Research Update:

Svenska Cellulosa Upgraded To 'BBB/A-2' On Strong Performance And Pricing, Offsetting Investments; Outlook Stable

August 6, 2021

Rating Action Overview

- We revised upward our 2021 performance expectations for Svenska Cellulosa AB SCA (SCA) on higher-than-expected demand and prices across its end markets that should drive S&P Global Ratings-adjusted EBITDA margins close to 35.0%, from 17.5% in 2020.
- Thanks to the significantly stronger cash flow, SCA will finance its heavy capital expenditure (capex) program running until 2023 (to expand its pulp and kraftliner production capacities) with less debt, resulting in funds from operations (FFO) to debt comfortably above 30%.
- We therefore raised our long-term ratings on SCA and its senior unsecured notes to 'BBB' from 'BBB-', our short-term rating to 'A-2' from 'A-3', and our Nordic regional scale short-term rating to 'K-2' from 'K-3'.
- The outlook is stable because we expect that SCA will maintain strong market positions, and EBITDA margins will improve to 33%-35%, fuelled by volume and strong price momentum across all end-markets and its exit from the publication paper business, with FFO to debt comfortably above 30% over the next 24 months.

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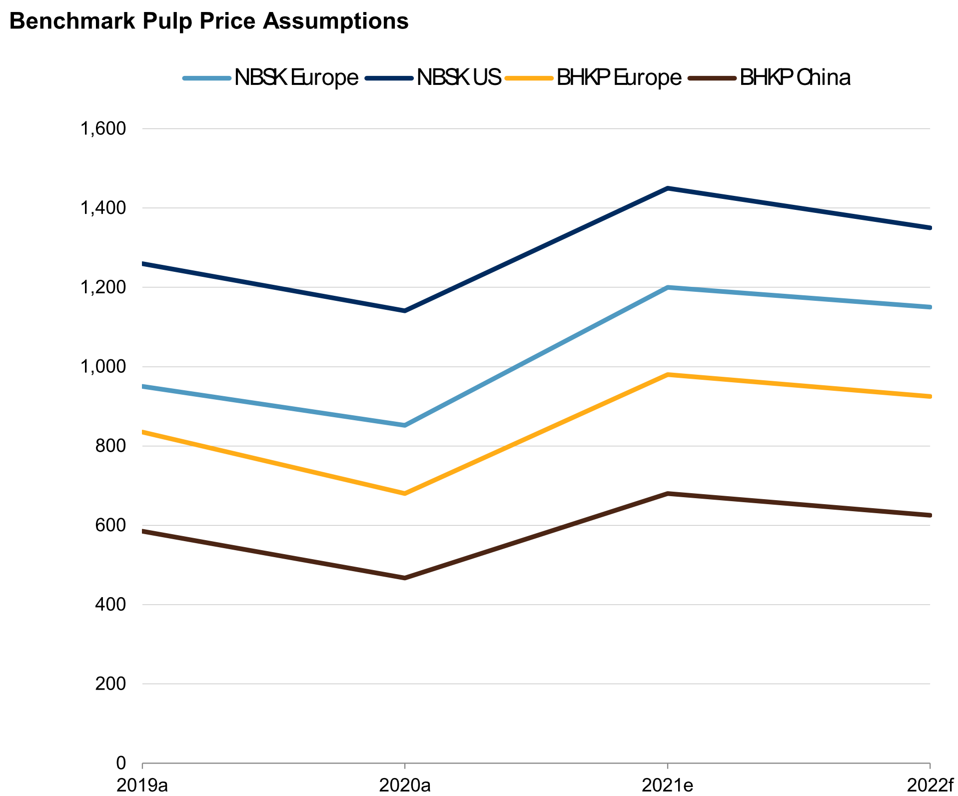
Rating Action Rationale

We revised upward our sales forecast for SCA in 2021, based on strong performance across all of its divisions. We now forecast SCA's sales to remain constant in 2021 despite the termination of its publication paper operations and divestment of its U.K. wood distribution operations (revenue of approximately Swedish krona [SEK] 4.5 billion in 2020) at the end of 2020. So, in 2021, we expect organic growth of the forest, wood, pulp, and containerboard divisions to compensate for nearly all of previous contributions from the assets sold. The main driver is the strong macroeconomic momentum globally following the COVID-19-related slump in 2020, as we are now seeing higher demand for wood-based products, either in the construction or packaging industry. Longer term, we expect global green trends to favor demand for wood-based products, which are eco-friendlier than fossil-based materials such as cement or plastic.

We expect S&P Global Ratings-adjusted EBITDA margins will climb to 34%-35% in 2021. The improvement will stem from higher topline that eases absorption of fixed costs. SCA takes full advantage of its high vertical integration since it produces more than half of its pulpwood and sawlogs needs that are then used in the production of solid wood products and pulp--the latter ultimately used in the making of kraftliner (containerboard division). In this context, SCA's operating margins are less volatile than that of peers with a higher proportion of outsourced wood. Moreover, compared with other players in the forest and paper industry, SCA's mix of end products requires less chemicals than the production of publication paper, for example; this further reduces the company's exposure to an increasingly expensive commodity. SCA's proprietary logistics system also allows it to suffer less of the container shortages seen in numerous parts of the world and therefore increase logistic cost. Moreover, the closure of the weak-margin publication paper production line will boost margins in 2021.

We see market correction as likely in the coming months, but we do not anticipate a massive fall. We expect the currently very strong impetus across the company's end markets to fade out over the coming months as demand for forest and paper products in Europe softens, similar to what we're observing in the U.S. and China, especially for plywood and pulp. Moreover, new supply will likely come into play in the near term, notably from the Latin American pulp market.



a--Actual. f--Forecast. E--Estimate.

We expect SCA's credit metrics to remain strong despite heavy investments in 2021-2022. Considering our assumptions of very solid operational performance in 2021, SCA will generate strong cash flow and would rely less on debt to finance its SEK7.5 billion kraftliner line in Obbola and SEK1.45 billion chemi-thermo-mechanical pulp line in Ortviken, with the bulk of the spending taking place in 2021-2022. We forecast free operating cash flow will remain negative in 2021, at around half a billion, before returning to positive SEK500 million in 2022. Consequently, we expect FFO to debt of above 50% in 2021 and of 35%-40% in 2022.

We continue to add one notch to the rating on SCA to reflect the credit strength of the company's extensive forestland assets. We view SCA's 2.6 million hectares in Sweden and the Baltics of forestland as a credit enhancement and a potential source of liquidity in a distressed situation, as has been the case for some of the company's Latin American peers. The company's timberlands have a book value of roughly SEK77 billion, which compares with S&P Global Ratings-adjusted net debt--including pension obligations and lease liabilities--of SEK10.2 billion as of June 30, 2021. Supporting our view is the recently increased interest of institutional investors in Swedish forest assets, which has pushed valuations significantly up and improved the liquidity of these assets. The very low debt to capital ratio of about 12% at end-June further strengthens our assessment. That said, SCA generates over 80% of its cash flow from industrial operations and sees its forest assets as core with no intention to sell them. This approach differs from timber real estate investment trusts (REITs) we rate in the U.S., such as Weyerhaeuser Co., Rayonier Inc,. and PotlatchDeltic Corp. We therefore do not see SCA as a timber REIT and continue to use FFO to debt as our main performance indicator.

Environmental considerations are key to the sustainability of SCA's business. 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 (CO_2) annually, which makes SCA a net absorber of CO_2 emissions. Furthermore, SCA 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 satisfactory assessment of SCA's governance reflects management's experience and expertise, adherence best practices, and the balance of different stakeholders' interests.

Outlook

The stable outlook reflects our expectation that SCA will maintain its strong market positions while its EBITDA margin improves to 33%-35%, fueled by strong price momentum across all end markets and its exit from the publication paper business. We anticipate FFO to debt will approach 40% on a weighted-average basis over the next 24 months.

Upside scenario

We see rating upside as rather limited at current ratings due to the group's scale, diversity and commodity exposure. So to consider a potential rating upside, the financial performance needs to be a long-term pillar, with public financial policies committing management to secure adjusted FFO to debt over 50% through the cycle while dividend and investment policies buffer price volatility.

Downside scenario

We could take a negative rating action on SCA if adjusted FFO to debt falls below 30% for a prolonged period. This could result, for example, from a significant drop in demand, lower selling prices, cost pressure, capital expenditure (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 SEK76 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 725,00 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, 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 4.6% in 2021 and 4.1% in 2022; real GDP growth in Sweden of 3.0% in 2021 and 2.8% in 2022; real GDP growth in Germany of 3.5% in 2021 and 4.9% in 2022.
- We expect revenue growth to be between -1% and +1% in 2021 as the termination of

publication paper operations and the divestment of the U.K. wood trading business in 2020 is more than compensated by higher pricing across all divisions and higher volumes, particularly in pulp. We expect only minor sales of publication paper to take place in 2021 to liquidate the existing stock. We also forecast a positive contribution from increased harvesting of SCA's own forest. On a comparable basis, we forecast around 20% sales.

- We assume sales will decline about 9%-11% in 2022 due to lower selling prices as the market environment normalizes following the peak of 2021.
- A stronger adjusted EBITDA margin of 33%-35% in 2021 thanks to higher selling prices (in pulp, kraftliner, and wood). In 2022, we expect slightly lower EBITDA margins of 30%-32% as sales prices decrease.
- Working capital outflow of about SEK700 million-SEK900 million in 2021 driven by the revenue increase, reverting to around SEK200 million in 2022.
- 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 billion-SEK3 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 1.6x-1.9x at year-end 2021, increasing to 2.2x-2.5x at year-end 2022.
- Adjusted FFO to debt of 52%-57% in 2021, reducing to 35%-40% in 2022.
- Negative adjusted FOCF of about SEK300 million-SEK800 million in 2021, increasing to positive SEK300 million-SEK800 million in 2022.

Liquidity

The short-term rating is 'A-2', 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 SEK500 million as of June 30, 2021.
- SEK8.9 billion available under committed credit facilities.
- Cash FFO of about SEK4.8 billion.

Principal liquidity uses:

- Debt maturities of about SEK1.1 billion.
- Working capital outflows of SEK400 million-SEK600 million.
- Capex of about SEK4.5 billion.

- Dividends of about SEK1.5 billion.

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 SEK11.0 billion debt (on June 30, 2021) included bank loans, bonds, and leases. Except for the SEK698 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/Stable/A-2

Business risk: Satisfactory

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

Financial risk: Significant

- Cash flow/Leverage: Intermediate

Anchor: bbb-

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
- 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: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Upgraded; Outlook Action

	To	From
Svenska Cellulosa AB SCA		
Issuer Credit Rating	BBB/Stable/A-2	BBB-/Positive/A-3
Nordic Regional Scale	--/--/K-2	--/--/K-3
Senior Unsecured	BBB	BBB-