISI added that this increase excludes any converted capacity (to containerboard) from Nine Dragons' ND Paper, and that industry contacts expect such a move. To put this projected capacity growth into perspective, U.S. box demand grew by an average of 1.5% over the past five years, so if the trend of the past five years continues, supply growth would comfortably exceed domestic demand growth. And if demand growth slows over the next five years, which we think quite likely given where how late we are in the economic cycle, supply growth could even more substantially exceed demand growth. More below, including an update on the hurricane impact.

Containerboard: One might be tempted to ask why so much capacity is being added given where we are in the cycle. Containerboard is a commodity business, and when the going is good in commodity businesses (as it is now in containerboard), producers tend to add supply. Presumably, producers expect the good times to continue, even though the box demand upturn over the past two years has coincided with the strongest U.S. economy in many years. The same scenario unfolded in 2013-2015, and, sure enough, prices fell thereafter. This time around, even more supply additions have been announced, and we're that much later in the economic cycle. For that matter, there are signs that U.S. box demand growth is already starting to slow: blended avg. growth over the past four months has been just 1.1%, compared to 1.8% YTD. The large, publicly traded U.S. containerboard producers International Paper (IP), WestRock (WRK), and Packaging Corp. of America (PKG) have seen their shares come under pressure this year (all have underperformed the S&P 500) owing to concerns about future supply growth and to a lesser extent the recent slowdown in demand growth. YTD, IP is down 15%, WRK is down 14%, and PKG is down 8%, compared to the S&P 500 up 11%.

Uncoated freesheet: As stated above, conditions have gone from lousy to exceptionally good in a short period. RISI's VP of graphic papers said that industry operating rates in the low 90's compared to high 80's at this time last year indicate that the recent dramatic increase in U.S. uncoated freesheet prices (the current \$50/ton increase, if fully effective, will have driven prices up \$140/ton over the past nine months) are "more of a function of increased costs in a moderately balanced market, rather than attempts to sharply improve profits in a tight market." He believes industry conditions next year will support one last price increase to a new peak. Domtar (UFS) among our companies is by far the largest beneficiary of this dramatic turnaround in industry fundamentals; IP and PKG also produce uncoated freesheet, but this business is a far smaller percentage of their sales and profits.

Hurricane Florence: RISI noted that Sonoco Products' (SON) flagship Hartsville, SC mill, which went down on September 13, still faces an extended outage, though the Company expects startup of some operations beginning early next week, and that of IP's three mills that went down, one restarted (its Georgetown, SC uncoated freesheet mill on September 21, per RISI's contacts), one was in the process of restarting (its New Bern, NC fluff pulp mill began a restart on September 21 and was expected to be back operating by now), and a third remained down with no restart date as of September 28 (its Riegelwood, NC fluff/BSK pulp mill). We estimate that IP incurred a ~\$30 million-\$35 million pre-tax hit in 3Q related to the hurricane, with potentially continued higher costs in 4Q. For perspective, WRK last week disclosed an approximate \$12 million pre-tax hit in its September quarter (with one of its mills having gone down for about a week, compared to three of IP's mills having gone down) and expects some additional increased costs to carry over into its December quarter.

Disclosure Appendix

Important Disclosures

International Paper Company - IP

We expect to receive or intend to seek compensation for investment banking services from International Paper Company within the next three months.

As of the date of this report, we make a market in International Paper Company.

For the three-year history represented in this chart, the stock has been rated Sector Weight.

Packaging Corporation of America - PKG

We expect to receive or intend to seek compensation for investment banking services from Packaging Corporation of America within the next three months.

As of the date of this report, we make a market in Packaging Corporation of America.

Sonoco Products Company - SON

We expect to receive or intend to seek compensation for investment banking services from Sonoco Products Company within the next three months.

As of the date of this report, we make a market in Sonoco Products Company.

For the three-year history of this chart, the stock has been rated Sector Weight.

Domtar Corporation - UFS

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As of the date of this report, we make a market in Domtar Corporation.

WestRock Company - WRK

We expect to receive or intend to seek compensation for investment banking services from WestRock Company within the next three months.

During the past 12 months, WestRock Company has been a client of the firm or its affiliates for non-securities related services.

As of the date of this report, we make a market in WestRock Company.

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Three-Year Rating and Price Target History

Disclosure Appendix (cont'd)

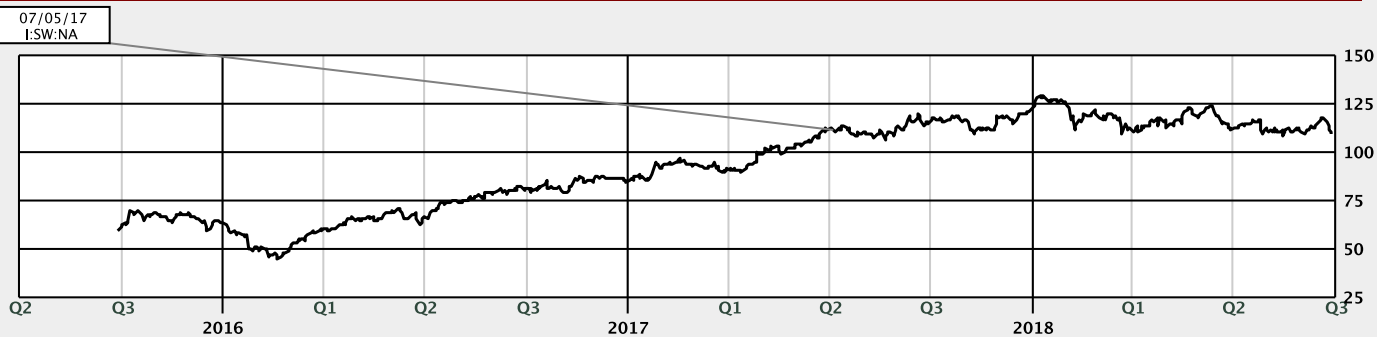
Rating and Price Target History for: International Paper Company (IP) as of 09-28-2018



For the three-year history represented in this chart, the stock has been rated Sector Weight.

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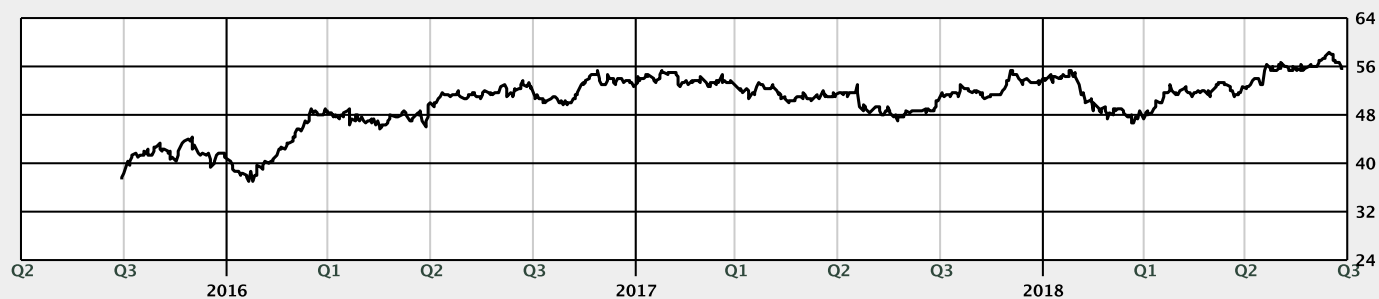
Rating and Price Target History for: Packaging Corporation of America (PKG) as of 09-28-2018



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Disclosure Appendix (cont'd)

Rating and Price Target History for: Sonoco Products Company (SON) as of 09-28-2018



For the three-year history of this chart, the stock has been rated Sector Weight.

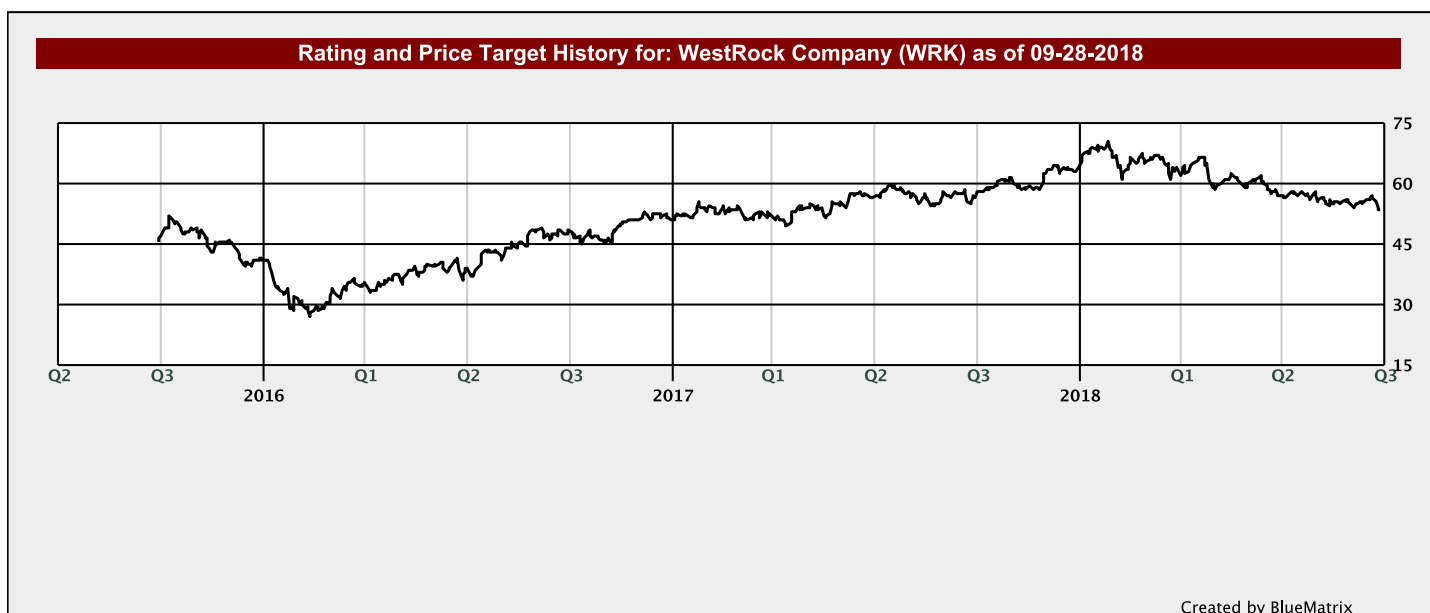
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Rating and Price Target History for: Domtar Corporation (UFS) as of 09-28-2018



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Disclosure Appendix (cont'd)



Rating Disclosures

Distribution of Ratings/IB Services Firmwide and by Sector									
KeyBanc Capital Markets					Industrial				
Rating	Count	Percent	IB Serv/Past 12 Mos.		Rating	Count	Percent	IB Serv/Past 12 Mos.	
			Count	Percent				Count	Percent
Overweight [OW]	258	45.91	61	23.64	Overweight [OW]	71	42.26	15	21.13
Sector Weight [SW]	294	52.31	47	15.99	Sector Weight [SW]	95	56.55	8	8.42
Underweight [UW]	10	1.78	4	40.00	Underweight [UW]	2	1.19	1	50.00

Rating System

Overweight - We expect the stock to outperform the analyst's coverage sector over the coming 6-12 months.

Sector Weight - We expect the stock to perform in line with the analyst's coverage sector over the coming 6-12 months.

Underweight - We expect the stock to underperform the analyst's coverage sector over the coming 6-12 months.

Disclosure Appendix (cont'd)

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Please refer to the analysts' recently published reports for company-specific valuation and risks.

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