Tullis Russell and Inveresk: a contrast in ownership strategies and in results.

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Abstract.

Between 1990 and 2009 two Scottish papermaking companies, competing with an overlapping product range, chose two very different ownership strategies. The first, Tullis Russell, chose all-employee ownership and ended up out-performing the whole UK industry; the other, Inveresk, followed the more traditional route of MBO with subsequent listing, and in the end was forced to close, one by one, four of its five mills, leaving only a tiny one going. This paper sets out evidence that the different ownership strategies had a material effect on those different outcomes.

The Paper Industry.

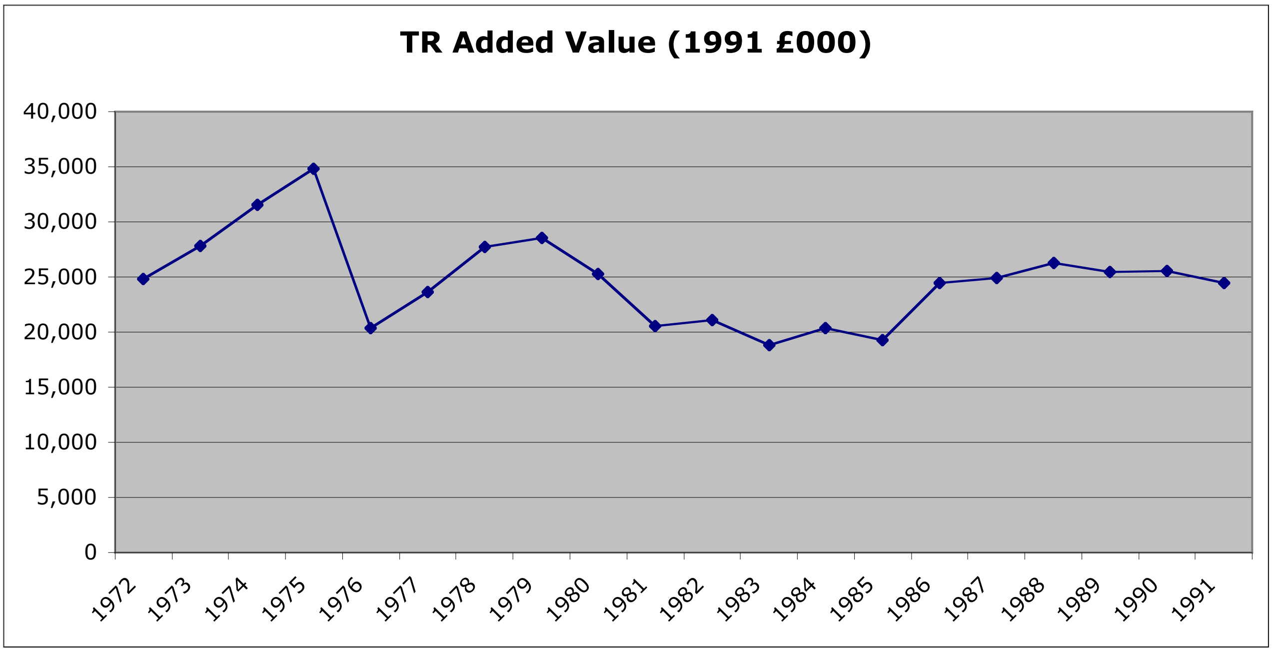
In his book *Competitive Strategy* Michael Porter argues that it is impossible over the medium and long term to make high returns on capital in the paper industry[1]. The major drivers include: huge investment scale (a new paper machine at a competitive scale in a competitive geographical position may involve a total investment of $1bn or more) which means that capacity is increased in large steps; significant economies of scale in a continuous process, giving a strong incentive to acquire the latest plant; many competitors, which encourages a tendency to overbuild capacity; very specialised assets, providing a high barrier to exit; heavy fixed costs, so that downtime is a disaster – every mill competes viciously on price for the last tonne of demand; very little ability to differentiate the products - one copier paper is very like another; powerful upstream suppliers. In addition, the paper industry is highly cyclical, moving directly with GDP, but with much larger swings in demand.

The UK industry has not fared well over the decades. As the industry has been consolidated into a much smaller number of truly global competitors, even the Scandinavian companies, who can build mills in the middle of soft-wood forests, have found it hard to compete with the new mills in South America built among faster-growing cloned eucalyptus forests. In these circumstances, the smaller independent paper companies have had only one recourse: to specialise, to develop high grade niche products, and to differentiate themselves on any measure that the processes of time, fashion and technology render favourable. In the early 21st century, for example, that includes being cleaner and greener than the competition, and the use of recycled fibre rather than virgin pulp. Quality is always key. Specialisation in itself is no guarantee of success: there has been a tendency for high value specialist grades to turn into commodities over time. The price of security cheque paper, for example, which incorporates chemicals to show up any attempt to alter a cheque, stayed more or less constant in nominal terms (i.e. in real terms declined by inflation) from the late 1980s onwards.

Both companies exported at least half of their production, mainly to Europe. The fact that the UK stayed out of the Euro dealt a serious blow to both companies in 2000-01: pulp prices were set in US dollars, which appreciated against Sterling, and export sales were primarily in Euros, which depreciated against Sterling.

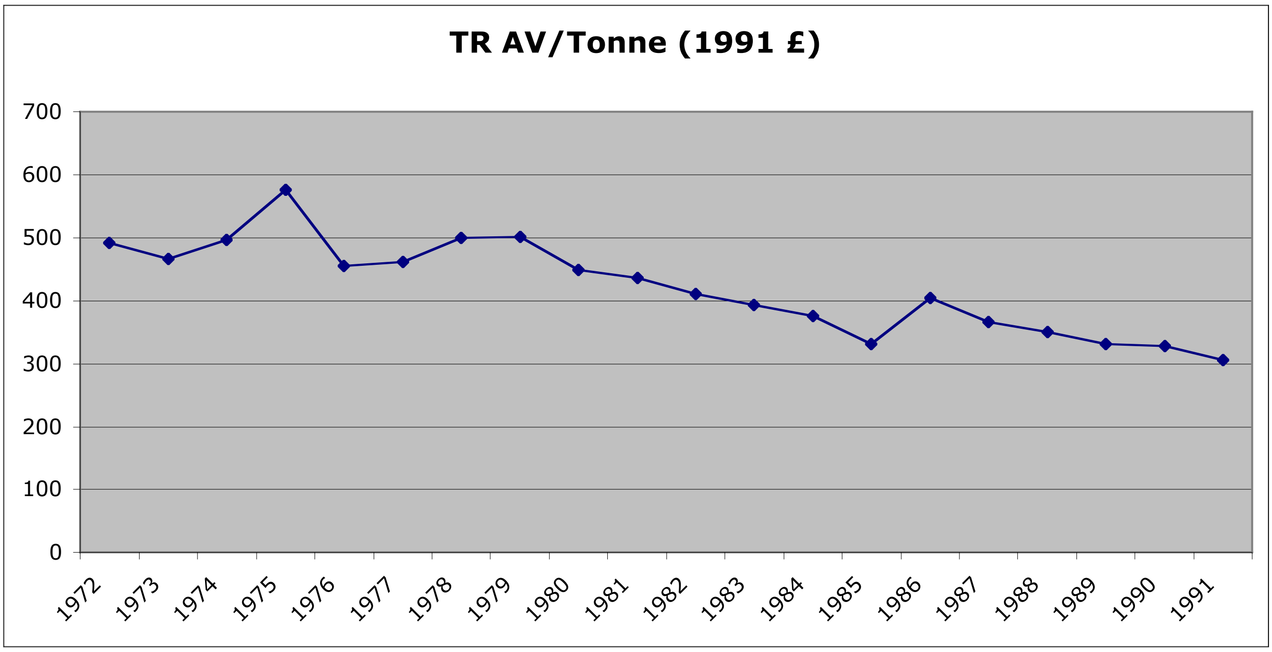
The Tullis Russell (TR) trends from 1972 to 1991 show the pressures clearly (Figure 1). The total value added by the company was maintained pretty steady after a steep decline in the 1970s. The cyclicality of the business is clearly visible, with low points during the recessions in the mid 1970s (following the first 'oil shock'), the early 1980s (with the introduction by Thatcher and Reagan of monetarist policies, and the appreciation of sterling with North Sea oil) and the early 90s.

Figure 1.



But the pressure from the endemic forces within the industry is shown by the added value per tonne of paper sold, which fell almost 40% in 20 years (Figure 2). This was not due to any move down-market, simply to the price pressure on every grade, driving and driven by the move to larger scale in the industry.

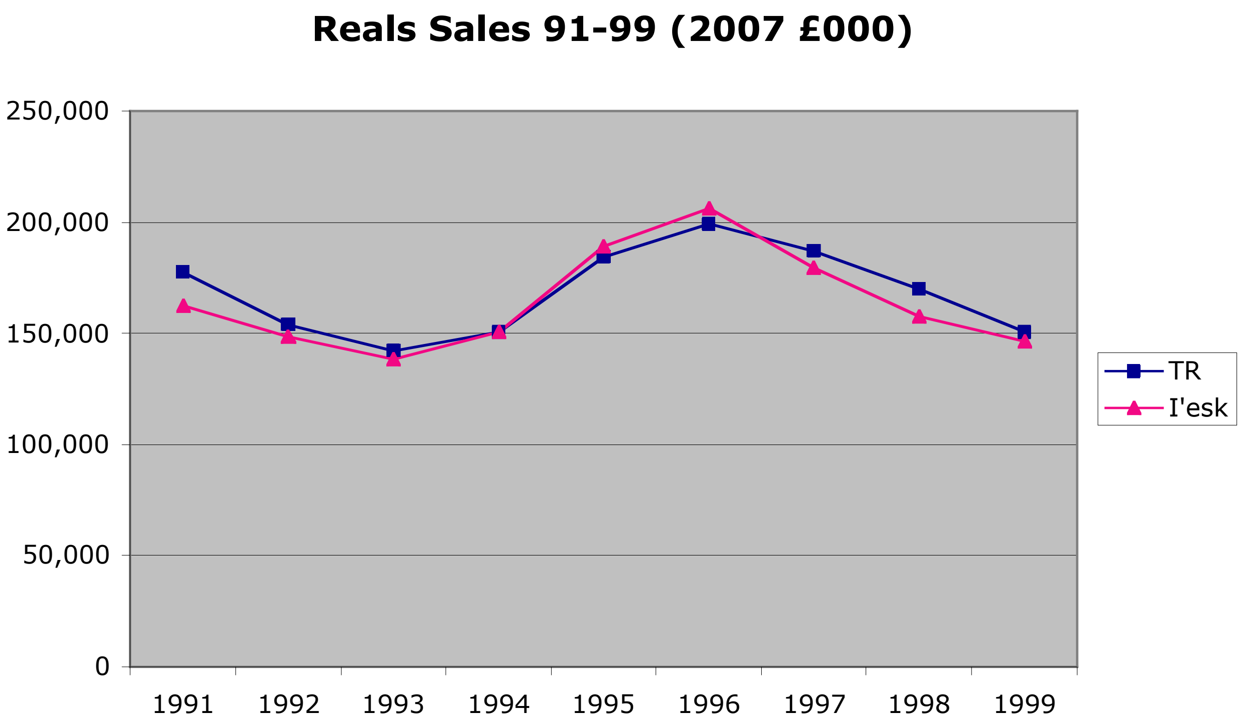
Figure 2.



In 1990 the two companies in question had very similar profiles. Inveresk had sales just below £100m and Tullis Russell a little above. They both competed primarily in the market for high-grade printing papers and boards, and they each produced a number of specialist grades – such as high voltage cable insulating paper and transfer paper for decorating ceramics in the case of Tullis Russell, and glossy label papers and various artists' papers in the case of Inveresk. The main area of direct competition between the two was one- and two-side coated boards, for applications such as greetings cards, fancy packaging and the covers of glossy brochures. TR had one very large papermaking site with five paper machines and a large coater, and two smaller sites for specialist, added-value coating; while Inveresk had five papermaking sites, the largest having three paper machines.

The similarity of the companies, and the cyclicality of the industry, can be seen in the real sales (i.e. adjusted for inflation) achieved during the 1990s (Figure 3).

Figure 3.



Ownership Strategy.

TR's ownership strategy in its first 176 years, from its founding by Robert Tullis in 1809, was to remain independent in more or less beneficent paternalistic family ownership. The first Russell invested in a 50% share in 1874, the second bought out the Tullises in 1924, the third led a period of well-judged heavy investment from the 1950s to the early 1980s, and then passed on the baton to his nephew, David Erdal.

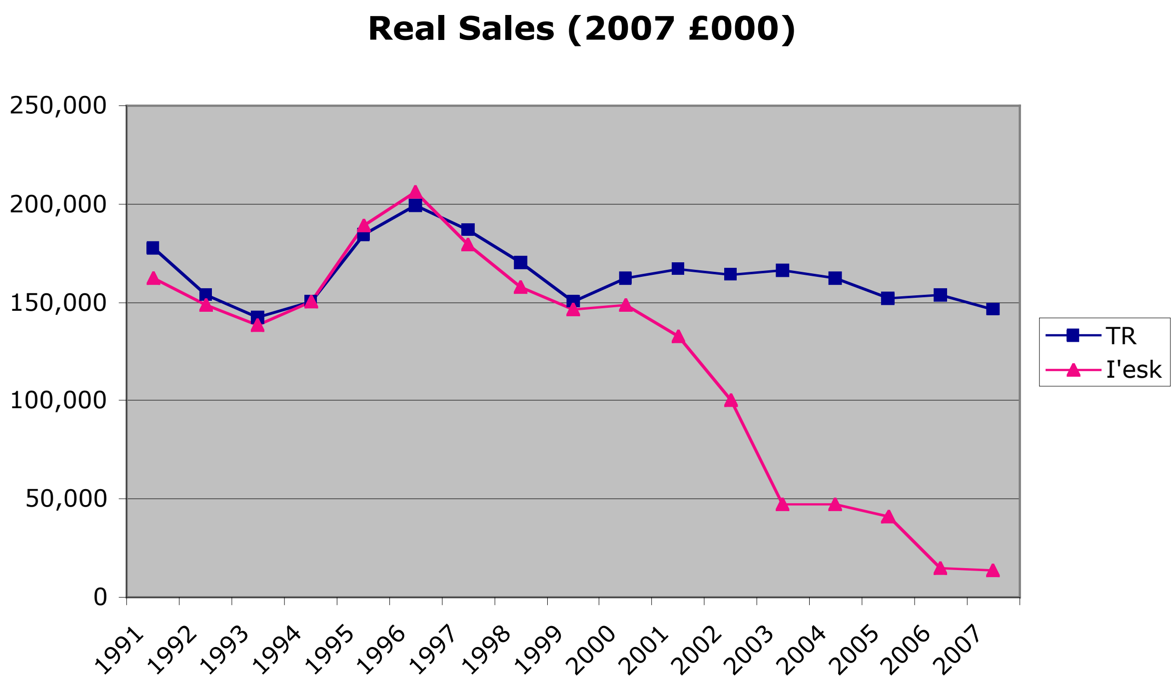
Taking over in 1985 he set about transforming the management style of the company from secretive, top-down and overmanned to open, participative, profit-sharing and strongly performance-oriented. This included redundancies totalling over 200 of the 1500 strong workforce, a traumatic contradiction of the paternalistic tradition. And discovering some appetite among his siblings and cousins to sell their so-far low-yielding shares he introduced a profit-sharing share scheme which started buying family shares and passing them out to all employees with more than a year's service. This was received with joy by the family and rank suspicion by the employees, who took probably three years to begin to trust the scheme. Stage two was to set up an Employee Benefit Trust in 1987, to buy a block of some 15% of the equity for the employees. It took a full three years also to persuade the company's advisers that employee ownership would be a good way forward. By 1990 Tullis Russell was poised to buy all the remaining family shares into the trust, but the plans were postponed when the general recession required all eyes to focus entirely on the management of the business, rather than its ownership. The buyout was eventually completed in 1994.

The history of Inveresk was different. It was formed in 1922 to bring together a number of independent mills, eventually eight in number, with a complex overlapping ownership of shares between the mills. In 1981 the company was taken over by one of the giant American competitors, Georgia Pacific. Four of the mills were closed, but still, like TR, Inveresk found themselves manufacturing printing grades on paper machines that were increasingly less competitive in scale. The only solution would be to remain resolutely up-market.

In 1990 the American owners agreed to a £35m management buyout – MBO – with the backing of four what would now be called private equity firms. The lead investor – Morgan Grenfell Development Capital – put a director on the board, and the company set about reducing the five year loan of nearly £18m. Luckily the economy began to pick up and cash flow was strong. Two years later in 1993 they managed a very healthy flotation, at a total company valuation of just under £80m – more than double the MBO price, enhanced for the shareholders by the high leverage.

Fifteen years later Inveresk had closed its three large mills and sold its flagship product line – to Tullis Russell, which had outperformed the whole UK industry. The story is illustrated by completing the graph of real sales (Figure 4).

Figure 4.



In analysing how two such similar firms ended up so differently in the space of only 15 years, the thesis of this paper is that the dynamics of the top management groups were crucial, and that a key determinant was ownership strategy.

Inveresk.

In 1990, Inveresk had a relatively new MD, Stefan Kay, with lifelong experience in the paper industry, where he had run mills successfully from a young age. In March 1990 their American parent company, Georgia Pacific, acquired Great Northern Nekoosa in a $3.74bn all-cash deal – one of the earliest contested takeovers in the paper industry – which took the debt of the combined operation to $8bn. As a result, Inveresk's owners were desperate for cash. Kay saw an opportunity and his overture to explore the possibility of a buy-out was welcomed.

That started six months of pure pressure, finding backers, negotiating with multiple groups of lawyers, going through repeated cycles of despair and hope, until in the end the buyout was completed.

Kay found that the four providers of capital were supportive through the deal and afterwards. There was no pretence that for them the plan was anything but to make as much money as possible in as short a time as possible. Nonetheless they supported a three year programme of substantial capital investment to upgrade the equipment in the mills. Most of the buyout funding was debt, with the team of executives in the business buying 30% of the equity, the providers of capital 70% between them. Morgan Grenfell wanted the employee equity to be limited to just seven people - three at the small head office and the directors of each of the four mills. Kay got agreement that everyone down to department manager level would be allowed to buy shares. So about 100, a little under one in nine of the people employed, took part in the buyout.

The immediate focus after the buyout was to get the debt down. The American system was to pay suppliers promptly, and allow fairly long credit to customers. By negotiating longer payment terms from suppliers, and moving their customers back from 90 to 60 days credit, large amounts of cash were released. And they reduced their stocks substantially. The result was that they were able to repay most of the debt early.

There was not much of a breathing space before the preparations for the exit started. In Kay's words

The first thing you're asked is "Where is the exit?" We decided from the first to go for flotation. We felt that through the buyout we were taking our own destiny in our hands and we didn't want to lose that. That was a misapprehension. That was wrong. But at the time, we weren't keen on being taken over – we didn't just want to go back to being part of a conglomerate. So we set ourselves out very clearly to go for the float.

The MBO had been pressured, but the float was much worse. It was a total distraction for about 18 months, becoming all-consuming in the last six. Kay again:

In the buyout it was as if the shape of the hole you were going to go through was changed to suit your characteristics. So if you were strong in this they'd move the boundary this way, if you were weak in that they'd move that boundary that way – it shifted in order to fit what the company shape and culture and philosophy were. When it came to the float there was this hole and you were going to go through it come what may, and there's no hole with any other shape. This is what you're going to do. It really was not a pleasant experience. I never want to go through that again.

In a flotation it is the sponsoring merchant bank that calls the shots. In this case Schroders put the company forward, vouched for the documents produced, certified that all the rules had been met and that the prospectus was factually correct. The total fee cost was about £3m. It felt as if most of the work was done by the Inveresk team.

The paper industry is not an exciting one in terms of natural growth opportunities or technological change. The principles of the paper machines currently in use would be recognised by Louis Robert who patented the first paper machine design in 1799 – until then paper had been made by hand, sheet by sheet. In this slow-changing and pressurised environment it is essential to make every small improvement: investment is vital but equally key is the gradual and continuous honing of the way things are done by the people involved. Although the principles of the technology have stood still for centuries there can be no standing still in the operations. Kay tried to protect the people running the mills from the pressures created by the MBO and the float, but inevitably they were distracted.

Kay had fought hard to achieve a broader spread of shareholding than normal – he had wanted to involve everyone, but that was rejected as 'too complicated'. So the great majority of the operatives did not have a stake in the company. The cut-off point was at department manager level – the managers participated, ordinary employees immediately below that level did not. The logic for that doubtless seemed good in the City – why allow the opportunity to buy equity to people who aren't even managers? To see how bad a decision that was, it is necessary to understand how paper-machines work. Paper-machines are huge, several in both companies being over 100m long. They run continuously, flat out, 24 hours a day, seven days a week, producing paper at 10 tonnes or more an hour. They are controlled by complex electronic systems, and the quality of the final product may be adversely affected by a host of different factors, many of which interact in subtle and barely foreseeable ways in the liquid mix of 99% water, 1% fibre and chemicals, that is projected out onto the roaring machines. If any quality problems develop, the machine just keeps churning out bad paper until somebody notices and intervenes. It sometimes takes an hour or more to get a machine back under control if a parameter has wandered off specification – and an ill-judged attempt to intervene may make it wholly unstable. Speed of response and good judgement on exactly what corrections to make are both vital, and both depend utterly on the machine operator and crew.

The way that paper machine operators gain advancement is by working on the machines, year after year, sometimes for decades, before being given overall responsibility for the machine and its team. Experience is vital, both to recognise what is going on in the complex system, and to know how to get it settled again.

On the other hand, the position of department manager is often given to relatively young and inexperienced people, including graduates on fast-track management training schemes. They depend for success utterly on the machine operator and machine assistants. And now the youngsters fresh from college were given the chance to make significant amounts of money, while the long-serving and experienced machine operators, on whom the whole operation depended, were excluded.

A Quoted Company.

Kay cannot honestly articulate a benefit to the business that accrued from the flotation. The banks that had backed the MBO made a lot of money. The company gained about £7.4m in cash from the issue of new shares, enabling them to pay down the last of their debt. But with that came enormous pressure to make acquisitions. Kay used to talk to the City investors every six months.

Question number one was always, 'Who are you going to buy?' 'What are you going to do with your cash?' 'Why aren't you taking over anyone else?'

The attitude of the City investors was that the paper industry was not one in which to make much money – except by acquisitions. The Irish Smurfit group and the American James River Corporation had both made (and lost) very large amounts of money for investors through aggressive acquisition programmes. The Inveresk directors were made intensely aware that the low percentage growth of the industry would not attract investors: to keep the share price high they would have to make acquisitions.

In the1994 accounts they made a public commitment to search out acquisitions, and in anticipation their share price soared to a peak at a company value of about £120m. The paper industry was in a cyclical boom with high demand giving good profits all round.

The Acquisition.

TR was also looking for acquisitions at that time, both in the UK and abroad. Both companies found that there were simply no good mills available. However, Pratt's, a large Australian company, was keen to sell its mill in Fife and gave the MD the incentive of a significant share any sale price above a minimum of just a few million pounds. TR decided not to pursue it – the brands, while not bad, were not great and the mill was rumoured to be struggling. Inveresk, partly because of the alley into which they had backed with their public commitment to make acquisitions, and with time running out before their year-end, bought it, paying £24m.

The timing, in Kay's words, proved to be 'immaculately wrong'. Within three months the tide turned for the paper industry, and prices collapsed. Pulp, of which the new mill had substantial stocks and which they had bought forward for nine months, fell from $950 a tonne to about $400. The acquisition had been paid in cash, so Inveresk was highly geared.

From then on they spiraled downwards. As they did so, the dynamics of the Stock Market and the board became deeply disruptive, with the non-executive directors preventing initiatives proposed by the executives, and trying to impose a buy-in backed by the Royal Bank of Scotland. Kay was able to show that the proposal did not make sense. A Vulture fund bought shares and began to exert pressure to extract cash. A discussion on a possible merger with the Swedish company Klippan prompted it and its friends to buy shares, eventually being able to impose their appointees to dominate the board. All this was an enormous distraction from the business itself, and Kay was relieved to leave the company in 2001, as Klippan's influence grew.

In 2005, Inveresk put its flagship brand up for sale: it was bought by Tullis Russell. Inveresk closed four of its mills, opening the sites for property developers, and at time of writing the fifth site looks as if it may take the same route.

<u>Tullis Russell.</u>

The all-employee buy-out at Tullis Russell had very different effects.

Firstly, after the initial intense suspicion aroused by the handing-out of shares in 1985 had worn off – this took three years – the annual distribution of shares began to generate a positive response throughout the whole workforce. Not with all of them, but creating an ever-spreading confidence that this was for real, that everyone really was going to share in the wealth they were creating together. The share scheme was an overt commitment to an inclusive approach. At the same time, the board were wholly focused on backing up that inclusive ownership approach with an inclusive management style aimed at making everyone *feel* like an owner. Monthly briefings were introduced, also from 1985, and taken seriously, although as in any institution there are always complaints about communication. Previously the quarterly financial figures had been given out to the directors at the board meetings and then taken back at the end; now they were given out in a simple, comprehensible form to everyone, every month. Performance results and plans were announced and explained and questions answered.

Managers are only human and do not change overnight. People accustomed to holding information and giving it out only on a 'need to know' basis can feel exposed and even threatened when they are now asked to give it out to everyone – even more so when they are told to find out what the people whom they manage think of the plans, before they are implemented. And shop-floor workers who have been suppressed and pushed around for all their working lives can react with less than gentleness when given the chance to embarrass their manager. But bumpy as the process was, by the early 1990s it was well established and gaining trust.

In a different way from the share scheme, the cash profit sharing scheme backed up the participative approach, another token of good faith that knocked the soap boxes from under the cynics. 15% of the profit for the previous year was distributed every summer as a percentage of salary. That paid for many a holiday, and news of it got out in the locality in the form of delighted boasts in the pubs.

Another aspect of the approach was the formation of improvement teams. Again, the process of starting them was not smooth, but some of the teams soon made serious reductions in costs, and others a visible impact on the quality of life - for example, revamping all the signposts on the huge and complex site by using a system copied from the local hospital.

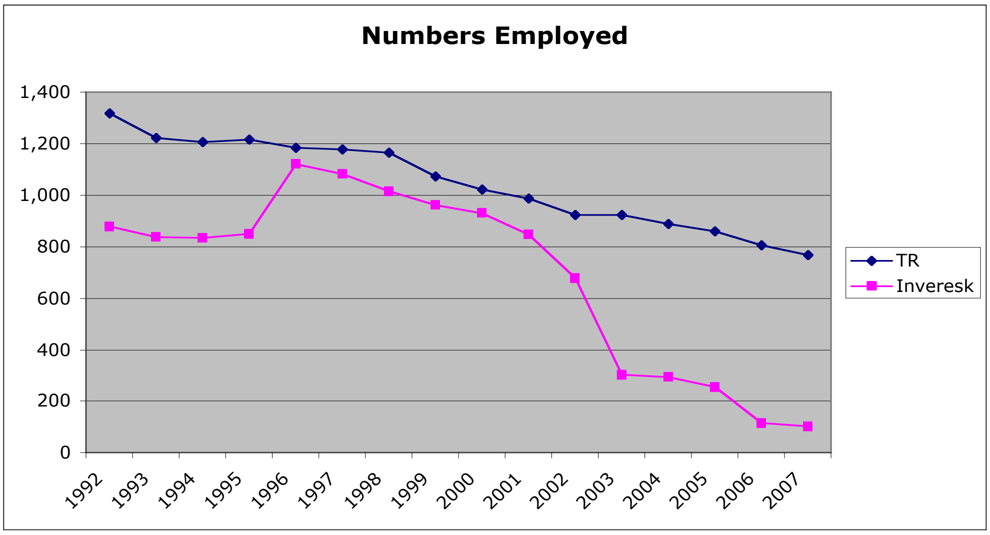
One impact of this integrated approach was the overt commitment to staying independent. This played a role in achieving something that was entirely unexpected – the attraction of some of the best operating managers in the industry. Three in particular, each of whom became MD in succession, would simply not have joined TR if it had still been in family ownership, with the family having the final say, or if it had floated on the Stock Exchange. One was an expert and experienced operations director in a global company; one a similarly top-rated sales director in another global company; the third was a talented young accountant attracted by this approach to move from a different industry. The two older ones had experienced the traumas suffered when the companies in which they worked had been taken over, one of them more than once. These effects tend to demoralise operating managers not just in the short but in the longer term too. It is no surprise that acquisitions have been shown to have a high probability of destroying value[2]. In employee ownership the commitment to continuing independence was clear, however, and also the pre-eminent role of the top managers. They needed to be robust enough to face being accountable at the end of each year to those they managed throughout that year. That meant that they would face at the AGM people who would know them better and be better informed about the business than any City analyst, and many of whom might have the desire to bring them down a peg or two. There would be no room for bullshit. But they knew that they would be the leaders of the group, in an environment where everyone would have the strongest possible incentive to cooperate. The company would not be sold over their heads.

In strong contrast with Inveresk, who faced enormous distraction because of the City pressure for acquisitions, the end result of this was a steady focus from top to bottom on the business, its operations, and on ways of improving it.

Productivity.

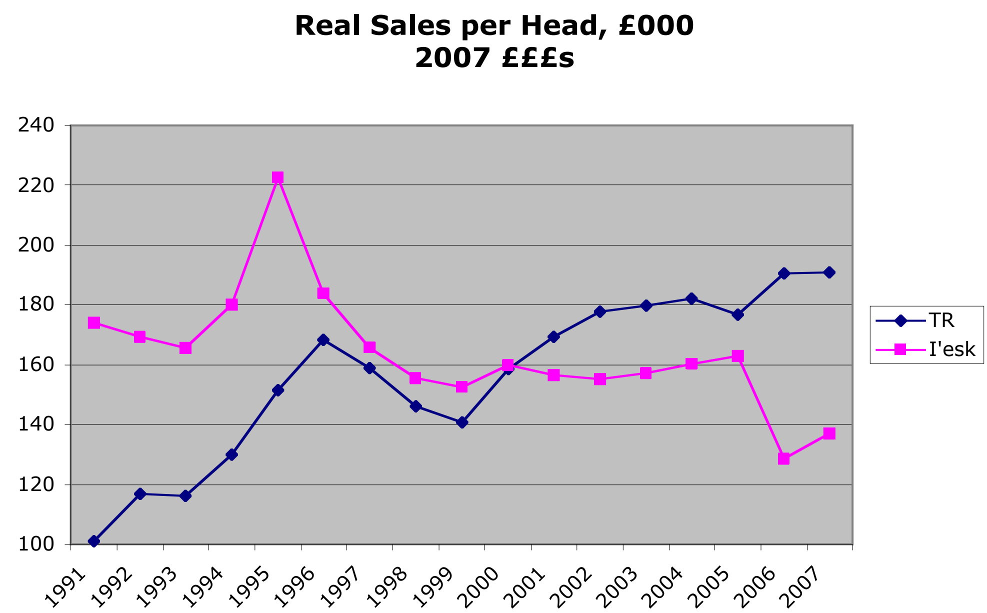
One of the many predictions made by outsiders, conventional thinkers, advisers steeped in the status quo and economists addicted to the unrealistic models of classical economics, is that employee-owned companies will hesitate to make 'difficult' decisions, such as reducing employment. The facts prove this to be simply wrong. Figure 5 shows the numbers employed in the two companies.

Figure 5.



There is no distinguishable difference between the rates at which the two companies reduced their numbers employed, until Inveresk began to collapse. But the difference in the effectiveness of the two companies is shown by the productivity figures. Figure 6 shows the sales per head for each company, adjusted for inflation to express them all in 2007 pounds sterling.

Figure 6



Inveresk started over 70% ahead of TR. But apart from the spike in 1995 as the industry reached its cyclical peak, Inveresk never managed to increase its productivity significantly. TR was affected by the same peak in 1995 and subsequent decline (the financial years overlap, so that the TR graph really needs to be brought back by half a year), but then steadily improved its productivity. TR overtook Inveresk after 2000, while Inveresk remained static and eventually collapsed. So much for the much vaunted benefits of Capital Market Discipline. TR made just as ‘difficult’ decisions, but combined that with the committed application of participative management and gave everyone involved the best possible reason to collaborate to make it succeed – ownership in common, so that, as well as the struggles and the pain, they shared the rewards, the wealth that they created together.

A Difficult Decision

An example illustrating a difficult decision being taken, and being taken in a very different way from the standard approach, is the closure of TR’s specialist coating mill in Stoke on Trent. This had been acquired in 1981 when its parent company went bankrupt. It was the world’s leading producer of decal transfer papers for the ceramic industry. In the 21st century, Chinese competition gradually forced the closure of the UK operations of all its customers, the major ceramic producers, which were mainly centred on Stoke on Trent, the whole area being known as the ‘Potteries’. In 1998 TR acquired a Korean producer of similar papers. The elected council in Tullis Russell had a veto over such investments, and it was clear to all that the acquisition would affect the Stoke site, but recognizing that it was necessary for production to be near the now-dominant Chinese customers, the elected representatives, including the two from Stoke, voted 100% in favour. By 2004 it was clear to the board that it would be necessary to close the Stoke plant, and the decision was taken to do so. The MD, Fred Bowden, set a two year time frame on the closure, and indicated that he would start by communicating the plan to everyone who would be affected. The two outside non-executive directors baulked at this: surely it would be risky, quality would suffer in the production of this highly sensitive product, consequential loss claims could escalate horrendously (a kiln full of ceramics is a valuable thing), it could be chaotic and TR might lose its preeminent position in the world market. Bowden maintained his position, and the Stoke people were duly briefed. Over the next two years the factory performed impeccably, right through to the final closure. Through consultation, steps were taken to help those affected in the most relevant and useful ways, and the redundancy terms were better than the statutory requirement. The trust not just of those directly involved, but of all in the TR group, was strengthened by the way the board had behaved.

Conclusion.

The death of Inveresk was caused primarily by the pressures created by private equity and the stock market. Defenders of the system will claim that private equity is creative, that capital market discipline stimulates effective behaviour, and that companies in old industries must die so that capital may be used more efficiently elsewhere.

The truth is rather different.

Inveresk's MBO needed capital. The people providing that capital had no interest in the performance of the company other than in the very short term. They wanted the managers to extract as much cash as possible, and provide an exit as fast as possible. They shared ownership only with the managers and only to motivate them to take a similarly short-term view. Then the much vaunted capital market discipline of the Stock Market pressured the managers to such an extent that they overpaid for an acquisition at the top of the cycle, which proved ultimately fatal.

By contrast, the all-employee buyout of Tullis Russell also needed capital. They got that from the family vendors as long-term debt (15 years) with a reasonable cost. Having this debt still pressured the managers to produce cash, but with a long term horizon that was entirely compatible with continuing to build the business.

Above all, the employee buyout provided *everyone* with a common interest in making the company successful, and stimulated a management style to suit. Instead of the owners causing an enormous distraction, with greedy demands leading to disaster, every time a director spoke to employees, he or she was talking to informed shareholders, and every time a director talked to shareholders he or she was talking to people who cared and made a difference in the operations.

And they did.

And finally, instead of sucking out millions of pounds for the benefit of a few merchant bankers, Tullis Russell has over the years distributed millions of pounds to all the employees, in the form of profit sharing and dividends and shares. The economic multiplier effect in the whole community is powerful and sustained and thoroughly beneficial. The effects on the employees and their families is also immensely positive, spreading new opportunities widely. Being treated as a genuine partner in the business has important knock-on effects on families and communities, as well as on the individuals involved.

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[1] Porter, Michael, 1980. *Competitive Strategy: techniques for analyzing industries and competitors.* New York: The Free Press

[2] The following references are taken from O.Sullivan, Mary, 2000. *Contests for Corporate Control.* Oxford: Oxford University Press, a superb analysis of why takeovers usually fail to build value, and critique of the theory behind them. Porter found that the majority of acquisitions by 33 major corporations between 1950 and 1980 had been divested by 1986 (Porter, Michael, 1987. From competitive Advantage to Corporate Strategy. *Harvard Business Review* 65 (3): 43-59); Brooks analysis showed that many of the acquisitions were dreamed up by fee-driven merchant bankers (Brooks, John, 1987. *The Takeover Game.* NY: Dutton); and Jensen and Ruback, two ardent supporters of efficient market theory, were disturbed to be forced to conclude that acquiring companies frequently had abnormal negative returns (Jensen, M. and Ruback, R. 1983. The Market for Corporate Control: the Scientific Evidence. *Journal of Financial Economics* 11: 5-50) a feature later confirmed by other studies.