DIALOGUE

AN INTERVIEW WITH THE BOARD OF MANAGEMENT OF SCHLOTT GRUPPE AG
BY ROLAND TICHY AND HEIKE SCHWERDTFEGER

For some forty years, the task of printing Germany's leading financial review WirtschaftsWoche has been entrusted to a subsidiary of schlott gruppe. In this year's annual report, the Board of Management of schlott gruppe AG respond to the questions asked by Wirtschafts-Woche editor-in-chief Roland Tichy and editor Heike Schwerdtfeger. The print industry is in the middle of a difficult process of consolidation marked by over-capacity, rising prices for energy and raw materials and changing customer requirements. Bernd Rose, Heiko Arnold and Adam Valeri offer their views on the company's economic prospects in this business environment.

As recently as the middle of 2008, we were told that it could turn out to be a successful year for the printing industry. Then around that time there was a sudden change of mood. So what is really happening?

Bernd Rose: The situation deteriorated significantly in the last few months of 2008. We have always regarded the optimistic pronouncements that were primarily spread by the print equipment manufacturers as exaggerated, however. We met our own expectations for the financial year to September 30, and given the current state of the market we are satisfied with the outcome. However, we are not satisfied with the level of profitability we achieved in 2007/8. That's why we have introduced comprehensive measures to optimise our costs.

Is that also the case looking at the year ahead?

Bernd Rose: We are expecting it to be a difficult year, although we believe it will remain in line with our planning. We know that much is going to change in the way people use different media, and we took steps to prepare ourselves for those changes early on. Having said that, we are not in a position to predict future economic developments in Europe or Germany with any great certainty.

What impact does an economic downturn have on the demand for print products?

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Bernd Rose: We are, too, dependent on advertising spending. Higher advertising budgets mean a greater volume of print products. At present, many publishers are cutting back on the number of pages they print. While that may not affect the number of copies, it does reduce the overall volume. We are quite fortunate in that many of the television magazines we print are relatively immune against cuts in advertising budgets. At the same time, both retailers and to some extent mail order firms are trying a little harder still to encourage consumers to buy using advertising inserts and catalogues.

So are we seeing an increase in advertising at the moment?

Bernd Rose: In the past, trouble in the wider economy used to hit us a bit later, and we generally leave choppy waters behind us faster, too. As soon as retailers see the first signs of economic recovery, they advertise more to secure their market share.

That seems likely to be some way into the future. At the moment, the share prices of print machine manufacturers such as König & Bauer and Heidelberger have taken a plunge. Is the printing industry worldwide seeing a fall-off in demand, with its machines no longer required?

Heiko Arnold: The printing industry as a whole, especially the gravure segment, which accounts for most of our work, is marked by severe over-capacity. Up to 2006, there was a further rise of nearly ten per cent in capacity, even though, temporarily, existing capacity was not being fully utilized. If, on top of this, the macro-economic situation is poor, capital expenditure is also reduced. In addition, many – especially smaller – printing firms currently face problems in the area of financing. If we take all these factors together, the result will be to speed up the consolidation process in the European printing industry even further. For schlott gruppe, this is actually a positive development because at present there is no new printing capacity flooding the market. Of course, the machine producers are suffering badly.

Adam Valeri: Another factor here is that the machines have a very long life-span of over twenty years. In the short to medium term, delaying such an investment has only a minor impact on a company's technical resources. For the manufacturers, however, it creates an enormous gap.

But do you make sure the expensive machines are available, too, regardless of print quantity?

Bernd Rose: Yes, and of course that represents a significant fixed cost. Depending on the season, there may be substantial over-capacity in the entire market. That makes it unavoidable to push ahead with the restructuring process in our industry.

Is there a European region that could make up for the economic downturn in Germany?

Bernd Rose: Unfortunately not. Around two-thirds of our revenue comes from Germany and the rest from Western Europe. The contribution made by Eastern Europe is still very small, although the trend is positive. We are today in a position that allows us to supply even customers in Poland and outcompete our rivals in that country. For the last fifteen years it was the other way around. Now, though, the trend is

in reverse, by which I mean that we have become more competitive in Germany thanks to a high level of productivity, quality and reliability.

Despite the fact that you are setting your hopes on the East, you nevertheless sold your Sachsendruck subsidiary. Was that a sensible move?

Bernd Rose: Our Sachsendruck operations were no longer part of our core business. We sold the company to a family-run firm that already operates a number of print shops in Saxony. Sachsendruck is strategically valuable to that firm and offers potential synergies.

If we were to draw a circle around your major printing sites in Nuremberg, Lübeck, Hamburg, Maarssen, Freudenstadt and Landau, over what radius would you be able to compete?

Bernd Rose: We provide a rapid service covering the entire Western European and Scandinavian regions at market average prices. That goes for catalogues and advertising inserts for the retail industry. From a logistical perspective, it is difficult to supply the UK magazine business, because we are two to three hours short in terms of logistics. The same applies to the magazine market in France. To break into the French market, we would need a production site much nearer Paris. Still, except for these two local markets for weekly up-to-date magazines, we are very well positioned north of the Alps.

But do you have enough time to supply Scandinavia?

Bernd Rose: There is enough time for publishers and for advertising inserts from Scandinavian retailers – as well as for French retailers and British mail order firms. The time factor only becomes more critical in the case of periodicals with up-to-date content.

The crisis has been with us for a while. What action have you taken apart from selling Sachsendruck to ensure that you come out the other side?

Bernd Rose: Over the last financial year, we were obliged to make cuts in the workforce at all our sites in order to cut costs – with the exception of Hamburg, where there was an agreement to safeguard jobs up to the end of

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HEIKO ARNOLD *Member of the Board of Management responsible for the areas of Treasury, Financing/Controlling, Investor Relations, Human Resources, IT and Commercial Administration.*

2008. That was a painful but unavoidable process. It was accompanied by changes in collective pay agreements and other organisational measures. One of the important issues for us is working-time accounts. Thanks to the introduction of flexible working time and working-time accounts, we are in a position for the first time to compensate, at least in part, for the lower levels of capacity utilisation we anticipate in the first few months of 2009.

But isn't it true in the age of the Internet that the printing industry is now a highly evolved dinosaur that can no longer attract enough orders to survive?

Adam Valeri: Our customers demand very flexible technologies. Nevertheless, I believe that the dinosaurs within the printing industry will become extinct. That's why schlott gruppe does not rely on outsize equipment and doesn't have any 4.30-metre wide machines. They won't be needed in the future, either. We took the decision early on to stay out of the mad rush for massive, extra-wide machines in both the gravure and offset segments. We have stuck to the mid-size category, and our customers appreciate that.

Heiko Arnold: The most successful businesses with the best prospects of growth are those that rely on an intelligent mix of online and print advertising. Even now, in the age of e-commerce, paper remains the crucial medium when it comes to providing the impulse for a purchase. You may well place an order on the Internet, but in most cases you get the catalogue first, see what you like, then, rather than using the mail order slip or a call centre, you order via the internet. Over 70 per cent of online orders can be traced back to catalogues or advertising inserts. That's why we are not afraid that print is about to die out as a medium, although the industry does need to ensure that it operates in a modern and customer-driven manner with costs, reliability of supply and quality being the key factors in terms of competition.

Isn't it a lot more convenient to check out what you want to buy sitting at the computer? With a catalogue, you can't unfold a dress or look at a tent from the back.

Bernd Rose: But first of all you have to create an impulse for the customer to buy. When people search the Internet, they are looking for something specific. It's important to make a distinction between creating demand and meeting demand. If we are talking about simply meeting demand, then, yes, the Internet does have an advantage, but in terms of creating demand, it is printed materials that deliver the push effect. A large proportion of the new customers we have made in the last few years come from the etail sector, by which I mean those retailers who until recently had only been trading online. They have come to the conclusion that it makes good sense to combine online and print advertising. Print acts as a kind of fertiliser for their online business. There are studies that show how the size of the average shopping basket and the frequency of purchases both increase when printed advertising is used to target online buyers. So there is no doubt that print will remain one of the most important elements of the media mix.

You say that the printing industry is becoming more flexible. Does that imply that the size of the average print run is decreasing?

Adam Valeri: Yes. The size of the average print run is decreasing, although the range of print formats is increasing. In our experience, catalogue customers are increasingly turning to midi and mini-catalogues. That's where our own strengths lie. The print industry will be aiming above all to reach the customer in a flexible way – one that meets the needs of customers, combining greater frequency with lower page volume and possibly even larger issue numbers.

When e-commerce businesses turn into catalogue firms, will Amazon be publishing its own books catalogue at some point?

Heiko Arnold: We've already got the eBay magazine and several other concepts that have led to a more wide-ranging marketing mix. If we look at the digital generation of 14–29 year olds, 69 per cent of the top Internet sellers use catalogues. Etailers themselves have realised that they can increase both the average size of their shopping baskets and the frequency of purchases through additional printed advertising.

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With staff cuts on the one hand and greater flexibility at the print shop on the other, how can you maintain the same level of print quality and service?

Heiko Arnold: That depends on your productivity and your experience. Naturally, whatever measures we take, we ensure that quality and service don't suffer. Most of our staffing reductions have now been implemented, and we have made permanent cuts in staffing costs by introducing changes to shift systems and the way work is organised. In most cases, we are able to do that by engaging in a constructive dialogue with representatives of the workforce. The staffing cost ratio in a gravure printing division is well over 50 per cent, so it's natural that this particular cost centre will be high on the agenda when it comes to deciding on measures to reduce our costs.

How many of your employees are available for the nightshift in Nuremberg when WirtschaftsWoche's editorial team finishes its work at 11 pm?

Adam Valeri: At that time we have around 30 staff at work. From one o'clock onwards we print some 50,000 copies an hour. Post-press work starts at around 6 a.m. Nowadays, our services are available around the clock and seven days a week. There's no other way. This isn't a five-day week business.

Last year saw a number of strikes that forced us, for example, to bring forward our editorial deadline, which is a tremendous nuisance. Are we likely to see more strikes in 2009?

Bernd Rose: : We are faced here with a dilemma. We need to ensure that production is as cost-efficient as possible while at the same time remaining on call 24/7. That reduces your scope for discussing changes with the unions or your workforce. Having said that, in the past we have always delivered. To completely rule out the possibility of a strike, we would have no choice but to pay top wages, and that would make us uncompetitive. For this reason we ask

for a little flexibility from our customers. That's important if we are to remain competitive. We can also make up for lost production at our other sites, so as yet we haven't caused anyone any really major problems.

Heiko Arnold: : We still need to implement some measures at our Hamburg site. The whole issue of cost optimisation remains on the agenda in our company. It has to be. Competitive pressures in the market are pushing us down that road. That's no surprise, though, especially in these times.

At 6.8 per cent, your dividend yield seems attractive, but your share price is in the doldrums. According to the analysts, the printing industry can expect to suffer for another 18 months. What's your story?

Bernd Rose: The European printing industry has been undergoing a period of consolidation for the last ten years, and we have helped to drive that process through a large number of takeovers and cost savings. It has proven

to be a successful strategy. Once the economic downturn finally levels off, I'm certain we shall be in a strong position to take advantage. We have the expertise and the right answers in this process and will continue to put them to good use.

So you are still on the lookout for acquisitions?

Heiko Arnold: We anticipate that in future three major gravure printing firms will account for over 60 per cent of the market. That is our expectation, and we intend to help bring that about, albeit with a different strategy. As recently as a couple of years ago, people were saying that 1 and 1 can make 2.5 in terms of capacity using intelligent production methods. The prevailing logic now is that 1 and 1 are less than 2 as a result of overall optimisation. In this context, though, it's important to bear in mind that we can't afford to pay over the odds or engage in financial adventures. We are prepared to take normal business risks.

What size of takeover could you really manage?

Heiko Arnold: In the case of larger acquisitions, the transaction would be executed via ownership interests on the basis of shares. We have adopted a financing structure of 3.5 times sustained EBITDA. In other words, we have a self-imposed limit on borrowing to ensure that we maintain a sound financing structure. The fact that we were unable to achieve this leverage target in the last financial year highlights the problem facing the industry and the need for the cost-reduction measures we have introduced.

What are your prospects for 2009? When do you expect the market to recover?

Bernd Rose: We don't get involved in that kind of forecasting. What we do instead is roll up our sleeves and get to work. We rely on our strengths and focus on avoiding mistakes if possible. We should be able to improve our position vis-à-vis the competition, keep earnings at a stable

level and as a result reduce our debt still further through our free cash flow. We are not expecting any major improvement in earnings. Given the current macro-economic situation, that just isn't feasible in any case.

Heiko Arnold: In the medium term, any increase in profit will have to come through the measures we have implemented. With regard to financing, we created a very solid base in 2008 by transferring more funds from short- to long-term financing via a promissory note. Given the loan criteria in question, it's imperative that we boost profitability and achieve our planning targets in the medium term. We have noticed that the banks are trying to tighten their interest terms, and we are also seeing a greater reticence to grant new credit lines or extend existing ones.

Bernd Rose: That will speed up the consolidation process, create new strategic openings and prevent any further expansion of capacity, especially in the gravure printing sector.

Which product would you most like to print?

Bernd Rose: Prestige products are always "expensive". That's why we prefer to avoid them. Our staff wouldn't understand it. We are not here to collect awards. We aim to run the company in a business-like fashion. Our objective is to keep our customers happy – not to make a particular print product. That is the corporate philosophy we have signed up to in the interests of everyone involved – both staff and especially shareholders, too.

The interview was conducted by Roland Tichy, editor-in-chief of WirtschaftsWoche, and Heike Schwerdtfeger, editor of Geld + Börse (Money + Exchange).