Company Case Study: Asia Pulp & Paper

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Focus on Finance Newsletter, Juni 2001

APP: A textbook case

In a few years time the rise and fall of Indonesia's Asia Pulp & Paper (APP) will be a classic case in any financial textbook, illustrating the risks involved in neglecting sustainability issues. It is a story of greed and unrealistic growth estimates, which lured virtually all globally active financial institutions to inflate the company with a massive US$ 13.4 billion debt, only to find out this year how the balloon is going flat at maximum speed.

Early warnings

In the late 1980s, Indonesia's business tycoons such as Eka Tjipta Widjaja (Sinar Mas Group), Sukanto Tanoto (Raja Garuda Mas Group) and Projogo Pangestu (Barito Pacific Group) unfolded their clearly over-ambitious plans to develop the world's largest pulp and paper industry. Ever since, Indonesian environmental groups such as Skephi, Walhi and YLBHI have been ringing the alarm bell over this development, warning that a pulp and paper industry would only lead to massive deforestation and intense social conflict. Despite of these early and repeated warnings, the international investment community jumped on the opportunity. In the last 10 years, more than US$ 15 billion of international investment has been poured into a handful of oversized pulp and paper mills.

The report "Paper Tiger, Hidden Dragons", published in June 2001 by Friends of the Earth-England, Wales & Northern Ireland, provides a case study on Indonesia's largest pulp and paper producer, APP, its unsustainable and damaging operations and the role of international financial institutions in fuelling these operations. The report follows an earlier landmark publication by the Centre for International Forestry Research (CIFOR) and WWF Macroeconomics Program Office entitled "Profits on Paper: the Political Economy of Fiber, Finance and Debt in Indonesia's Pulp and Paper Industries".

The FoE-report shows that APP's assets (valued at US$ 17.5 billion) are largely financed by is shareholders (25%), bondholders (38%) and banks (20%). Over 300 international financial institutions, including many leading financial institutions and export credit agencies, are identified as being heavily involved in providing and guaranteeing this finance over the last ten years.

Apart from the Indonesian Widjaja family, which is the most important shareholder of the APP Group, important outside shareholders are the American fund managers Franklin Templeton Investments and Capital Group.

The American investment banks Merrill Lynch, Morgan Stanley Dean Witter, Goldman Sachs, and J.P.Morgan have played an important role in issuing a huge amount of bonds for the APP Group. Other investment banks playing an important role in this respect were ING Barings (The Netherlands), Credit Suisse First Boston (Switzerland), UBS Warburg (Switzerland) and Deutsche Morgan Grenfell (Germany).

Banks playing an important role in arranging international loan syndicates for the APP Group were, among other: ABN Amro Bank (The Netherlands), Barclays Bank (United Kingdom), Bank of America (United States), Dresdner Kleinwort Benson (Germany), Fuji Bank (Japan), Development Bank of Singapore (Singapore), ING Bank (The Netherlands), Bank of China (China), Crédit Lyonnais (France), and Deutsche Bank (Germany).

Export credit agencies (see also elsewhere in this newsletter) involved in guaranteeing some of these loans are, among others, the US Export-Import Bank (United States), Hermes (Germany), Exporkreditnamnden (Sweden) and Österreichische Kontrollbank (Austria).

Risk assessment failures

All these financial institutions have failed to sufficiently recognise and act upon a number of risks that are inherent in any investment in the Indonesian pulp and paper industry. The FoE-report identifies these risks as follows:

Massive growth in Indonesian pulp and paper capacity, fuelled by international investment, has not been matched by efforts to gain a sustainable supply of raw materials. As a result, of the 100 million m3 of wood estimated to have been consumed by the pulp industry between 1988 and1999, only 8% was harvested from plantations. The remaining 92% has been sourced by clear cutting rainforest. This has led the Indonesian pulp and paper industry to destroy 835,000 hectares of highly biodiverse rainforest. The pulp and paper industry will depend upon clearing rainforests to supply their pulp requirements for at least the next seven years and possibly much longer.

Indah Kiat, one of Indonesia's largest pulp mills and part of the APP group, accounts for 77% of APP's pulp production capacity and 40% of Indonesia's overall pulp output. In 2000 Indah Kiat sourced approximately 85% of its logs from clear-cutting natural forests and their operations have accounted for 287,000 hectares of deforestation over the last 10 years.

Financial institutions have also failed to recognise and act upon evidence that APP are running out of a legal wood supply in Riau, Sumatra. It is estimated that even with massively increased investment in their plantations, it will be seven years and possibly much longer before plantations are able to fully supply their pulp requirements. APP are now faced with having to buy timber from further afield, which will increase costs. At present Indah Kiat sources logs at US$ 19 / m3. Indah Kiat will either have to produce logs domestically at a higher cost or import them, which could cost US$ 45 / m3 at today's prices.

Financial institutions queued up to invest in the Indonesian pulp and paper companies because they perceived that they had a competitive advantage due to their access to cheap raw material resources. The low cost of timber supplies was made possible however because these companies were given access to natural forests by the Indonesian Government at virtually no cost, because they did not adequately develop their plantation resource and, in some cases, it appears that they have been able to buy substantial volumes of illegal timber. The CIFOR-WWF report calculates that between 1995 and 1999, Indonesian pulp producers obtained as much as 20 million m3 of timber from undocumented sources. Although their figures are not conclusive, they suggest that Indonesian pulp producers have obtained as much as 40% of the wood they consumed during this period from illegal sources.

Financial institutions have also failed to appreciate that by offering paper products at such low cost, undercutting most of their competitors, APP may have distorted the global paper market, contributing to the falling global paper prices. Ironically, APP's supposed competitive advantage may have significantly contributed towards its mounting debt problems and consequently its tumbling share value.

Financial institutions also failed to recognise and act upon the risk regarding the poor financial regulation of the Indonesian pulp and paper industry. According to the CIFOR-WWF report, each of the major pulp and paper conglomerates was involved in the banking industry before the 1997 financial crisis and some have regularly violated the Indonesian Government's capital adequacy requirements and legal lending limits for capital loans to related parties, including to their associated pulp and paper companies. The use of financial 'mark-up' practices - that is the artificial inflation of the cost of an investment project - have allowed some pulp and paper producers to secure much larger amounts of financing for their projects than needed.

Foreign creditors have failed to recognise that they have enabled APP and other Indonesian pulp and paper companies to engage in a debt driven expansion. It is reported that they have sometimes resolved outstanding debts to foreign creditors by raising funds through further expansion of their processing operations.

Financial institutions have not adequately recognised the high level of social conflict and the accompanying political risk that APP has generated as a result of its operations. Indah Kiat came into conflict with the indigenous Sakai people after they cleared 3,000 hectares of their forested land. The conflict came to a head on 3 February 2001 following the blockade of a logging road by the Sakai. According to various reports, employees of Arara Abadi were involved in serious clashes with the villagers of Betun Village, Pangkalankuas sub-district in Riau. According to those reports, at least five villagers were injured in the clashes, two seriously and 52 people were detained by Arara Abadi security forces before being handed over to the local police.
APP is also involved in a joint venture plantation project, Borneo Pulp & Paper (BPP), in Sarawak, Malaysia, which has been at the centre of major opposition from indigenous groups. The project has been given access by the Malaysian Government to more than 600,000 hectares of land. As a result, up to 20,000 Iban indigenous people may be forced off their land. One Iban community has already won a landmark court case against BPP after the Kuching High Court ruled that part of the land that had been handed over to the company for the plantation was the community's native customary land. The Court declared that the land title issued to BPP which included the disputed area was void.

Financial institutions should also consider the risk of financing a paper company which has a market strategy designed to bring paper to markets in a way which does not identify APP as the manufacturer and source. APP is flooding the UK market with un-branded and re-branded paper products. APP has covered up the environmental impacts of its operations, referring to ISO14001 certification in brochures and with references to plantation based forestry, obscuring the fact that most of the raw material is sourced by clear cutting natural rainforest. Although it is not clear to what extent the following are aware of the environmental and social impact of APP's activities, Robert Horne, Spicers, Kingsfield Heath and Thomas Potts, which together with the buyers groups they feed in to represent more than 50% of the UK stationary market, all distribute APP paper in the UK.

APP's financial woes

APP announced a standstill on all debt repayments on 12 March 2001, followed on 4 April 2001 with a decision by the New York Stock Exchange to suspend all trading in APP's shares. The shares had crashed by 98.6% since early 2000, falling from US$ 8.50 to US$ 0.12. At this moment, APP is involved in a very complicated process of debt-restructuring. The financial institutions involved face the possibility of losing as much as 90% of their investment in APP.

Conclusion: investors' responsibility

APP's debt-restructuring process also offers opportunities to investors: as the creditors and shareholders of APP, they are now in an excellent position to fundamentally change the environmental, social and business policies of APP. As a result of their inadequate investigations and understanding of the Indonesian pulp and paper industry, combined with their substantial investment in APP over a number of years, financial institutions have the obligation to press for this policy change.

Investors must recognise that unless they take immediate action to address the environmental and social impacts of APP's operations they will be knowingly facilitating further rainforest destruction and social conflict. They should reflect on the reputational risk that their institutions face as a result of their involvement. Lessons in risk learned from the APP crisis should be applied by financial institutions to all their pulp and paper investments. Without ensuring that their investments are both socially and environmentally sustainable, their investments will not be economically sustainable.

Despite the excessive capacity of Sumatra's pulp and paper industries, capacity expansion projects and even completely new mills in Sabah, Sarawak and Kalimantan are in the pipeline. NGOs will no doubt demand that investors involved in these projects prove they have learned from APP's Hidden Dragons.