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Research Update:

Forest Owner Svenska Cellulosa Affirmed At 'BBB/A-2' Despite Strong Performance; Outlook Stable

June 7, 2022

Rating Action Overview

- Svenska Cellulosa AB SCA (SCA) performed better than expected in 2021, fueled by strong end markets, which drove adjusted EBITDA margins to 38.5%, from 17.5% in 2020, and funds from operations (FFO) to debt to 72%, from 35% in 2020.
- In 2022, we expect SCA will continue to perform very strongly, still boosted by strong demand and pricing across all its end markets, but also benefitting from its high self-sufficiency rate in terms of wood sourcing, energy, electricity, and logistics, which together will drive FFO to debt above 80%.
- In 2023-2024, we forecast that lower prices will be partially compensated by the additional volumes coming from the ramp up of its new chemically pre-treated mechanical pulp (CTMP) line in Ortviken and containerboard (kraftliner) line in Obbola, supporting FFO to debt above 50%.
- Nevertheless, the rating remains constrained by lack of financial policy commitment to maintain credit metrics commensurate with a modest financial risk profile.
- We have therefore affirmed our 'BBB' long-term ratings on SCA and its senior unsecured notes, our 'A-2' short-term rating, and our 'K-2' Nordic regional scale rating.
- The outlook is stable because we expect that SCA will successfully execute its expansion projects over the next 24 months, which will support higher volumes, and partially compensate for expected price decreases.

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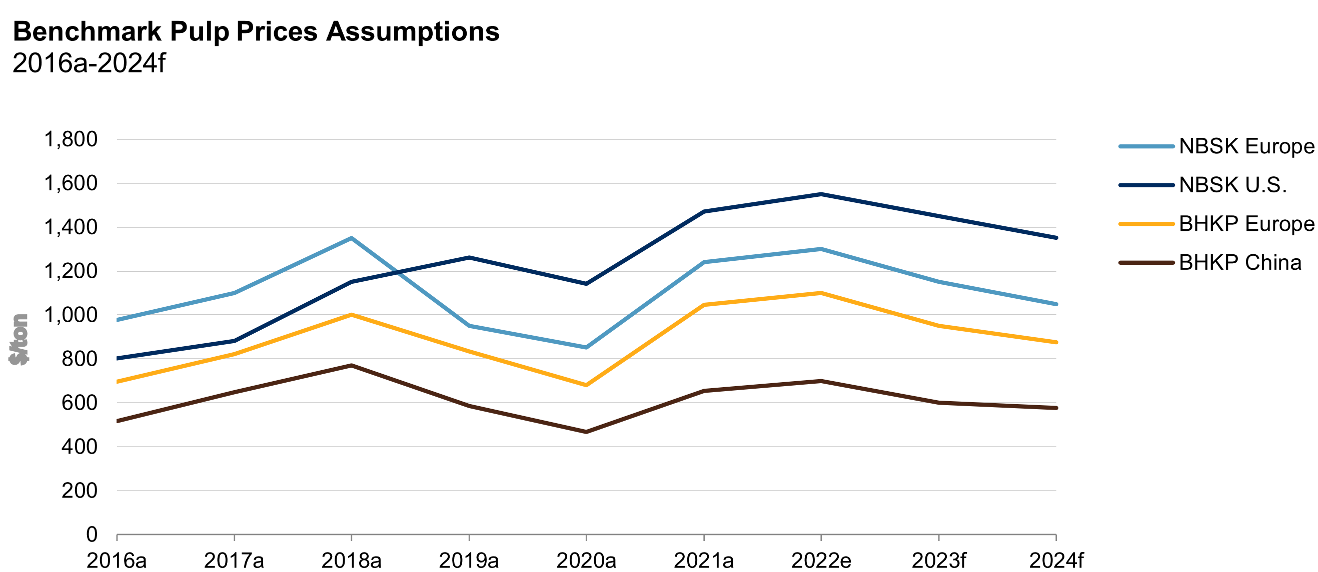
Rating Action Rationale

SCA's margin and cash flow performance in 2021 was above our expectations, boosted by higher prices and strong demand for all its products. Sales increased marginally by 2.2% to Swedish krona (SEK) 18.8 billion, and S&P Global Ratings-adjusted EBITDA margins more than doubled to 38.5%, from 17.5% in 2020. Sales growth was supported by like-for-like growth of

36.2%, which more than offset the 2020 disposal of its publication paper operations and its U.K.-based wood distribution business. Both divisions generated 25% of sales in 2020. EBITDA margins improved with the disposals (because they were low-margin businesses) as did revenue growth (thanks to better absorption of the fixed costs). This resulted in FFO to debt of 72% in 2021, compared with 35.7% in 2020. At €863 million, the group also generated much stronger free operating cash flow (FOCF) in 2021 than the negative €582 million we had anticipated.

We expect SCA's sales will increase significantly in 2022. We forecast sales growth of 17%-19% in 2022. The pulp division continues to benefit from strong demand and limited capacity additions. Pulp prices also benefitted from manufacturing disruptions due to strikes at Finland-based UPM-Kymmene Corp. and global challenges in transportation and logistics. Containerboard sales also benefitted from very high prices, due to growing demand for e-commerce and the general move away from plastic packaging. SCA's wood division, which mainly produces solid wood products for the renovation and maintenance of houses, is also expected to benefit from high global demand and reduced supplies from Russia, which previously exported 10 million cubic meters of wood per year.

Chart 1



NBSK--Needle bleached kraft pulp. BHKP--Bleached hardwood kraft pulp. a--Actual. e--Estimate. f--Forecast. Source: S&P Global Ratings.

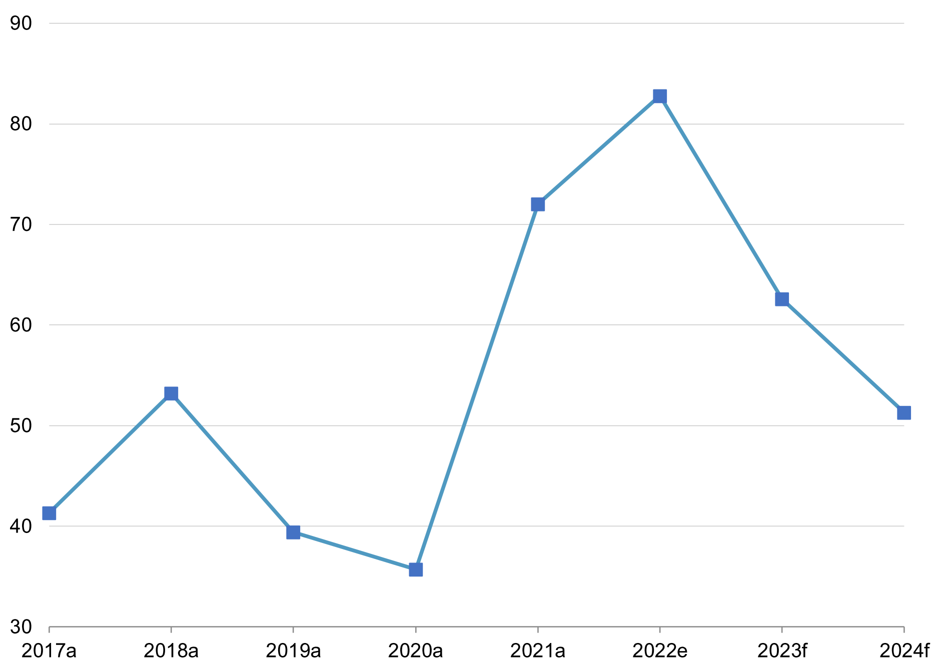
We forecast S&P Global Ratings-adjusted EBITDA margins will further progress in 2022, supported by SCA's high degree of self-sufficiency. We expect adjusted EBITDA margins of 39%-41% in 2022, driven by top-line growth, with better absorption of fixed costs, and prices increases, which we forecast will exceed cost increases. SCA's strong vertical integration partly insulates it from cost increases. Half of SCA's wood logs are internally sourced from its own forests and 30% are covered by long-term agreements with private forest owners in Sweden. Wood log prices are likely to increase, due to reduced supply from Russia, which used to export about 10 million cubic meters to Europe. SCA is well placed to cope with rising energy prices. It is

95% self-sufficient in terms of electricity as it generates electricity from its pulp activities and from wind turbines installed on its forest lands. The situation is similar regarding solid biofuels where the company is 100% self-sufficient, thanks to logging residue and wood fuel. Finally, SCA's own transport and long-term agreements with freight companies cover about 40% of its freight needs.

We expect credit metrics to remain strong, despite declining markets in 2023 and 2024. We expect prices for SCA's products will decline from 2023 due to economic slowdown and capacity additions. Nevertheless, we expect that these lower prices will be partially compensated by higher pulp and kraftliner volumes. The new 300,000 ton CTMP line in Ortviken is expected to start operations in the first quarter of 2023; the new 275,000 tons kraftliner line in Obbola is forecast to start in early 2023. Furthermore, the massive expansion capital expenditure (capex) related to these two projects will end in 2023. We therefore expect capex to reduce to about SEK3.1 billion in 2023 and SEK2.6 billion in 2024 from about SEK5.3 billion in 2022, boosting cash generation and consequently reducing debt and cash interest paid. All in all, we expect FFO to debt of 60%-65% in 2023 and 50%-55% in 2024.

Chart 2

SCA--FFO To Debt
2017a-2024f



a--actual. e-Estimate. f--forecast. Source: S&P Global Ratings.

We use a volatility adjustment to account for swings in prices through the cycle. SCA posted FFO to debt of more than 60% in 2021 and we expect it to do so again in 2022 and 2023, which is consistent with a minimal financial risk profile. However, we believe that FFO to debt could fall below 60% if pulp and paper prices decline or following material changes in its investment cycle. We therefore use our volatility adjustment to adjust the financial risk profile to modest. This results in a 'bbb+' anchor.

We see the rating as constrained by the lack of financial policy commitment. SCA does not have a clearly stated financial policy target. We therefore believe that credit ratios could deteriorate and become inconsistent with a modest financial risk profile. This could be caused by further shareholder returns, such as dividend payments or share buybacks, or large debt-funded investments. We therefore apply a one-notch negative financial policy modifier. This is in line with our approach for peers of the sector (UPM-Kymmene, Holmen, Metsa Board) and results in a stand-alone credit profile of 'bbb'.

We removed our positive comparable rating modifier as we believe the value of the company's extensive forestland assets is fully reflected within our satisfactory business risk profile assessment. SCA's 2.6 million hectares of forestland in Sweden and the Baltics provide the company with significant vertical integration. This results in higher margins than peers and somewhat compensates for its lower scale, asset base, and product diversification versus larger, more diversified groups like UPM Kymmene or Empresas CMPC.

Outlook

The stable outlook reflects our expectation that SCA will successfully execute on its expansion projects over the next 24 months. We expect these to drive higher volumes, and partially compensate for lower prices. SCA will also benefit from the progressive reduction of its capex, driving stronger cash flows and consequently lower debt. This will result in FFO to debt comfortably above 50% over the next 24 months.

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, capex overruns or unexpected maintenance-related production standstills.

Upside scenario

We see rating upside as rather limited at the current rating level due to asset breadth, diversity, and commodity exposure. So to consider a potential rating upside with such a business configuration, the financial performance needs to be a long-term pillar, with SCA's public financial policies committing to maintain ratios commensurate with a modest financial risk profile, such as minimum adjusted FFO to debt of 50%.

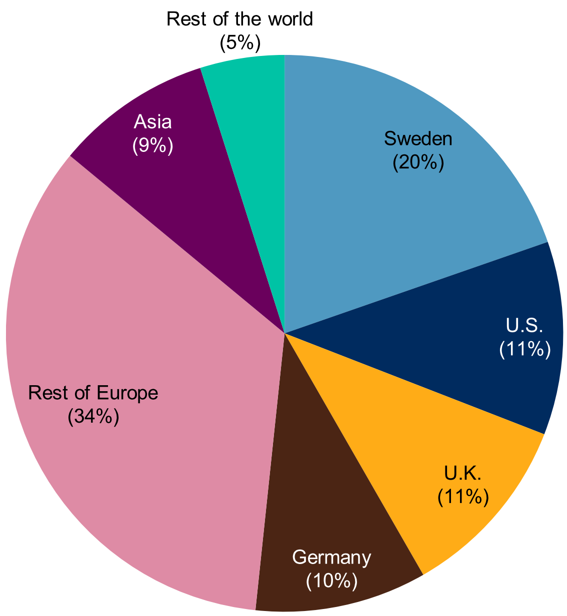
Company Description

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 SEK84 billion.

In 2021, SCA generated revenue of SEK18.8 billion and adjusted EBITDA of SEK3.2 billion. Its external sales relate to containerboard (kraftliner), wood products, and pulp.

Chart 3

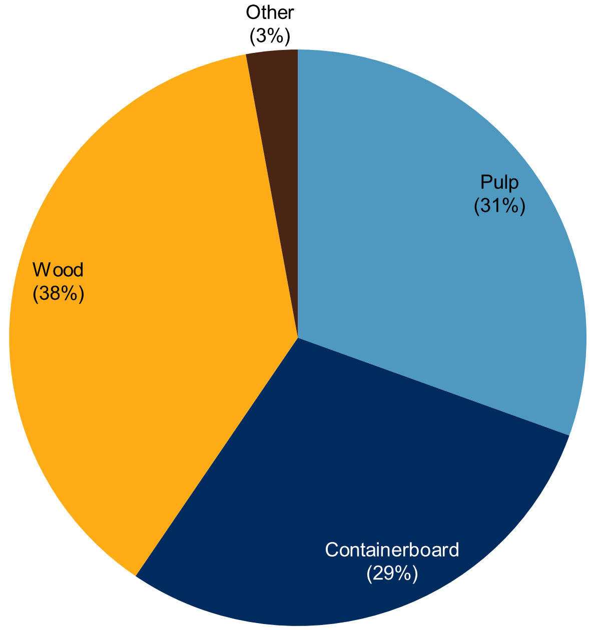
SCA--External Revenue Split By Geography
2021



Source: Company reports.

Chart 4

SCA--External Revenue Split By Segment
2021



The group is the third-largest kraftliner manufacturer in Europe, with current investments aiming to increase capacity by a further 275,000 metric tons (mt) to 1,140,000 mt by 2023. Although kraftliner [made from virgin pulp] prices are volatile and somewhat correlated to testliner (made from recycled paper) prices, we expect e-commerce, the transition to environmentally friendly materials away from plastic packaging, and food safety regulations to continue fueling growth.

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 sawn timber. 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 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 line, 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, which it largely uses in its own plants.

Our Base-Case Scenario

Assumptions

- Real GDP growth in Europe of 2.7% in 2022 and 2.2% in 2023; real GDP growth in Sweden of 3.0% in 2022 and 2.8% in 2023; real GDP growth in Germany of 1.9% in 2022 and 2.5% in 2023.
- We expect 17%-19% revenue growth in 2022, driven by higher prices across all businesses, particularly wood and kraftliner. We also forecast a positive contribution from increased harvesting of SCA's own forest. We assume sales decline of about 4%-6% in 2023 due to lower selling prices as the market environment normalizes following the peak of 2022.
- A stronger adjusted EBITDA margin of 39%-41% in 2022 due to higher selling prices in pulp, kraftliner, and wood. In 2023, we expect lower EBITDA margins of 32%-34% as sales prices decrease.
- Working capital outflow of about SEK500 million-SEK700 million in 2022 driven by the revenue increase, reverting to around SEK100 million in 2023.
- Strategic capex of about SEK4.0 billion in 2022 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 about SEK1.8 billion in 2023. Annual maintenance capex is forecast at about SEK1.3 billion.
- About SEK75 million net forestland acquisitions in 2022 and 2023.
- Annual dividend payments of SEK1.75 billion in 2022 and SEK1.9 billion in 2023.

Key metrics

- Adjusted debt to EBITDA of 1.0x-1.5x at year-end 2022 and year-end 2023.
- Adjusted FFO to debt of 80%-85% in 2022, reducing to 60%-65% in 2023.
- Adjusted FOCF of about SEK2.00 billion-SEK2.20 billion in 2022, increasing to SEK2.45 billion-SEK2.65 billion in 2023.

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, 2022. 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 SEK1.165 billion as of March 31, 2022.

- SEK5.5 billion available under committed credit facilities.
- Cash FFO of about SEK7.2 billion.

Principal liquidity uses

- Debt maturities of about SEK1.1 billion.
- Working capital outflows of SEK500 million.
- Capex of about SEK4.75 billion.
- Dividends of about SEK2.3 billion to be paid.

Environmental, Social and Governance

ESG credit indicators: E-2, S-2, G-2

ESG factors are an overall neutral consideration in our credit rating analysis of SCA. We believe SCA benefits from its extensive forest assets in Sweden. Its 2.6 million hectares of forest land bound 5.4 billion tons of CO_2 in 2021. Like other forest and paper companies, SCA faces long-term risks from climate change potentially affecting its forests. Nevertheless, we see SCA's Swedish forests as less exposed to this risk given its geographic position in Sweden's north. We see environmental risks coming from SCA's pulp and paper operations as these require significant amounts of energy, water, and chemicals. These risks are partially compensated by the CO_2 sequestration in its tree plantations and its use of fossil-free energy sources.

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 SEK10.4 billion debt as of March 31, 2022, included bank loans, bonds, and leases. Except for the SEK636 million in leases, 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: Modest

- Cash flow/Leverage: Modest

Anchor: bbb+

Modifiers:

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

Stand-alone credit profile: bbb

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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

Ratings Affirmed	
Svenska Cellulosa AB SCA	
Issuer Credit Rating	BBB/Stable/A-2
Nordic Regional Scale	--/--/K-2
Svenska Cellulosa AB SCA	
Senior Unsecured	BBB