

Research Update:

Forest Owner Svenska Cellulosa AB SCA Outlook Revised To Positive On Strong Market Momentum; Affirmed At 'BBB-/A-3'

May 17, 2021

Rating Action Overview

- In 2021, we expect Svenska Cellulosa AB SCA (SCA) will perform significantly above our previous expectations, driven by strong momentum across its end markets, with S&P Global Ratings-adjusted funds from operations (FFO) of 37%-42% at year-end 2021 and 26%-31% at year-end 2022.
- Nevertheless the heavy capital spending (capex) program the company is implementing until 2023 to expand its pulp and kraftliner production capacities will drive negative free operating cash flow (FOCF) in 2021 and 2022.
- We have therefore revised our outlook on SCA to positive from stable, and affirmed our long-term ratings on SCA and its senior unsecured notes at 'BBB-', our short-term rating at 'A-3', and our Nordic regional scale short-term rating at 'K-3'.
- The outlook is positive because we expect that SCA will maintain strong market positions, and EBITDA margins will improve to 28%-30%, fueled by strong price momentum across all end-markets and its exit from the publication paper business, with FFO to debt near 30% on a weighted average basis over the next 24 months.

PRIMARY CREDIT ANALYST

Guillaume Colomer
Milan
+393402116723
guillaume.colomer
@spglobal.com

SECONDARY CONTACT

Terence O Smiyan
London
+ 44 20 7176 6304
terence.smiyan
@spglobal.com

Rating Action Rationale

We forecast SCA's profitability in 2021 will be significantly above our previous expectations, spurred by higher prices across its end markets. We expect S&P Global Ratings-adjusted EBITDA margins of 28%-30% for 2021. The main driver will be increasing pulp prices, which are driven by the economic recovery globally, but particularly in China, and no new capacity coming onto the market before the end of the year. We also expect SCA's wood products division will see strong growth as demand for construction wood in North America drives prices up in Europe, which exports significant amounts to North America. Moreover, as an integrated producer, SCA is not negatively impacted by higher pulp prices on its containerboard production cost. Higher

production volumes across all business lines also mean better utilization rates and therefore a lower marginal cost. The closure of the weak-margin publication paper production line will furthermore positively affect margins in 2021.

SCA's current rating remains constrained by heavy investments in 2021 and 2022. The positive outlook signals the strengthening of credit metrics toward the intermediate financial risk profile category. However, SCA is currently investing Swedish krona (SEK) 7.5 billion in a new kraftliner line in Obbola over 2019-2023 and SEK1.45 billion in a chemi-thermo-mechanical pulp line in Ortviken over 2021-2023, with the bulk of investments taking place in 2021-2022 for both projects. As a result, we forecast negative FOCF generation until 2022. We also expect SCA will need to raise additional debt and draw additional funds on its existing bilateral export credit facility to finance those investments. Despite our estimate of FFO to debt near 40% in 2021 thanks to strong operating performance, we forecast this metric will fall below 30% in 2022 and 2023 as a result of the additional debt and softening end markets.

Environmental considerations are key to the sustainability of the company's business.

Environmental concerns are paramount to SCA given it is a forest products company. As Europe's largest private forestland owner, the group promotes sustainable forest management, and its growing forest binds a net of 5.4 million metric ton (mt) of carbon dioxide (CO₂) annually, which makes SCA a net absorber of CO₂ emissions. SCA also continuously invests in improving the energy efficiency of its industrial assets. The Östrand pulp mill, for example, is a net seller of green electricity and heating. SCA is also seeking to expand its renewable energy generation. In addition to biofuels production, the company leases out forestland for wind power projects.

We view governance as a supporting factor for the ratings. Our assessment as satisfactory reflects management's experience and expertise, governance in line with best practices, and the balance of different stakeholders' interests.

Outlook

The positive outlook reflects our expectation that SCA will maintain its strong market positions and EBITDA margins will improve to 28%-30%, fueled by strong price momentum across all end markets and its exit from the publication paper business. We forecast large capex levels will drive FOCF into negative territory in 2021 and 2022 and result in additional debt issuance. We therefore anticipate FFO to debt will be approach 30% on a weighted average basis over the next 24 months.

Upside scenario

We could raise the rating if operating performance sustainably improves to the extent that adjusted FFO to debt exceeds 30% on a sustained basis. This could happen in case of better than expected pricing across end markets in 2022 and 2023, which would drive better cash flows and reduce the need for additional debt. It could also result from lower capex than expected.

Downside scenario

We could take a negative rating action on SCA if adjusted FFO to debt fell and stayed below 30% for a prolonged period. This could result, for example, from a significant drop in demand, lower selling prices, cost pressure, capex overruns or unexpected maintenance-related production

standstills.

Company Description

SCA is a Swedish forward-integrated forest products company. It is Europe's largest private forest owner with about 2.6 million hectares of forestland (of which 2.0 million hectares are productive). The market value of the forest in Sweden and the Baltic countries is estimated at over SEK69 billion.

In 2020, SCA generated revenue of SEK18.4 billion and adjusted EBITDA of SEK3.2 billion. About 39% of its external sales related to paper (kraftliner and publication paper); over 34% to wood; and the remainder to pulp.

The group is the third-largest kraftliner manufacturer in Europe, with current investments aiming to increase capacity by a further 275,000 mt to a total of 725,000 mt by 2023. Although kraftliner prices are volatile (and somewhat correlated to testliner prices), we expect e-commerce, the transition to environmentally friendly materials from plastic packaging, and food safety regulations to continue fueling growth in the medium to long term.

In the first quarter of 2021, the group closed its publication paper mill in Ortviken, which we view as positive given that demand for publication paper had been in structural decline for many years.

SCA also operates five sawmills that transform the most valuable parts of trees into sawlogs. It has invested heavily in its sizable, efficient sawmills. Its wood products are sold to wood converters and traders (such as manufacturers of furniture, doors, and windows) and the building materials trade.

Following the expansion of the Östrand plant's annual pulp production capacity to 1 million mt, the volume of SCA's produced pulp increased significantly in 2019. SCA mainly focuses on northern bleached softwood kraft pulp, which is used for packaging, tissue, filter, and publication paper applications. The group also produces 100,000 mt of chemically pre-treated mechanical pulp (CTMP), used in hygiene and packaging products, with current investments aiming to increase capacity to 300,000 mt thanks to a new production line in Ortviken replacing the publication paper machine, and is expected to start operating in 2023.

SCA rents a small area of its forestland to wind-power operators, and is diversifying into the production of wood-based biofuels (largely used in its own plants).

Our Base-Case Scenario

Assumptions

- Real GDP growth in Europe of 4.2% in 2021 and 4.0% in 2022; real GDP growth in Sweden of 3.0% in 2021 and 2.8% in 2022; real GDP growth in Germany of 3.2% in 2021 and 3.7% in 2022.
- We expect revenue to decline by about 6.5%-7.5% in 2021 due to the termination of publication paper operations in first-quarter 2021 and the divestment of the U.K. wood trading business in November 2020. We expect only minor sales of publication paper to take place in 2021 to liquidate the existing stock. On a comparable basis, we forecast 21%-26% sales growth driven by significantly higher prices across all other divisions and marginally higher deliveries.
- We assume sales decline of about 5%-6% in 2022 due to lower selling prices as the market environment normalizes following the peak of 2021.

- A stronger adjusted EBITDA margin of 28%-30% in 2021 thanks to higher selling prices (in pulp, kraftliner, and wood). In 2022, we expect slightly lower EBITDA margins of 27%-29% as sales prices decrease.
- Working capital outflow of about SEK100 million-SEK200 million in 2021 driven by the revenue increase.
- Strategic capex of SEK3.5 billion-SEK4.0 billion in 2021 mainly due to the construction of a new kraftliner machine in Obbola and a new CTMP machine in Ortviken. Thereafter, we expect strategic capex to decrease to SEK2.0 billion-SEK3.0 billion in 2022. Annual maintenance capex is forecast at about SEK1.3 billion
- No net forestland acquisitions in 2021 and 2022.
- Annual dividend payments of SEK1.4 billion in 2021 and SEK1.6 billion in 2022.

Key metrics

- Adjusted debt to EBITDA of 2.3x-2.6x at year-end 2021, increasing to 3.0x-3.3x at year-end 2022.
- Adjusted FFO to debt of 37%-42% in 2021, falling to 26%-31% in 2022.
- Negative adjusted FOCF of about SEK1.3 billion-SEK1.8 billion in 2021, increasing to negative SEK0.1 billion-SEK0.6 billion in 2022.

Liquidity

The short-term rating is 'A-3', reflecting the long-term issuer credit rating and our assessment of SCA's liquidity as strong. We expect that liquidity sources will cover uses by more than 1.5x over the 12 months started March 31, 2021. Our view of SCA's liquidity is supported by the group's well-established relationships with banks and high standing in the credit markets.

Principal liquidity sources

- Cash balances of about SEK1.2 billion as of March 31, 2021.
- SEK7.1 billion available under committed credit facilities.
- Cash FFO of about SEK3.8 billion.

Principal liquidity uses

- Debt maturities of about SEK1.7 billion.
- Working capital outflows of SEK100 million-SEK200 million.
- Capex of about SEK4.7 billion.
- Dividends of about SEK1.4 billion to be paid out.

Issue Ratings - Subordination Risk Analysis

SCA's capital structure has no significant prioritized obligations and an intermediate financial risk profile. Therefore, we consider there is little risk that any lender will be significantly disadvantaged compared with other lenders.

Capital structure

The SEK10.3 billion debt (on March 31, 2021) included bank loans, bonds, and leases. Except for the SEK734 million in leases and SEK20 million in chattel mortgages, all of the debt is unsecured.

Analytical conclusions

With no contractual subordination and an intermediate financial risk profile, we rate SCA's unsecured obligations 'BBB-', in line with the issuer credit rating.

Ratings Score Snapshot

Issuer Credit Rating: BBB-/Positive/A-3

Business risk: Satisfactory

- Country risk: Low
- Industry risk: Moderately high
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb+

Modifiers

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

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Svenska Cellulosa AB SCA		
Issuer Credit Rating	BBB-/Positive/A-3	BBB-/Stable/A-3
Nordic Regional Scale	--/--/K-3	--/--/K-3
Senior Unsecured	BBB-	BBB-

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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on 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.

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