Spotlight: Klabin — Factors Leading Back To Investment Grade Ratings

Four Scenario Analyses Undertaken

Scenario Analysis: Fitch Ratings analyzes different operating and financial scenarios to assess the resilience of Klabin's credit profile at the current rating level and what situations could trigger an upgrade to investment grade. Given the issuer's 'BB+' rating and Stable Outlook, Fitch does not consider these scenarios likely over the medium term. Therefore, the purpose of this analysis is to illustrate situations regarding pulp prices, a potential new investment cycle, and the effects of both on the company's credit metrics.

Four Situations: Fitch analyzed four scenarios to assess the resilience of Klabin's credit profile at the current rating level. The first considers pulp prices of USD575/ton at the Paranagua port in 2018 and USD600/ton in 2019, with no relevant investments. The second scenario includes the same pulp prices with a new investment cycle beginning in 2019. The third and fourth scenarios are the same as the first and second, respectively, but assume pulp prices that are USD100 lower.

Recent Rating Downgrade: In May 2017, Fitch downgraded Klabin's ratings to 'BB+' with a Stable Outlook from 'BBB–' with a Negative Outlook. Although a positive rating action is not expected in the medium term, higher than expected cash generation during 2018 and 2019, allowing for consistent and faster deleveraging, may positively affect the ratings. Proactive steps by the company to materially bolster its capital structure in the absence of higher operating cash flow could lead to an upgrade.

Leverage Reduction Slow: The downgrade reflected the company's high leverage following the startup of the Puma pulp mill and slower-than-expected deleveraging due to weaker pulp prices, a strong Brazilian real and a weak consumer market for packaging products. Fitch estimates Klabin's net leverage remained elevated at about 4.5x for 2017 and will fall to about 3.0x for 2018 due to higher pulp prices. Fitch's base case scenario incorporates a period of lower capex before entering a new investment phase. If the company decides to move forward with a new investment cycle, deleveraging will be delayed beyond the base case expectation. During the LTM ended Sept. 30, 2017, net debt/EBITDA was 4.7x.

Leading Position in Packaging Segment: Ratings are supported by a leading position in Brazil's (BB/Negative) packaging sector, a large forestry base providing a low production cost structure, access to inexpensive fiber and a high degree of vertical integration, which enhances product flexibility in the competitive but fragmented packaging industry. Klabin is the leader in the Brazilian corrugated boxes and coated board sectors. In the Brazilian market, the company is the sole producer of liquid packaging board and is the largest producer of kraftliner, multiwall and industrial bags. The company's 1.5 million-ton Puma pulp mill started operations in 2016.

Exposure to Demand from Local Market: Klabin is more exposed to demand from the local market than other Latin American pulp and paper companies as about 60% of sales are in Brazil. The company's size, its concentration of sales to the food industry, which is relatively resilient to downturns in Brazil's economy, and its position as the sole producer of liquid packaging board adds stability to operating results. Klabin's exposure to pulp accounts for the balance of revenue.

Solid Liquidity: The company's solid liquidity position and low refinancing risk benefit its ratings. The debt maturity schedule is manageable and evenly distributed. Fitch expects Klabin to continue to preserve strong liquidity, conservatively positioning the company in regard to price and demand volatility, which is inherent to the packaging industry.

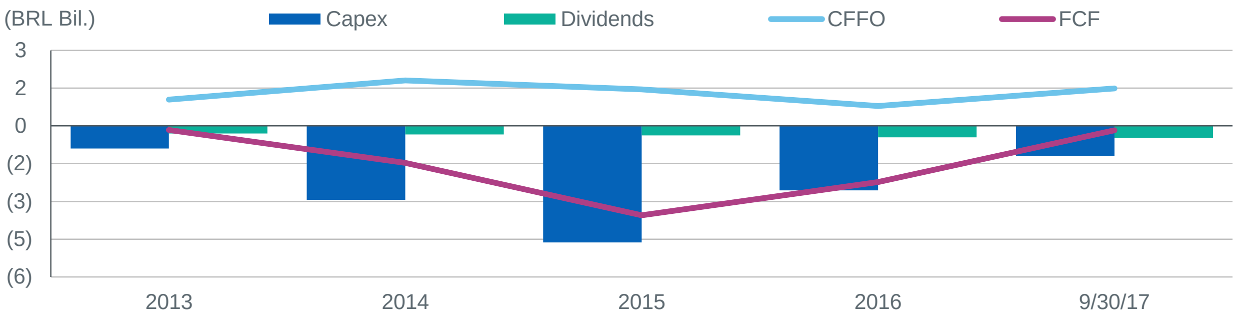
Pulp Pricing Approach: Fitch's price assumptions are not made to predict the actual commodity price but to provide a range of foreseeable operational and financial profiles commensurate with a rating level expected to persist through pulp cycles. The ratings have a standard five-year rating horizon. For years one to three of the rating horizon, Fitch typically uses conservative market-based commodity prices.

Recent Rating Downgrade

Commodity producing companies' credit profiles are typically analyzed through supply and demand dynamics and pricing cycle. This allows tolerance for peaks in leverage over one to two year periods when a return to credit metrics commensurate with the rating level is anticipated. Weaker than normal capital structures are typically demonstrated when a low pricing cycle coincides with a period of heavy investment, as was the case for Klabin S.A. during 2015 to 2017. Fitch revised Klabin's rating Outlook to Negative from Stable in May 2016. Ratings were downgraded in May 2017 to 'BB+' with a Stable Outlook from 'BBB–' with a Negative Outlook as credit metrics deteriorated and leverage did not decline as anticipated. Net leverage declined to 4.7x in the LTM ended Sept. 30, 2017 from 5.6x in 2016 and 6.6x in 2015. This was above Fitch's expectation of leverage declining to below 3.0x in 2017.

Klabin conducted a BRL8.3 billion capex project from 2013 to 2017 to expand production capacity. The Puma pulp mill began operations in March 2016 and added an annual production capacity of 1.5 million tons of pulp, or 1.1 million tons of hardwood pulp and 400,000 tons of softwood pulp, which can be converted to fluff. The mill has low transportation costs and is among the lowest cost mills in Brazil. This growth capex coincided with low pulp prices, delaying the deleveraging process.

Cash Flow Performance



CFFO – Cash flow from operations.
Source: Klabin S.A., Fitch.

Scenarios Undertaken

Fitch constructed four scenarios to illustrate Klabin's credit metrics under various operating environments. Key differences between the scenarios are the different pulp prices used and the company's decision to enter into a new investment cycle. Klabin is currently analyzing three expansion projects, including new production capacity of coated board, kraftliner or fluff. The company is expected to make a decision during 1H18. Estimated investments for the projects are still not available.

Assumptions remaining constant through all four scenarios include volumes sold for packaging products and pulp; prices for coated boards, kraftliner, corrugated boxes and industrial bags; a currency exchange rate of BRL3.2/USD1.0 in 2017 and BRL3.3/USD1.0 in 2018; and dividends paid at 20% of EBITDA. Fitch considered relatively flat sales volume for packaging products, close to full capacity, and some recovery of prices. For pulp, the company is expected to operate at full capacity. Klabin's liquidity position remains strong in the four different scenarios and is never expected to fall below BRL5 billion. Fitch also considered the conversion of the 6th debentures issuance into equity in January 2018.

Scenario One

Fitch used base case assumptions for pulp prices at the Paranagua Port and no expansion project.

Scenario Two

Fitch used base case assumptions for pulp prices at the Paranagua Port and a new investment cycle starting in 2019. Fitch considered the assumption of USD1 billion in investments, with 70% invested in 2019 and 30% in 2020.

Scenario Three

Fitch used stress case assumptions for pulp prices at the Paranagua Port and no expansion project.

Scenario Four

Fitch used stress case assumptions for pulp prices at the Paranagua Port and a new investment cycle starting in 2019. Fitch considered the assumption of USD1 billion in investments, with 70% invested in 2019 and 30% in 2020.

Pulp Prices Assumptions (Paranagua Port)

(USD/Ton)		2017	2018	2019	2020	2021
Scenario One	Hardwood Pulp	475	575	600	625	575
	Softwood Pulp	500	600	625	650	600
Scenario Two	Hardwood Pulp	475	575	600	625	575
	Softwood Pulp	500	600	625	650	600
Scenario Three	Hardwood Pulp	475	475	500	525	475
	Softwood Pulp	500	500	525	550	500
Scenario Four	Hardwood Pulp	475	475	500	525	475
	Softwood Pulp	500	500	525	550	500

Source: Fitch.

Capex Assumptions

(BRL Mil.)	2017	2018	2019	2020	2021
Scenario One	1,077	1,042	1,150	900	945
Scenario Two	1,077	1,042	3,460	1,890	945
Scenario Three	1,077	1,042	1,150	900	945
Scenario Four	1,077	1,042	3,460	1,890	945

Source: Fitch.

Scenario Results

The results of four different scenarios are shown in the charts below. In all scenarios, Klabin's EBITDA generation capacity will improve compared to 2017 and the company will be able to reduce leverage. However, the deleveraging pace will vary in the different scenarios.

Scenario One

In scenario one, leverage reduction will be faster than in the other three scenarios, supported by higher pulp prices and low investments. Net leverage should be close to 3.0x in 2018, and decline to below 2.5x in the following years. A positive rating action could be considered as Klabin consistently preserves net leverage below 2.5x through the cycle. The net leverage average was 5.6x between 2015 and 2017, compared to a historical level of 2.7x between 2010 and 2014. Fitch would like to see operating cash flow generation used to pay down gross debt, with the maintenance of lower leverage for a longer period, for a potential positive rating action.

Scenario Two

Scenario two incorporates a new investment cycle and net leverage would remain around 3.0x to 3.5x during a higher capex period. These ratios are still adequate for the 'BB+' rating and ratings downgrades are unlikely. In Fitch's opinion, Klabin's robust liquidity, conservative debt amortization profile and strong operating cash flow generation should allow the company to increase capex without a significant negative effect on credit metrics. Fitch views this case as the most likely scenario. The expansion plans, strategic to Klabin, will further strengthen a leading market position in the packaging business as the company maintains a strong balance sheet to absorb a period of higher investments.

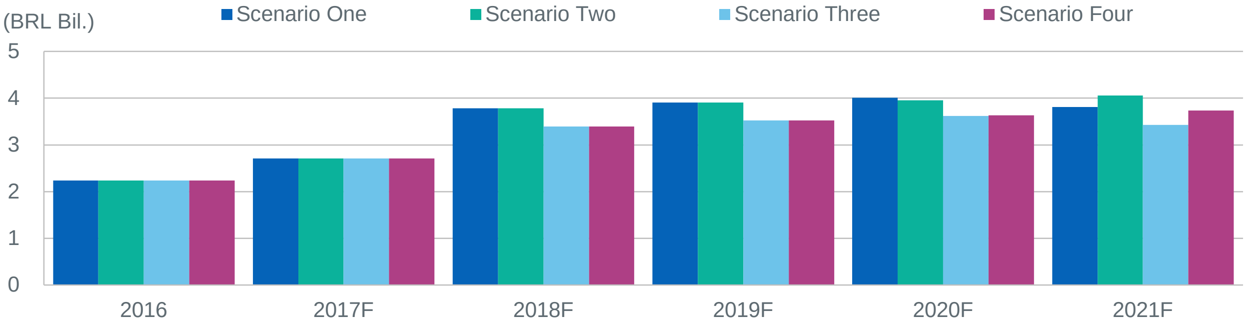
Scenario Three

Scenario three is pressured by weaker pulp prices and lower EBITDA generation of about BRL400 million per year compared with the base case price assumption considered in scenarios one and two. Still, low investments support strong cash generation that will allow net leverage to remain close to 3.0x.

Scenario Four

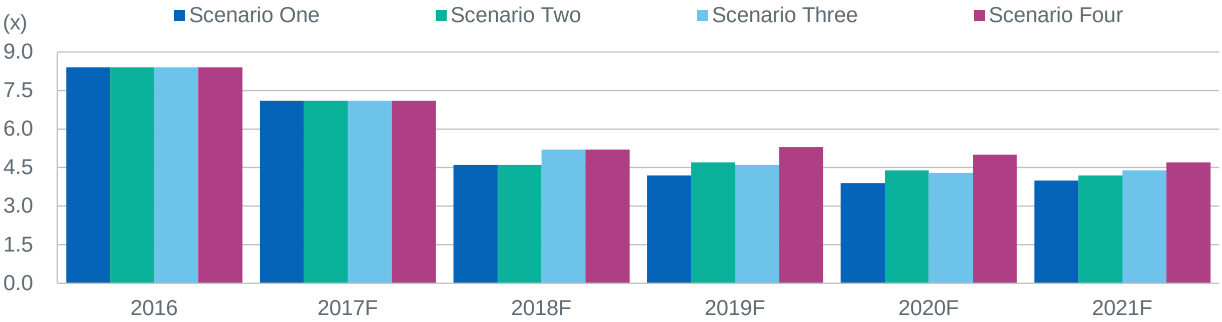
Scenario four is the weakest picture, pairing a low pricing cycle together with a period of higher investments. Under this scenario, Klabin's gross leverage would remain above 5.0x, while net leverage would be close to 4.0x. Fitch's expectation for leverage reduction after the completion of the expansion project will determine future rating actions.

EBITDA



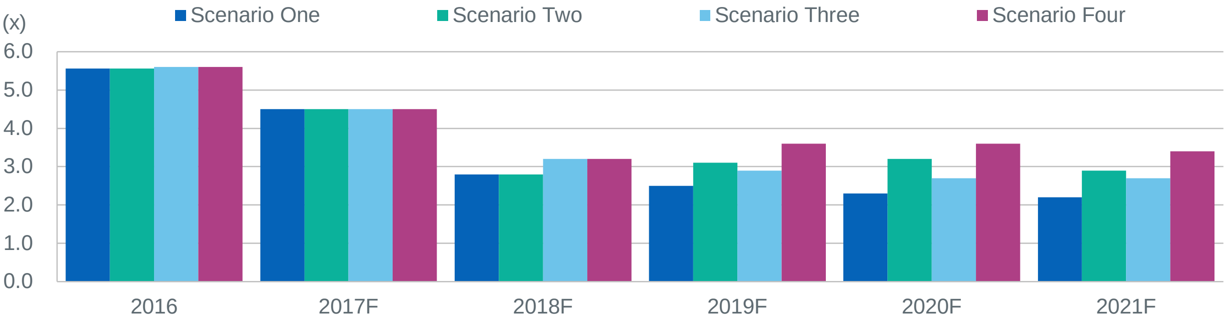
F – Forecast.
Source: Klabin S.A., Fitch.

Gross Leverage



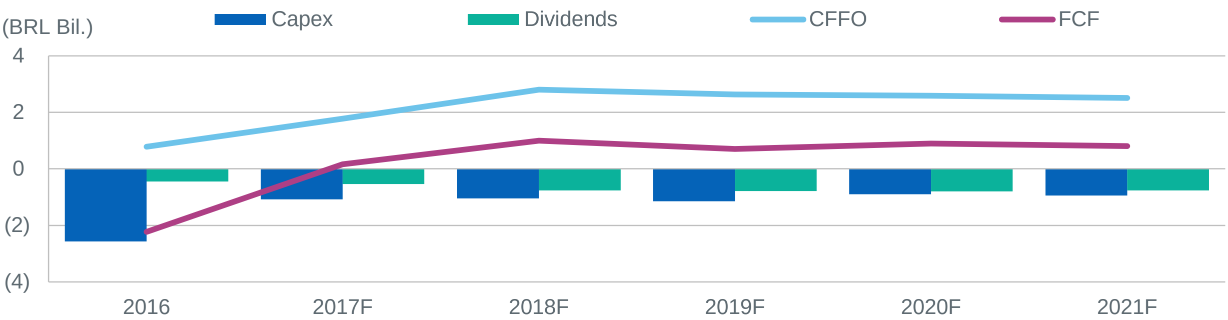
F – Forecast.
Source: Klabin S.A., Fitch.

Net Leverage



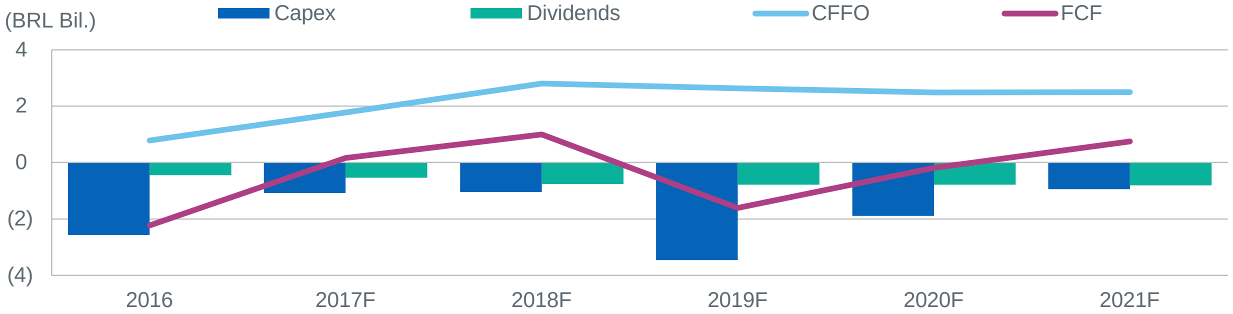
F – Forecast.
Source: Klabin S.A., Fitch.

Scenario One: Cash Flow Performance



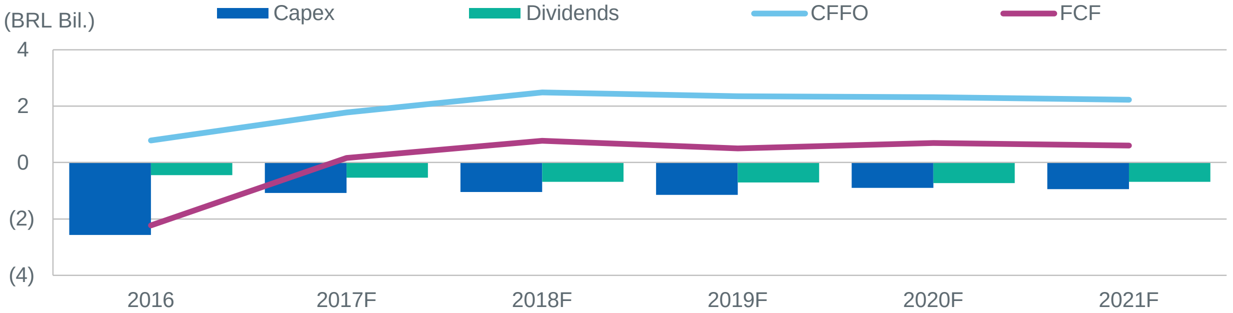
CFFO – Cash flow from operations. F – Forecast.
Source: Klabin S.A., Fitch.

Scenario Two: Cash Flow Performance



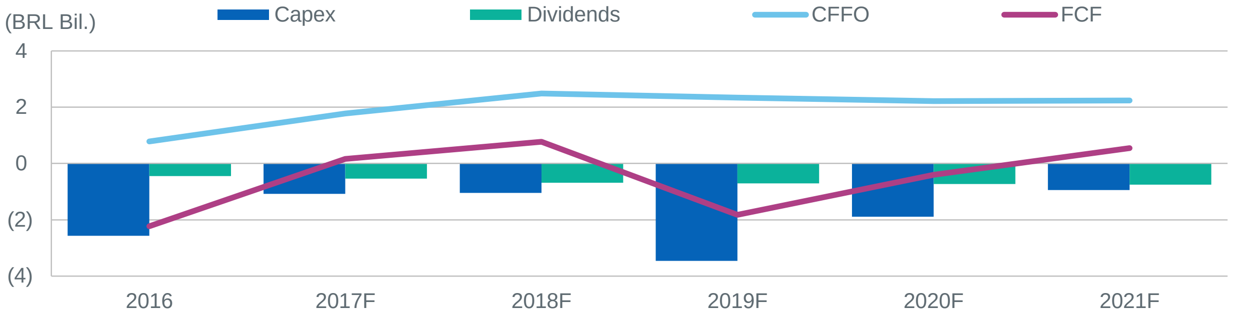
CFFO – Cash flow from operations. F – Forecast.
Source: Klabin S.A., Fitch.

Scenario Three: Cash Flow Performance



CFFO – Cash flow from operations. F – Forecast.
Source: Klabin S.A., Fitch.

Scenario Four: Cash Flow Performance



CFFO – Cash flow from operations. F – Forecast.
Source: Klabin S.A., Fitch.

Summary

The four scenarios above point to the conclusion Klabin is in a strong position to start a new investment cycle and to continue to generate strong operating cash flow, even in an environment of lower pulp prices. The 'BB+' ratings are consistent with the four scenarios analyzed in this exercise.

A rating upgrade to investment grade could be triggered in scenario one. However, positive rating actions are not expected until Klabin reduces gross debt, accumulated in the past few years to finance the pulp project, and lower net debt to below 2.5x through the cycle, combined with the maintenance of strong liquidity and debt coverage. Fitch considers a rating downgrade unlikely for Klabin under any of the four scenarios presented.

Outlooks

www.fitchratings.com/outlooks
Fitch 2018 Outlook: Latin America Pulp, Paper and Forest Products (The Beginning of a New Cycle) (November 2017)

Related Research

Corporate Rating Criteria (August 2017)
Latin America Pulp, Paper and Forest Products Handbook (November 2017)
Latin American Pulp, Paper and Forest Products Peer Comparison (Low Cost Position Supports Investment Grade Ratings Despite Negative Trends) (October 2016)

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