Rayonier Advanced Materials (RYAM) – Will an Unnatural Shareholder Base Create an Opportunity?

Date: July 3, 2014

Note: this write-up was sent out to my network on 26-Jun when RYAM was trading at $36 / share. It has since risen to $42. If you are an accredited investor / buysider and want to get on my VIP research list, email me at analyst @ this domain.

Rayonier (RYN) is known to most investors as a timber REIT. But to industrial and manufacturing companies, Rayonier is the leading supplier of specialty cellulose, a product used in a wide variety of end market applications (cigarette filters, cosmetics, pharmaceuticals, LCD display screens, and more). On 27-Jun, investors were introduced to this second business as Rayonier (RYN) completed its spin-off of Rayonier Advanced Materials (RYAM; here).

What makes this spin particularly interesting is that RYN is a REIT. The investor base interested in owning RYN is likely to be very different than the investor base interested in owning RYAM. So it's possible we experience a situation where yield-hungry investors indiscriminately dump RYAM over the coming weeks. And **indiscriminate selling creates opportunity**.

What's also interesting is that the CEO of RYN is now the CEO of RYAM. Now let's think about this… Why would the most knowledgeable person in the Company choose to go with the Advanced Materials business? My guess in one word: **opportunity**.

High-level, here's how the Advanced Materials business works:

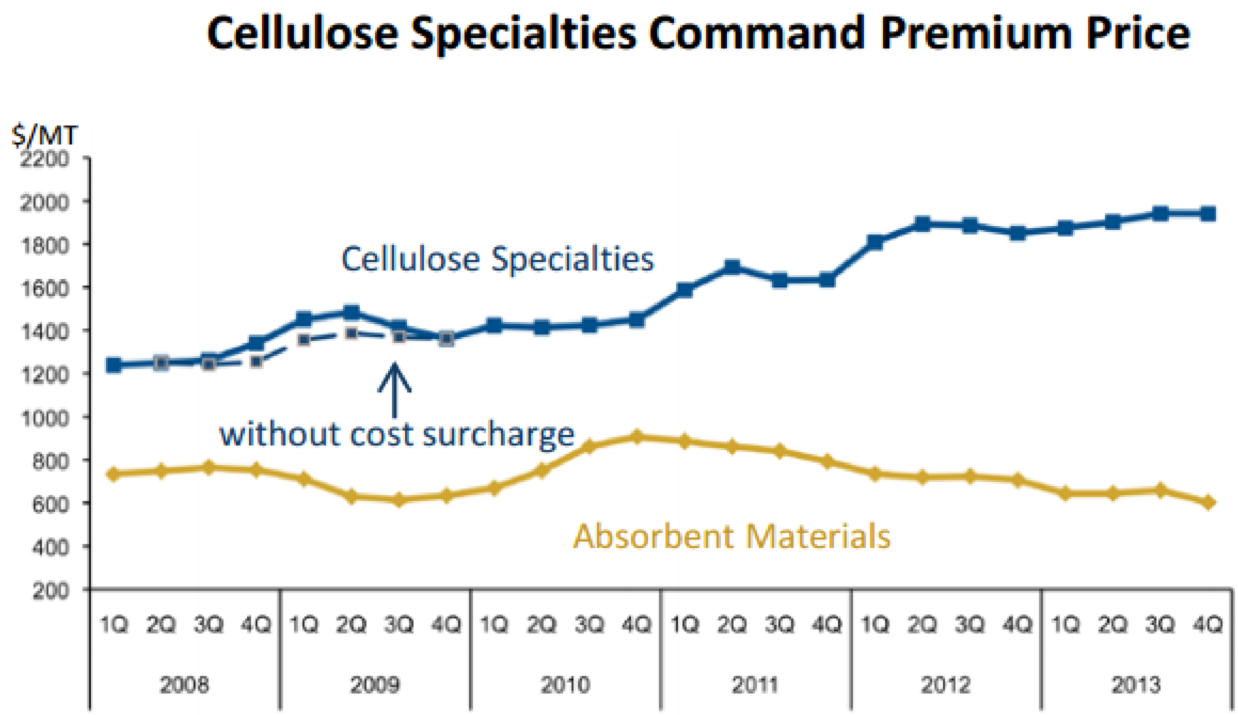
RYAM buys wood chips (hardwood or softwood) and through a sophisticated process of pulping, cooking, bleaching and finishing, produces a very unwood-like product known as dissolving pulp (you can think of it as a natural plastic). Here's an image pre- and post-processing:

This dissolving pulp is then marketed to customers as commodity cellulose and specialty cellulose, depending on the grade / characteristics. RYAM is the worldwide leader in the specialty cellulose business, with greater than 2x sales volume versus its competition. It ranks #1 in acetate (end product: cigarette filters, textiles, LCD film), is top 4 in ethers (end product: pharma, food products), and #1/#2 in high-strength viscose/specialty (end product: tire cords, casings, explosives).

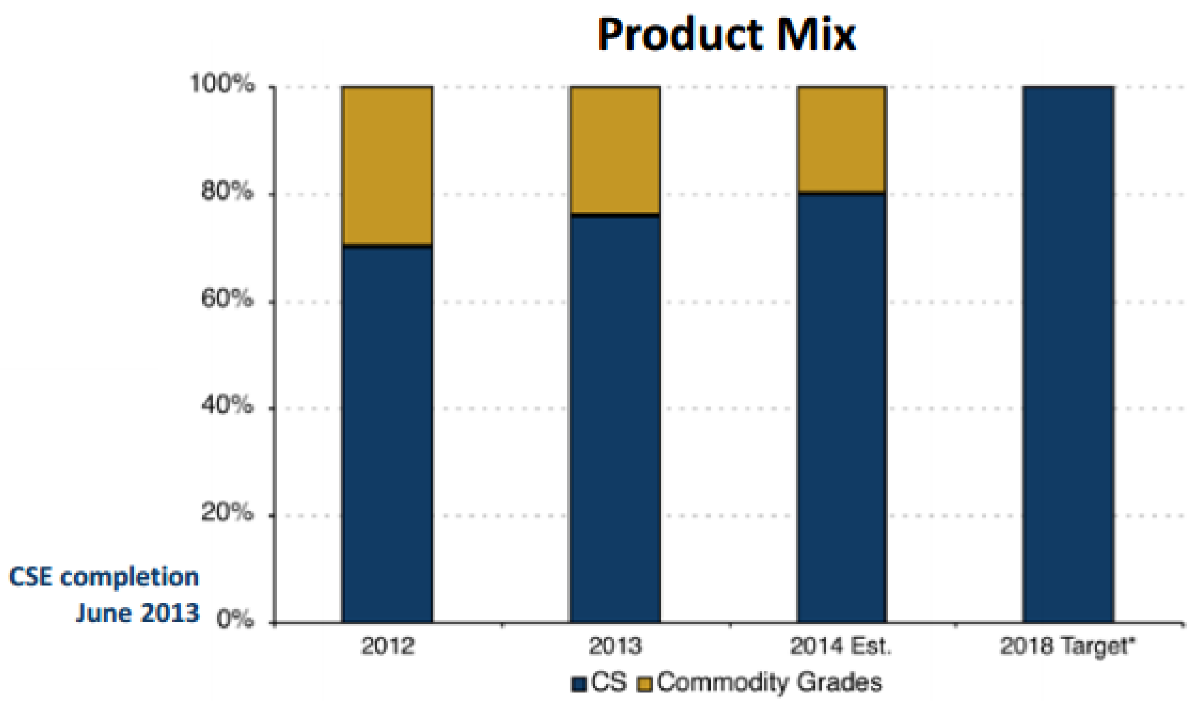
There are a few key points to understand about this business:

- Commodity cellulose is a commodity; many companies have the ability to produce it.
- Specialty cellulose (characterized by a purity of 95% alpha-cellulose or greater) requires an immense amount of technical expertise to produce; most of the world's specialty cellulose is manufactured by just a handful of companies.
- Because of the high capital costs and proprietary production processes, there are steep barriers to entry in the specialty cellulose business. To give you an idea, there has only been one new entrant in the past 25 years: Sateri in Brazil.
- Customers need a reliable supply of consistent, pure product; this means that history, experience and relationships matter greatly.
- Many customers require very exact specifications (e.g., unique optical, thickening and strengthening properties); this creates lock-in as switching costs are tremendous.

Each point above serves to support a key claim: **that specialty cellulose is the highest end of the value chain.** The market price differential versus commodity cellulose confirms it:



RYAM is focused almost exclusively on the specialty cellulose business ("almost" because they just spent $385MM to convert their remaining commodity capacity to specialty and are transitioning production as customer and market growth allows – they expect to be 100% specialty by 2018).



So let's rehash what we know:

- RYN just spun off RYAM. Selling pressure from an unnatural shareholder base may create a special situation.
- RYN's CEO has chosen to lead RYAM.
- RYAM is the leader in specialty cellulose, a business that has a solid moat built from over 85 years of experience, decades-long customer relationships, and a distribution network through 79 ports in nearly 40 countries.

Seems like this could be a pretty interesting investment opportunity, no? We'll have to see – investment returns are primarily determined by the price you pay. So while we wait for the market reaction to the spin, we can do two things: (1) understand the current valuation from the "when issued" / proxy RYAM stock, and (2) get a better grip on the economics of the business.

The market is currently valuing RYAM's business at $2.5BN.

Stock Price	$36.00
Diluted Shares	42,155,202
Diluted Market Cap	$1,517,587,260
- Cash	$0
+ Total Debt	$950,000,000
EV	$2,467,587,260

So what do you get for $2.5BN?

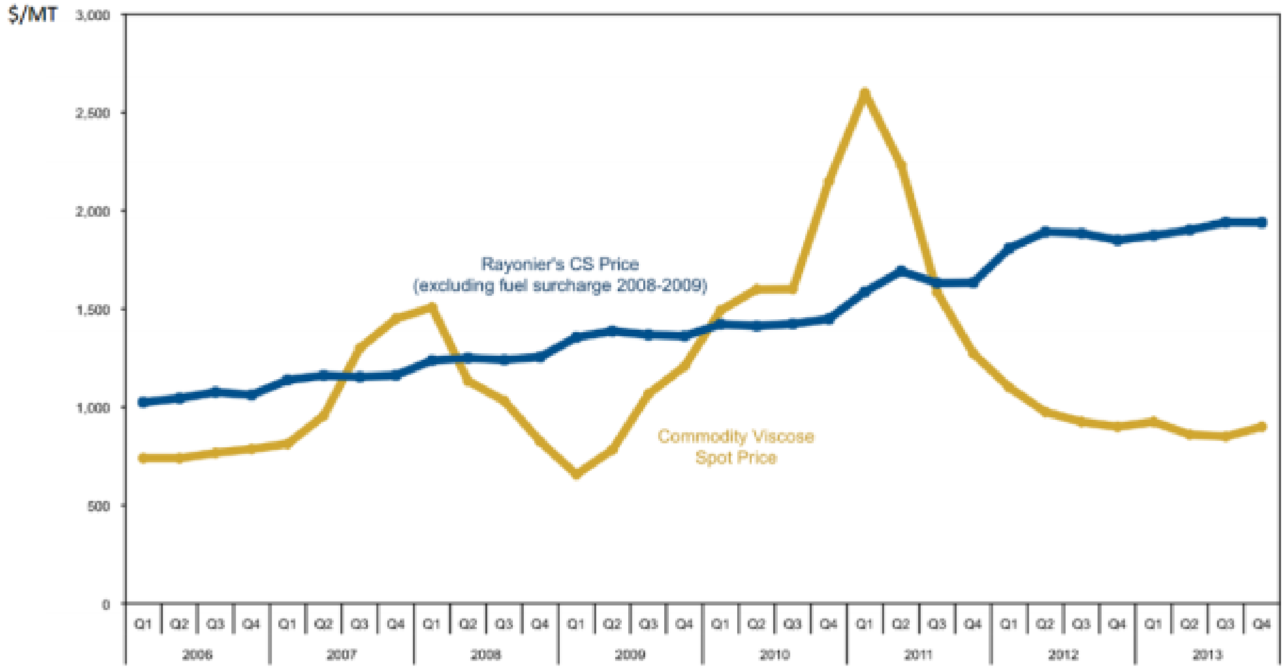
You get two manufacturing facilities in the Southeast: one in Jesup, GA (520k ton capacity) and one in Fernandina Beach, FL (155K ton capacity). You get process know-how developed over the past 85 years (note: similar to SpaceX, RYAM strategically chooses not to file patents). You get entrenched customer relationships. And you get access to a high-margin business that has generated $360MM in annual EBITDA and $160MM in annual free cash flow over each of the past 3 years.

With that, let me explain the drivers of this business and why I believe 2014 is going to be a disappointment for RYAM.

- Revenues are driven by production volume (determined by capacity and plant downtime) and the market price of specialty cellulose.
- Costs are driven by input costs (including the cost of wood chips, chemicals, natural gas, etc) and plant costs.

To estimate 2014 revenues, multiply volume by price. What are this year's volumes going to be? Well, management has guided to 516,000 tons of specialty cellulose. But the current run-rate is just above 2013 levels as equipment issues in 1Q14 impacted production. And while those issues are now largely resolved, it's going to take a significant amount of work to reach their guidance. So I think **RYAM will miss on production volumes in 2014** and end the year at 500k tons of specialty and 125k tons of commodity cellulose.

The market price for specialty cellulose has been remarkably strong over the years (see blue line below) – it was up even in the ‘08/’09 crisis. But with RYAM’s expansion (an additional 190k tons of capacity added) combined with capacity additions at Buckeye (42k tons) and Sateri (unknown), it’s possible we see pressure on the market price of the product over the next 12 – 24 months as the market slowly absorbs the excess capacity (the market is growing at 3%, requiring 45k – 50k tons of additional supply per year).



Gun to my head, Id' guess specialty cellulose will average $1,800 and commodity will average $1,000. Multiplying volume by price gets you to $1.025BN in revenues, a decrease of $17MM (2%) from 2013.

On the cost side, I have no opinion on where natural gas will trade, nor do I want to take a guess on the price of wood chips. One thing I do know is that this is primarily a fixed cost business. Assuming management knows what they’re doing, operating costs should be relatively easy to forecast each year (they should grow with inflation over the long term). Management has said that they expect EBITDA to come in 15% below 2013. If you do the math, which is [($386MM in 2013 EBITDA x 85%) – ($25MM in new corporate overhead) – ($17MM in lower revenues x 30% EBITDA margin)], you get to $298MM in EBITDA for 2014.

This is significantly less than the $328MM management is showing in their presentation (page 30 here).

For these reasons, I believe that investors expecting 2014 to be on par with management’s guidance are going to be disappointed.

But where others see disappointment, I see opportunity. To understand why, you have to look through the next 12 – 24 months. You see, RYAM has already executed their large capital program. They already spent $385MM to transition their remaining commodity cellulose capacity to specialty; those costs are sunk. And when the market soaks up the existing excess capacity, RYAM shareholders will be the biggest beneficiaries of future specialty cellulose inflation. RYAM's position reminds me of a quote from Warren Buffett:

> In an inflationary world, a toll bridge would be a great thing to own because you've laid out the capital costs. You built it in old dollars, and you don't have to keep replacing it.

One important thing to note on the capacity expansion: RYAM didn't execute this expansion mindlessly. They knew the additional capacity would create a transitional period of downward pricing pressure on specialty cellulose. But they did it anyway. Why? **Because customers asked RYAM to grow with them.** This is perhaps the most important piece of info in this note, so I'm going to repeat it:

RYAM spent nearly $400MM to expand their capacity because customers asked them to.

And this is really all you need to know about the strength of their end markets and the strength of their business.

When you look through this transitional period, you have a Company capable of producing 608k tons of specialty cellulose (675k tons of capacity x 90% uptime) at mid-30% EBITDA margins. I think you can pretty easily get to $425MM in annual EBITDA. Put an 8x multiple on that and the equity is worth close to $60 / share.

Will an unnatural shareholder base create a "no-brainer" type of opportunity in RYAM? We're about to find out.