

Research Update:

# Sweden-Based Forest Products Company SCA Downgraded To 'BBB-/A-3' On Expected Weaker Credit Metrics; Outlook Stable

September 7, 2020

## Rating Action Overview

- We believe Svenska Cellulosa Aktiebolaget SCA, which generated Swedish krona (SEK) 19.6 billion in revenue and adjusted EBITDA of SEK4.4 billion in 2019, will post lower revenue and EBITDA in 2020 and 2021 than we expected, primarily due to weaker market conditions.
- Moreover, we expect growth investments will constrain SCA's free operating cash flow (FOCF) and now forecast that adjusted leverage will exceed 3.0x and funds from operations (FFO) to debt will stay below 30% over 2020-2022.
- We are therefore lowering our long-term ratings on SCA and its senior unsecured notes to 'BBB-' from 'BBB', our short-term rating to 'A-3' from 'A-2' and our Nordic regional scale short-term rating to 'K-3' from 'K-2'.
- The outlook is stable because we expect that SCA will maintain strong market positions, and profitability will improve as the Östrand mill ramps up, it exits the publication paper business, and selling prices gradually recover, with FFO to debt above 20% over the next 24 months.

### PRIMARY CREDIT ANALYST

**Zoltan Lakos**  
Frankfurt  
(49) 69-33-999-193  
zoltan.lakos  
@spglobal.com

### SECONDARY CONTACT

**Desiree I Menjivar**  
London  
+ 44 20 7176 7822  
desiree.menjivar  
@spglobal.com

### ADDITIONAL CONTACT

**Industrial Ratings Europe**  
Corporate\_Admin\_London  
@spglobal.com

## Rating Action Rationale

**S&P Global Ratings expects a sharp decline in SCA's revenue and EBITDA margins in 2020.** The COVID-19 pandemic has accelerated the decline in demand for publication paper. SCA has just announced its plan to stop all publication paper production by converting its paper mill in Ortviken into a chemical-thermomechanical (CTMP) pulp mill. The pandemic has also diminished global economic growth prospects and weighed on paper and pulp prices. We therefore expect a revenue decline of 7.5%-9.5% and a decrease in our adjusted EBITDA margins for SCA to 14.5%-15.5% in 2020 from 22.3% in 2019. Given the transformational nature of the plant conversion, our adjusted EBITDA figure for 2020 excludes SEK1.1 billion-SEK1.2 billion of expenses related to the closure of the Ortviken mill.

**High investment spending related to the Obbola kraftliner mill expansion and the Ortviken CTMP project will constrain FOCF generation in 2020-2022.** Over 2019-2023, SCA is investing SEK7.5 billion to fund a new paper machine and develop the infrastructure at its kraftliner mill in Obbola, of which about SEK900 million was already spent in 2019. The group is also planning to build a 300 kilo ton per year CTMP line on the Ortviken mill site for SEK1.45 billion over 2021-2023. Although we expect a significant EBITDA contribution from both projects once they start operating in 2023, these investments will constrain FOCF generation in the near to medium term.

**Our adjusted debt to EBITDA metric is set to remain at 3.5x-3.8x and our adjusted FFO to debt at 24%-27% over 2020 and 2021.** We expect our adjusted leverage ratio for SCA to increase to 3.5x-3.8x by Dec. 31, 2020, from 2.1x at year-end 2019. We then forecast EBITDA growth will allow the group to deleverage to 3.3x-3.6x by year-end 2021. We forecast adjusted FFO to debt at 24%-27% in both years. The EBITDA improvement in 2021 will primarily stem from higher pulp prices and ramp-up of the Östrand pulp mill. For these forecasts, we also assume the group will raise additional debt to fund its expansion projects.

**In our view, the value of the company's extensive forestland assets is not fully reflected in our anchor** We therefore apply a one-notch positive adjustment to our anchor as part of our comparable ratings analysis. We view SCA's 2.6 million hectares of forestland as credit enhancing, because it could provide a potential liquidity buffer. Although SCA views its forestland as core and does not intend to sell it, we believe forest asset sales could generate significant cash proceeds in a distressed situation.

## Outlook

The stable outlook reflects our expectation that SCA will maintain its strong market positions and its profitability will improve as a result of the Östrand mill ramp-up, its exit from publication paper, and the gradual recovery of selling prices. We anticipate FFO to debt will exceed 20% over the next 24 months.

## Downside scenario

We could lower our rating on SCA if profitability deteriorated, such that adjusted FFO to debt fell and stayed below 20% for a prolonged period. This could result, for example, from a significant drop in demand, lower selling prices, cost pressure, or unexpected maintenance-related production standstills.

## Upside scenario

We could take positive rating action if operating performance improved to the extent that adjusted FFO to debt exceeded 30% on a sustained basis.

## 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 SEK70 billion.

In 2019, SCA generated revenues of SEK19.6 billion and adjusted EBITDA of SEK4.4 billion. About 47% of its external sales relate to paper (kraftliner and publication paper); over 32% to wood; and the remainder to pulp. The group recently announced that it is closing its publication paper operations. The group is the third-largest kraftliner manufacturer in Europe. 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.

## **Our Base-Case Scenario**

### **Assumptions**

- Negative real GDP growth in the eurozone of 7.8% in 2020, and a return to 5.5% growth in 2021.
- A revenue decline for SCA of 7.5%-9.5% in 2020, due to lower average prices in all segments and a substantial decline in demand for publication paper. We expect this to be only partly offset by an increase in pulp deliveries from increased production at the Östrand mill. We assume that revenues will decline by 10.5%-12.5% in 2021 as the group exits the publication paper segment, and that this will be only partly offset by higher pulp prices and volumes.
- Adjusted EBITDA margin to decline to 14.5%-15.5% in 2020 from 22.3% in 2019, as a result of lower prices and lower sales of publication paper. In 2020, we exclude SEK1.1 billion-SEK1.2 billion of restructuring costs from our adjusted EBITDA figure. We expect EBITDA margins to recover to 22.5%-23.5% in 2021 on the back of an improved product mix after the exit of publication paper, price improvements, and a stronger cost position at Östrand.
- Capital expenditure (capex) of about SEK2.7 billion in 2020 and about SEK3.8 billion in 2021.
- Working capital inflow of SEK200 million in 2020 and flat working capital needs in 2021.
- No dividend paid in 2020 and a payout of about SEK1.4 billion in 2021.

### **Key metrics**

- Adjusted debt to EBITDA of 3.5x-3.8x in 2020 and 3.3x-3.6x in 2021.
- Adjusted FFO to debt of 24%-27% in 2020 and 2021.

### **Liquidity**

The short-term rating is 'A-3', reflecting the long-term issuer credit rating and our assessment of SCA's liquidity as adequate. We expect that liquidity sources will cover uses by more than 1.2x over the 12 months started June 30, 2020. 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 SEK236 million as of June 30, 2020.
- SEK5.8 billion available under committed credit facilities.

- Cash FFO of about SEK2 billion.
- Working capital inflows of SEK100 million-SEK200 million.

### **Principal liquidity uses**

- Debt maturities of about SEK3.7 billion.
- Capex of about SEK2.8 billion.

### **Issue Ratings--Subordination Risk Analysis**

#### **Capital structure**

As of June 30, 2020, SCA's capital structure comprised about SEK8.8 billion of unsecured debt.

#### **Analytical conclusions**

The senior unsecured medium-term notes issued by the parent company are rated 'BBB-', the same as the issuer credit rating, since no sources of significant subordination have been identified.

#### **Ratings Score Snapshot**

Issuer Credit Rating: BBB-/Stable/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: Adequate (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

### Downgraded

	To	From
<b>Svenska Cellulosa Aktiebolaget SCA</b>		
Issuer Credit Rating	BBB-/Stable/A-3	BBB/Stable/A-2
Nordic Regional Scale	K-3	K-2
Senior Unsecured	BBB-	BBB

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