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Asian Corporate Finance and Business Strategy

Asia Pulp and Paper Company, Ltd.

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1. Introduction

In April 1999, a Singaporean company named Asia Pulp & Paper (APP) raised more than U.S.\$400 million on the New York Stock Exchange through an issue of American Depositary Receipts (ADRs). This was APP's third such offering in the United States. The company had originally listed on the NYSE through an initial public offering in April 1995, when it raised U.S.\$311 million at U.S.\$11.50/ADR. This IPO was followed in late 1997 by a secondary ADR offering, which raised U.S.\$228 million. Together these three equity issues raised almost U.S.\$1 billion for APP. This was quite an achievement for a company that had been only incorporated in Singapore in 1994.

APP was the darling of emerging-market equity investors. It represented a new breed of Asian entrepreneur. This company would not be confined to a home country or geographic region. It sought to compete globally in the brutally competitive pulp and paper commodity markets. The company also had the competitive advantage of being one of the world's lowest-cost producers of pulp through long-term concession rights to more than 540 thousand hectares of tropical hardwood forests (Lee 2001).

In 1994, the company embarked on a strategy to invest heavily in new paper/packaging production technologies, both to gain manufacturing economies of scale and to capitalize on its advantage of low-cost pulp production. Such expansion of plant and equipment in a capital-intensive industry would require billions of dollars. The company shrewdly cultivated the international capital markets and became a frequent issuer of Yankee bonds, syndicated loans and, as described above, equity. The company was solicited aggressively by international banks and investment banks, which soon realized that APP was the most frequent issuer in the emerging markets. In short, in Southeast Asia, APP was the top prospect on most banks' target client list.

The following is an excerpt from one of Asia Pulp & Paper's filings with the United States Securities and Exchange Commission:

2. Who We Are

We are one of Asia's largest pulp and paper producers outside of Japan, and one of the lowest-cost producers of pulp and paper in the world. Most of our production facilities are in Indonesia, and we also have facilities in China and India.

In recent years, we have had leading market shares in the Indonesian printing and writing paper market, as well as other paper markets in Singapore, Hong Kong, and Malaysia. As a result of our capacity expansion, as well as the economic difficulties in Indonesia beginning in late 1997, we shifted our primary focus to markets outside of Indonesia, particularly other markets in Asia, such as China and Japan, and key developed markets in Europe and North America. We now sell our products in over 60 countries worldwide. As a result, our sales outside of Indonesia increased to approximately 87% of our consolidated net sales in 1998 from approximately 65% in 1997.

From 1994 to the present, our annual production capacity for:

- Paper and packaging products, excluding converting capacity, increased from approximately 1.4 million tonnes¹ to approximately 4.4 million tonnes; and

¹ A tonne is a metric ton.

- Pulp increased from approximately 1.2 million tonnes to approximately 2.2 million tonnes.

Because of our expansion program, our sales have grown significantly. From 1994 through 1998, our net sales increased at a compound annual rate of 20.6%, from U.S.\$1,129.7 million in 1994 to U.S.\$2,385.9 million in 1998, and our net income grew at a compound annual rate of 76.3%, from U.S.\$14.8 million in 1994 to U.S.\$142.9 million in 1998.

We are now in the final phases of our expansion program. We expect to complete our ongoing projects in China this year, which should increase our annual paper production capacity in China by approximately 1.27 million tonnes to a total of 1.33 million tonnes by the end of 1999. This should make us the largest paper producer in China.

We consider production of printing and writing paper to be our core businesses. We intend to continue to focus on and strengthen our core businesses and to leverage other noncore assets, particularly packaging, tissue, and power generating assets, through joint ventures or strategic investments with strong global partners. In addition, we may also consider establishing a global strategic alliance through a strategic minority investment in our shares by a major industry investor.” (US SEC 1999).

3. Background

APP was incorporated in Singapore in 1994, but its roots were in Indonesia. The company was created to hold the pulp, paper and packaging operations of the Sinar Mas Group, an Indonesian business conglomerate that was controlled by the Widjaya family.

The Widjayas were well known in Indonesia and had a reputation as hard-nosed businessmen. Unlike some Indonesian business groups that relied on cronylike contacts with Indonesia’s then head of state, Suharto, to facilitate business dealings, the Widjayas maintained a low profile and concentrated on skillfully expanding their businesses. Those business interests included pulp and paper, palm oil plantations, real estate development and financial services, the last through Bank Internasional Indonesia (BII).

The pulp, papers and packaging assets of the Sinar Mas Group consisted of four Indonesian companies, two of which, Tjiwi Kimia and Indah Kiat, were publicly listed on the Surabaya Stock Exchange. (The other two companies were Pindo Deli and Lontar Papyrus.) These assets were consolidated into APP, the holding company in Singapore, prior to APP’s listing on the NYSE in April 1995.

4. The Widjaya Family

The patriarch of the Widjaya family, Eka Tjipta Widjaya, had emigrated from China to Indonesia as a child. From a modest start as a small merchant, Eka Tjipta Widjaya developed into Indonesia’s largest producer of pulp and paper. Many of his sons also participated in the business, including Teguh Widjaya, APP president and chief executive officer, and Oesman Widjaya and Muktar Widjaya, executive directors. The Widjaya family were controlling shareholders of APP. They controlled 66.85 percent of the voting power (Anthony and Antos 2001).

The issue of family control was fully disclosed, pursuant to APP’s listing in Singapore and New York. The registration statement filed with the SEC outlined several risks pertinent to control of APP by the Widjayas:

- The controlling shareholders continue to have the power to control APP and all its subsidiaries, including the power to (1) elect a majority of APP's directors and (2) determine the outcome of any action requiring shareholder approval.
- The controlling shareholders have other business interests, and it is possible that they may direct business opportunities to companies outside the APP group.
- The controlling shareholders have pledged a majority of the shares that they own as security, in part for APP's debt and in part for their own debt (U.S. SEC 1999).

5. Asia Pulp & Paper's Strategy

In many ways, the strategic expansion initiative behind the creation of APP was well conceived by the Widjayas. APP was already the leading Indonesian pulp and paper producer, with a 64 percent market share for printing and writing paper (Gluckstein 1997). Incremental sales in Indonesia were unlikely to grow rapidly. APP was a low-cost producer; it produced pulp from a captive source of timber derived from extensive forest concessions controlled by Sinar Mas-affiliated companies. The family's ethnic background naturally generated interest in China, and the Widjayas perceived the rapid growth of the Chinese economy as offering attractive potential for investment in papermaking. Lastly, capital was available. Foreign banks had dealt with the Sinar Mas Group over the years and saw an opportunity for incremental financing. Moreover, American banks were keen to bring one of Indonesia's most successful companies to the U.S. capital markets, whether in the form of syndicated loans, Yankee bonds or ADRs listed on the Big Board. A Singaporean holding company would be a logical platform to launch an international expansion. Singapore had a reputation for fiscal probity and a well-regulated capital market. Moreover, it was a city with historical ties to and good relations with China.

6. Indonesian Financial Crisis

In the summer of 1997, the East Asian economic miracle, which had produced unprecedented growth throughout the Pacific Rim, began to unravel.

The problem started in Thailand, where an overheated property market, weak banking system, deteriorating stock market and chronic government fiscal deficit combined to put pressure on the Thai baht. But the baht was largely pegged to the U.S. dollar through a currency basket. Given robust growth in the United States, the dollar was strengthening, which only exacerbated the devaluation pressure on the baht. In July, the currency basket was suspended, and the baht plummeted in value, ultimately depreciating by more than 50 percent by the end of 1997.

The Thai situation sparked a contagion that spread rapidly throughout the Asian emerging markets. Indonesia was next to feel the impact, followed soon after by Malaysia and Korea. Ultimately, the governments of Thailand, Indonesia and Korea had to turn to the International Monetary Fund to borrow billions of dollars to stave off a sovereign default.

In Indonesia, even though the rupiah had been freely floating for many years, the currency went into free fall, depreciating almost 85 percent by the end of the year. Similarly, the Jakarta Stock Exchange fell by 60 percent and the spread over U.S. Treasury rates for the Republic of Indonesia's widely held Eurobonds soared to 1,800 basis points.

The financial crisis quickly engulfed local Indonesian banks, which not only were hurt by having cross-border dollar liabilities but also were confronted by burgeoning nonperforming

property and commercial loans. As the banks became illiquid, the government had no choice except to take over the defaulting banks. Among these troubled banks was Bank Internasional Indonesia, which was found to be insolvent and was nationalized by the Indonesian Bank Restructuring Agency.

7. Postcrisis

Though the family bank was gone, APP was largely unaffected. The company kept its books in U.S. dollars and sold its pulp and paper production on the basis of global commodity prices, which were also in U.S. dollars. In fact, with the devaluation of the rupiah, the cost of pulp translated into approximately U.S.\$100–132 per ton. Given that pulp prices were at historical highs in 1995–96, at one point almost U.S.\$1,000 ton, APP enjoyed a tremendous competitive advantage. It was perhaps the world's lowest-cost producer of pulp and paper (Dillon and Waite 1998). In 1997, approximately two-thirds of APP's cash costs were in devalued rupiah, while almost two-thirds of sales were exports denominated in U.S. dollars or Japanese yen. The Widjaya family considered this further validation of its strategy to go international.

8. China Strategy

The China strategy was aggressive and called for more than U.S.\$4 billion of capital investment (Dolven and Webb 2002). Not only were there to be several plants in China but also the papermaking capability was to be top quality. The APP China plants would be state-of-the-art facilities with sophisticated equipment capable of manufacturing such high-end products as coated writing paper and carbonless copying paper. Such machines cost in excess of U.S.\$135 million apiece (Dolven and Webb 2002). Because China relied on imports for more than half of its high-end paper, the APP investment would facilitate import substitution and ultimately lead to export sales as well.

Given the 18- to 24-month lead time needed to complete a pulp or paper mill expansion, APP anticipated commercial production from its first China plant (Ningbo) by early 1998. China's growth in paper and packaging consumption had been strong, and many industry observers forecast continued strong demand as literacy levels, office automation, industrialization and use of home computers increased. This bullishness carried over to forecasts of paper consumption in Asia overall. In a research report published in October 1997, the firm Arnhold Bleichroeder cited an eminent research institution that predicted 5.5 percent annual growth in Asian per capita paper consumption (Gluckstein 1997).

Aside from the significant financial commitment to this strategy, the expansion of papermaking capacity in China outstripped APP's overall pulp capacity (400,000–600,000 tons). Moreover certain high-quality papers required long-fiber pulp for strength. APP's pulp came from short-fiber tropical hardwood trees. This meant that the APP Chinese plants would need to import much of their pulp, particularly from Northern Hemisphere suppliers, forgoing a cost advantage the firm had historically enjoyed in its Indonesian operations thanks to its low-cost local sources of pulp. (Rubin 2000).

9. 1998 Annual Report

In its 1998 Annual Report (APP 1999, 12–13), APP commented on its capacity expansion as follows:

We have now completed our expansion of Indonesian paper capacity at Tjiwi Kimia, Lontar, Pindo Deli and Indah Kiat. In 1998, our capacity expansion program in China made substantial progress and almost all of the 1.2 million tonnes per annum of paper and 120,000 tonnes per annum of tissue capacity have been installed.

The company further commented on its marketing initiatives as follows:

As a result of the slowing demand for our products in Indonesia . . . and a continuation of our plans to enlarge our market-place, we opened 14 offices in Asia, four in the Middle East, two in Africa and one each in Europe and South America. . . . We have increased our global distribution capabilities significantly and now sell our products in over 60 countries worldwide.

We continued to focus on strengthening our position in the global markets so that when the Asian markets return to normal, we will emerge stronger than ever.

Financially, the company reported a 19 percent increase in sales to U.S.\$2.4 billion but a 33 percent decline in net income from the previous year to U.S.\$143 million. Moreover, long-term debt increased 35 percent to U.S.\$8.5 billion, while interest expense increased 63.2 percent to U.S.\$392 million. This increase in leverage prompted the president to comment in his remarks as follows:

We are committed to deleveraging our balance sheet. Our Board of Directors has adopted a resolution establishing our objective to achieve a debt to equity ratio of 1:1 and to improve the overall capital structure by 2002.” The debt/equity ratio in 1998 was 4.6x (APP 1999, 12–13).

10. Market Views

Despite the concern with leverage, equity analysts remained upbeat about APP’s long-term prospects.

In a July 1998 research report on APP, Salomon Smith Barney rated APP as a “buy” with a 12–18 month price target of U.S.\$23/ADR. The company felt that Indonesia’s economic problems were a positive for APP and that pulp pricing trends, which were negative, would be volatile in the short term but recover due to the cyclical nature of global commodity prices (Dillon and Waite 1998).

Roughly one year later (June 1999), Morgan Stanley Dean Witter issued an “outperform” rating and reported that APP was “well-positioned for Asia’s recovery” (Spencer et al. 1999).

This recommendation was reiterated in a research report in November 1999 with another “outperform” recommendation by Morgan Stanley Dean Witter titled “Asia Pulp & Paper: Here Comes the Cash Flow!” Notwithstanding the optimistic assessment, the report commented that APP shares had been held back by increasing investor concern about the company’s ability to repay or refinance its U.S.\$1.4 billion debt amortization that would come due in 2000. Acknowledging that debt investors clearly remain skeptical—most of APP’s debt today yields 20 percent—the report took the view that the company would be able to generate enough cash flow in the following year to cover all its financial obligations (Choi, Spencer and Tanoko 1999).

11. Exchange Offer

APP was well aware of its looming amortization payments. The company initially offered to exchange its approximately U.S.\$800 million outstanding zero-coupon and 3.5 percent convertible bonds for new convertible bonds offering higher interest rates with longer maturity. This was subsequently rescinded because the cost to APP was deemed by management to be too expensive.

By August 1999, the company announced another exchange offer. This time the offer was considerably sweetened. In exchange for a combination of cash, new longer-term high-yield bonds and equity warrants, APP sought to restructure the U.S.\$1.4 billion in debt that was coming due in 2000. With the help of its bankers, the company lobbied bond investors to subscribe to the exchange offer. The process was time consuming, because investors were located all over the world. In addition, the SEC in the United States had many questions about the exchange offer and delayed its approval. However, many investors expressed a willingness to consider the exchange, subject to reviewing APP's 1999 financials.

12. APP's 1999 Financial Performance

APP's audited financial statements for 1999 were released in Singapore in May 2000. Although the company's sales had increased to U.S.\$3.1 billion, operating margins had deteriorated, and the company had incurred a net loss of U.S.\$23 million. Pulp and paper commodity prices (which had turned down in 1997) fell again and by late 2000 had declined almost 40 percent. In an effort to sell the additional inventory the company was producing, sales prices were discounted, especially where APP was trying to break into new markets. Because working-capital financing from Indonesian banks was unavailable and foreign banks were cautious, APP struggled to find short-term working capital. To induce buyers to pay cash, the company offered substantial discounts. Inventory levels were reduced to free up cash by running the plants at less than capacity. In short, the company was in a liquidity squeeze.

Moreover, leverage continued to rise. The company now had a 5.0x debt/equity ratio. There were 22 different outstanding bond issues with a variety of currencies, structures and obligors for a total of U.S.\$8.7 billion in debt. And looming ahead was not only the U.S.\$1.4 billion due later in the year and more than U.S.\$500 million in interest expense but an additional U.S.\$1.4 billion and U.S.\$1.0 billion due in 2001 and 2002, respectively.

Yet the company managed to launch another U.S.\$400 million bond for APP China in 2000.

13. Moratorium

Without SEC approval, which was still delayed, the exchange offer could not proceed. The refinancing was in limbo. The planned debt restructuring was necessary to avoid a default, and investors grew increasingly concerned. APP's bonds, already trading as "junk bonds," fell to distressed levels of less than 30 cents on the dollar. Market sentiment was decidedly negative. By February, the ADRs listed on the NYSE fell from an August price of U.S.\$5.02 per share to less than 17 cents.

On March 13, 2001, APP declared a moratorium on U.S.\$13.9 billion in debt. Shortly thereafter, the company disclosed that it had lost some U.S.\$220 million from two derivatives contracts that had never appeared in the financial statements and that the financial statements for 1997-99 would

have to be restated. Rumors about other audit issues arose when the company's auditor, Arthur Andersen, resigned. Audited financials for FY2000 would not be forthcoming.

The bonds promptly traded down between 5 and 7 cents on the dollar. The ADRs were delisted from the NYSE. Shareholders in New York promptly filed suit against APP's management, Arthur Andersen and Merrill Lynch, while investors in Singapore clamored for the Commercial Affairs Department, the police department that investigates white-collar crime, to get involved.

14. Epilogue

For several years, Asia Pulp & Paper was an emerging-market success story. It was the largest vertically integrated pulp and paper manufacturer in Asia outside Japan, employing more than 40,000 people producing pulp, paper and packaging in 14 plants located Indonesia, China and India. Its ambitions were bold, and its financial capacity to tap the global capital markets led to its position as the world's largest nongovernment issuer of high-yield Yankee bonds. Moreover, for a time it was the lowest-cost producer of pulp in the world.

But somewhere along the way, things went awry. With a staggering U.S.\$14 billion in debt, APP is now the largest defaulting obligor in the emerging markets.

As for a restructuring, it looks to be an untidy affair. At a creditors meeting held in Jakarta in February 2002, the Widjayas proposed a rescheduling that would stretch out the debt over 13 years. But there was no mention of a cash injection by the family, no proposal to deleverage through a debt/equity conversion or asset sales and no consideration of changes in management. Not unsurprisingly, the terms were rejected by creditors (Dolven and Webb 2002).

Several of the bankers involved have now seen their careers and reputations sullied. Bondholders and equity investors are likely to lose billions of dollars as well. Moreover, APP is the largest debt restructuring in the emerging markets, and its outcome will affect the ability of other emerging-market companies to raise capital in the international markets.

Many observers are asking the question, "Why did things turned out this way?" Was the company's strategy fundamentally flawed, or was it really a question of unfortunate timing, that is, a cyclical downturn in the commodity market coming on the heels of major capacity expansion? Or are there more fundamental issues at work?

Could the bankers who sought business from APP have handled things differently? Should the investors in the bonds or the equity of APP have acted differently? What about the management of APP? Or the auditors and lawyers? And what about the regulators who were assigned the task of overseeing disclosure and governance matters for a company that had headquarters in Singapore and operations in Indonesia and China and traded on the NYSE—could they have acted otherwise? How would you have handled the situation differently? And what do you do now?

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