Research Update:
Swedish Forest Products Group SCA Rating Lowered To 'BBB' On Hygiene Business Spin-Off; Outlook Stable

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Overview

- On April 5, 2017, the Svenska Cellulosa Aktiebolaget SCA's shareholders voted to spin off its hygiene business segment, SCA Hygiene.
- We think that the remaining business, which will be a pure forest and paper products group, has a weaker business risk profile than the combined group, since the hygiene segment is more diversified and has stronger growth prospects.
- We are therefore lowering the long-term rating on SCA to 'BBB' from 'BBB+', affirming our 'A-2' short-term rating, and removing both from CreditWatch with negative implications.
- The stable outlook reflects our expectation that SCA will maintain a conservative expansion strategy and that its credit metrics will gradually improve following the current expansion phase at its Östrand pulp mill.

Rating Action

On April 7, 2017, S&P Global Ratings lowered its long-term corporate credit rating on Sweden-based forest and paper products group Svenska Cellulosa Aktiebolaget SCA to 'BBB' from 'BBB+'. The outlook is stable. We also affirmed our 'A-2' short-term rating on the group.

At the same time, we lowered our Nordic regional scale short-term rating on SCA to 'K-2' from 'K-1'.

We also removed all ratings from CreditWatch with negative implications where we placed them on Dec. 20, 2016 (see "Swedish Forest And Hygiene Group SCA Downgraded To 'BBB+' On Planned Acquisition; Ratings Put On Watch Negative," published on RatingsDirect.)

Rationale

The downgrade reflects our view that SCA's business risk profile has weakened as a result of the spin-off of its hygiene business segment, which was decided upon at the annual general meeting on April 5, 2017. The hygiene segment constituted around 86% of group sales in 2016 or Swedish krona (SEK) 101 billion (about €10.6 billion) and is one of the world's largest producers of tissue paper, incontinence products, and various personal care products, such
as baby diapers and feminine care products. The rest of the group had sales of SEK16.6 billion in 2016 and once the spin-off is complete, SCA will be a pure forest and paper products group, with its assets concentrated in Northern Sweden. We understand the formal separation will take place in the second half of 2017 and that the hygiene business will be listed on the Stockholm Stock Exchange under the new corporate name Essity, while the forest products group will maintain the SCA corporate name.

As a result of the spin-off, SCA will be a much smaller and less geographically diversified group with fewer growth opportunities than the hygiene business, which are the main reasons why we consider its business risk profile to be weaker than that of the combined group (and that of the stand-alone hygiene business). However, we still consider SCA's business risk profile to be strongly positioned in the forest and paper products industry, supported by its large forest land holdings and competitive industrial base. SCA is Europe's largest forest land owner with about 2.0 million hectares of productive land (equivalent to about 6% of Sweden's land area). We think that forest land is a defensive holding, which has real estate-like characteristics, since it appreciates in value over time while providing annual cash flows through the harvesting of logs that are sold to saw mills and the paper and pulp industry and as biofuel. In addition, the land can be used for other purposes, such as leasing to wind power plants. SCA's forest land is forward integrated into an industrial base, which consists of five saw mills, two pellets plants, two kraftliner mills, one pulp mill, and one publication paper mill. We think that SCA's industrial base is highly competitive in its respective segment, supported by low logistical costs due to nearby forest lands, with its saw mills delivering stronger margins than those of peers, such as Holmen and Stora Enso, while its two kraftliner mills (producing containerboard paper from virgin fibers) are well positioned in an attractive and growing market segment. We also note that its pulp mill at Östrand will be one of the world's largest and most efficient producers of northern bleached softwood kraft (NBSK) pulp following the current expansion that will result in annual capacity of 900,000 tons per year.

We consider that these strengths are partly mitigated by SCA's relatively high geographic concentration, with virtually all capacity based in Northern Sweden, relatively small size, and scope compared with industry peers, such as Stora Enso and UPM. Additionally, about 24% of net sales are derived from the structurally declining publication paper market (7% newsprint and 17% light-weight coated paper). We also note that SCA's industrial operations are exposed to a degree of cyclicality, in particular in the solid wood and the pulp segments, where prices can swing sharply from year to year.

We think that SCA will maintain a financial profile that will be at least as strong as before the split, with S&P Global Ratings' adjusted debt to EBITDA below 3.0x and funds from operations (FFO) to debt of above 30%. We think that SCA's financial risk profile is supported by the large forest land holdings, which had a book value of SEK31 billion at the end of 2016 and is appreciating over time as growth exceeds annual harvest. Besides providing annual cash flows through harvesting, we think that the forest land provides a high level...
of asset protection, since parts of it could be disposed if SCA for any reason would like to lower its leverage or use cash for expansion. We also note that SCA's forest land is conservatively leveraged, with a debt to debt and equity of less than 20%. This compares well with U.S.-based timber real estate investment trusts such as Potlatch Corp. and Weyerhaeuser Co., which have ratios of about 25%. For this, we apply a one-notch positive adjustment under our comparable ratings analysis modifier. We do not make any material adjustments to SCA's pro forma reported debt but don't exclude future adjustments in the future as we analyze full stand-alone audited accounts, although we do not expect them to be material.

In our base case, we assume:
• European economic growth of 1.7% in 2017 and 1.6% in 2018 supporting demand for SCA's products, since about 85% of sales are targeted to Europe.
• Stable demand for kraftliner, solid wood products, and pulp while we expect publication paper demand to decline by about 2%-3% per year.
• Stable pricing environment for kraftliner and newsprint, while light-weight coated paper, NBSK pulp, and solid wood products could face slight price pressure in 2017. We expect a stable Swedish krona exchange rate or about SEK9.50 to the euro and about SEK8.90 to the U.S. dollar.
• Net sales at about the same levels as in 2016 and EBITDA slightly higher at SEK2.7 billion (compared with SEK2.6 billion in 2016) for 2017. In 2018, we assume a slight sales increase and further improving EBITDA margin resulting in an EBITDA of close to SEK2.9 billion.
• Maintenance capital expenditures (capex) of about SEK800 million per year and growth capex of about SEK3.0 billion in 2017 and SEK2.0 billion in 2018, the vast majority which is for the pulp mill expansion at Östrand.
• Some dividends to be paid from 2018.

Based on these assumptions, we arrive at the following credit measures:
• FFO to debt of about 35% in 2017 and slightly lower in 2018, due to increasing debt as a result of negative discretionary cash flow stemming from the Östrand pulp mill expansion.
• Debt to EBITDA of about 2.5x.

Liquidity
We assess SCA's liquidity profile as strong following the split from the hygiene business, meaning that we think that the company will continue to cover its liquidity uses over the coming 12 months with liquidity sources at a ratio of at least 1.5x. We take into account SCA's large committed banking lines, its well-established relationships with local banks as well as its established position in the capital markets, albeit as a larger more diversified group. We also think that management will run SCA with a generally conservative financial policy and that its risk management should ensure strong liquidity coverage going forward.

We estimate that the company's liquidity sources for 2017 will consist of:
• Relatively low cash balance of SEK238 million as of year-end 2016;
• Access to SEK9.5 billion of revolving credit facilities with five Swedish
banks; and
• Forecast unadjusted FFO of about SEK2.3 billion in 2017.

The liquidity uses for 2017 will include:
• Limited short-term debt;
• Total capex of about SEK3.8 billion; and
• A potential working capital increase of SEK160 million.

Outlook

The stable outlook takes into account our expectations of higher debt and slightly weaker credit metrics in 2017 and 2018 as a result of the large pulp mill investment at Östrand, but that this will be partly moderated by slightly higher earnings. Although we expect SCA will pay dividends from 2018, we think that SCA will adhere to a balanced financial policy and maintain moderate leverage following the current investment phase.

Downside scenario

We could lower the rating if operating performance were to deteriorate to such an extent that we think the stable forest land holdings no longer balance the cyclical nature in SCA's industrial operations. This could for example occur as a result of a sharp and prolonged downturn on the solid wood products and pulp segments at the same time. We could also consider a lower rating if SCA's credit metrics were to deteriorate from the levels we forecast for 2017 and 2018. We think that such a scenario could materialize if SCA's profitability weakens and the final stages of the Östrand investment and ramp-up does not go according to plan. We would view a ratio of FFO to debt of below 30% for an extended period as commensurate with a lower rating.

Upside scenario

Although unlikely in the coming 24 months due to SCA's expected high investment levels, we could consider a higher rating if its financial risk profile were to sustainably strengthen, with FFO to debt remaining above 45% on a permanent basis. We would also expect that the company's financial policy would support stronger credit metrics and that the risk of extraordinary dividends or large acquisitions is low.

Ratings Score Snapshot

Corporate Credit Rating: BBB/Stable/A-2

Business risk: Satisfactory
• Country risk: Low
• Industry risk: Moderately high
• Competitive position: Satisfactory

Financial risk: Intermediate
• Cash flow/Leverage: Intermediate

Anchor: bbb-

Modifiers
• Diversification/Portfolio effect: Neutral (no impact)
• Capital structure: Neutral (no impact)
• Financial policy: Neutral (no impact)
• Liquidity: Strong (no impact)
• Management and governance: Satisfactory (no impact)
• Comparable rating analysis: Positive (+1 notch)

Related Criteria
• Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
• General Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014
• Criteria - Corporates - Industrials: Key Credit Factors For The Forest And Paper Products Industry, Feb. 12, 2014
• Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
• Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
• General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
• General Criteria: Methodology: Industry Risk, Nov. 19, 2013
• General Criteria: Group Rating Methodology, Nov. 19, 2013
• General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 07, 2013
• General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
• General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research
• Sweden-Based SCA Hygiene Preliminary 'BBB+/'A-2' And 'K-1' Ratings Affirmed And Extended; Outlook Stable, Jan. 24, 2017
• Sweden-Based SCA Hygiene Preliminary Long-Term Ratings Lowered To 'BBB+' On Proposed BSN Acquisition; Outlook Stable, Dec. 20, 2016
• Swedish Forest And Hygiene Group SCA Downgraded To 'BBB+' On Planned Acquisition; Ratings Put On Watch Negative, Dec. 20, 2016
• Sweden-Based SCA's Announced Spin-Off SCA Hygiene Assigned 'A-/A-2' Preliminary Ratings; Outlook Stable, Oct. 27, 2016
• What's Behind Recent Positive Rating Actions On European Forest And Paper Companies, Aug. 26, 2016
Ratings List

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.