04 May 2020 | Affirmation

Fitch Affirms Klabin's Ratings at 'BB+'; Outlook Stable

Fitch Ratings-Rio de Janeiro-04 May 2020:

Fitch Ratings has affirmed Klabin S.A.'s Long-Term Foreign and Local Currency Issuer Default Ratings (IDR) at 'BB+' and national scale long-term rating at 'AAA(bra)'. Fitch also affirmed the 'BB+' to Klabin Finance S.A. and Klabin Austria Gmbh's senior notes, guaranteed by Klabin. The Rating Outlook for the corporate ratings is Stable.

Klabin's ratings reflect the company's leading position in the Brazilian packaging sector, 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. Because of its strong market business position in packaging products and integrated operations, Klabin is a price leader in the domestic market and is able to preserve more stable sales volume and operating margins during more instable economic scenarios in Brazil than its competitors, which have significantly lower scale of operations and high exposure in production costs. The company also benefits from its position as a low-cost producer of market pulp, in the lowest quartile, and maintains pulp production volumes above 90% of nominal capacity.

Klabin's solid liquidity position and low refinancing risk remain key credit considerations. The analysis considers the investments in the Puma II project, which will further strengthen the company's leading market position in the packaging business. Klabin's EBITDA fell to BRL3.6 billion during 2019, as per Fitch's calculations, from BRL4.0 billion in 2018 as a result of the weak price environment. Due to the drop in EBITDA plus the increase in capex for the project, Klabin's net debt increased to BRL14.5 billion from BRL12.5 billion and its net leverage ratio increased to 4.1x from 3.1x, according to Fitch's criteria. This amount of net debt and the leverage ratios remain within Fitch's expectation in the midst of the project and result in the maintenance of a Stable Rating Outlook.

The Stable Rating Outlook reflects Fitch's expectation of strong operating cash flow, despite the severe economic downturn and weak pulp prices, benefiting from the depreciation of Brazilian real. Fitch expects a limited impact on Klabin's packaging business due to the coronavirus pandemic. Krafliner, coated board and corrugated boxes' demand should remain relatively stable, supported by the company's leading position and diversified client base in the more resilient food sector. Industrial bags is the only segment that will be significantly affected by weaker demand; this segment represented 8% of Klabin's sales in 2019.

Key Rating Drivers

Leading Position in the Brazilian Packaging Segment: Klabin is the leader in the Brazilian corrugated boxes and coated board sectors with market shares of 18% and 50%, respectively. In the Brazilian market, the company is the sole producer of liquid packaging board and is the largest producer of kraftliner and industrial bags, with market shares of 42% and 56%, respectively. In Fitch's opinion, the expansion project is very strategic for Klabin and will add 920,000 tons of annual production capacity of kraftliner by 2023, positioning the company as the world's third largest kraftliner paper producer. Klabin's strong market shares allow it to be a price leader in Brazil. The company's competitive advantage is viewed as sustainable due to its scale, high level of integration and diversified client base in the more resilient food sector. This allows Klabin to preserve EBITDA margins above 30% throughout the cycle, while small players have margins below 15%.

Pulp Mill and Forestry Assets Positive Rating Considerations: Klabin has a 1.6 million-ton pulp mill that started operations in 2016. Klabin sources much of its fiber requirements from hardwood and softwood trees grown on 248,000 hectares of plantations it has developed on 542,000 hectares of land it owns; this ensures a competitive production cost structure in the future. During fourth-quarter 2019, the company's cash cost of production was USD167 per ton, which placed it firmly in the lowest quartile of the cost curve. The accounting value of Klabin's land was about BRL2.2 billion as of Dec. 31, 2019, and the value of the biological assets on its forest plantations was BRL4.7 billion. If needed, some of the forestry assets could be monetized to lower debt and improve liquidity.

FCF to Remain Negative: Consolidated adjusted EBITDA is expected to be around BRL4.4 billion for 2020 and BRL4.6 billion in 2021 and cash flow from operations of BRL2.8 billion and BRL3.0 billion, respectively. Klabin generated BRL3.6 billion of adjusted EBITDA and BRL2.7 billion of cash flow from operations in 2019, as per Fitch's calculations. Klabin's flexibility and product diversification will continue to soften the impact of the severe economic downturn in Brazil and weak pulp prices. Fitch's projections considered 1% reduction in paper and packaging sales volume, to 1.8 million tons in 2020, with an increase in 2021 following the start-up of the first phase of Puma II project and 1.5 million tons of pulp for 2020 and 2021. Fitch expects negative FCF of about BRL1.6 billion in 2020 and BRL955 million in 2021, due to investments in the Puma II project. Fitch's base case incorporates total investments around BRL7.5 billion during 2020 and 2021 and no dividends during 2020.

Leverage to Increase Due to New Investment Cycle: Fitch expects net adjusted leverage to increase to about 4.2x in 2020 due to investments in the expansion project. Net debt is expected to peak at

BRL20 billion in 2022; this compares with BRL14.5 billion at the end of 2019. Net adjusted leverage is expected to decline to lower levels only after 2023. Fitch expects Klabin to continue to manage its capital structure conservatively during the expansion phase and take proactive steps if leverage exceeds 5.0x. In 2019, net debt/adjusted EBITDA was 4.1x, according to Fitch's methodology, pressured by weaker pulp prices and high investments.

Downturn in Pulp Cycle: The market pulp industry is very cyclical; prices move sharply in response to changes in demand or supply. Fitch believes prices of bleached eucalyptus kraft pulp delivered to China have already bottomed out after plummeting to USD480/ton at YE19 from USD725/ton at YE18. Weaker demand for paper and packaging in Europe and a slowdown of the Chinese economy will continue to pressure the recovery of pulp prices. At current pulp price levels, high-cost producers are already operating at very low profit margins and may extend their maintenance capex or shut down their mills to reduce supply. Demand from printing and writing and specialty papers will decline due to depressed global economies, but the tissue market is showing signs of increasing demand, providing a level of support for pulp demand and prices. In 2019, tissue and fluff end use represented about 50% of market pulp demand.

Rating Pierces Country Ceiling: Klabin's 'BB+' Long-Term Foreign Currency IDR is one notch higher than Brazil's 'BB' Country Ceiling due to a combination of the following factors: exports of about USD1 billion, approximately USD350 million of cash held outside of Brazil and the USD500 million unused revolving credit facility. As of Dec. 31, 2019, the pro forma ratio of EBITDA from exports, plus cash held abroad and revolving credit facility covered hard currency debt service over the next 24 months by more than 1.5x. In line with Fitch's "Non-Financial Corporates Exceeding the Country Ceiling Rating Criteria" this could allow the company to be rated up to three notches above the Brazilian Country Ceiling. However, Klabin's Foreign Currency IDR is constrained by the company's 'BB+' Local Currency IDR, which is a reflection of the company's underlying credit quality.

Derivation Summary

Klabin has a leading position in the Brazilian packaging segment. Klabin's size, access to inexpensive fiber and high level of integration relative to many of its competitors give it competitive advantages that Fitch views as sustainable. Its business profile is consistent with a rating in the 'BBB' category.

Klabin's leverage is high compared to Latin America peers Empresas CMPC (BBB/Stable) and Celulosa Arauco (BBB/Negative). That is a key reason Klabin, which used to be rated investment grade, is now rated 'BB+'. Klabin's leverage increased as a result of the construction of the Puma pulp mill and low pulp prices following the completion of the mill have prevented a quick deleveraging process. Klabin's net adjusted leverage should increase to around 4.5x due to the investments in Puma II project and is not expected to decline to lower levels until 2023.

Klabin is more exposed to demand from the local market than Suzano (BBB-/Negative), CMPC and Arauco, as these companies are leading producers of market pulp sold globally. This makes Klabin more vulnerable to macroeconomic conditions than its peers, which is also a negative consideration. Positively, 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. As a result, should Klabin would lower its net adjusted leverage to between 2.5x (low pulp prices) and 1.5x (high pulp prices), it would likely be rated 'BBB-'. These ratios could be around 1x higher if the company was in the midst of a large expansion project.

Key Assumptions

Fitch's Key Assumptions Within Our Rating Case for the Issuer:

--Paper and packaging sales volume of 1.8 million tons for 2020 and 2.0 million tons for 2021;

--60% reduction in sales volume of industrial bags sales during 2020, with a gradual recovery in 2021 and 2022;

--Pulp sales volume of 1.5 million tons in 2020 and 2021;

--Average hardwood net pulp price of USD525 per ton in 2020 and USD575 per ton in 2021;

--Average FX rate of 4.9 BRL/USD in 2020 and 4.5 BRL/USD in 2021;

--Investments around BRL7.5 billion during 2020 and 2021, of which about BRL5.5 billion will be invested in the Puma II project;

--No dividends in 2020 and 20% of EBITDA in 2021.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Average net debt/EBITDA ratios of 3.0x or below throughout the pulp price cycle following completion of the expansion project could lead to positive rating actions;

--Sustained net debt at Klabin of less than USD3.5 billion after completion of the expansion project would likely lead to a positive rating action.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Net leverage ratios higher than 4.5x during the expansion project could lead to a negative rating action;

-- Average net debt/EBITDA ratios of 4.0x or higher throughout the pulp price cycle following completion of the expansion would lead to a negative rating action;

--Sustained net debt at Klabin of more than USD4.5 billion after completion of the expansion project would likely lead to a negative rating action;

--More unstable macroeconomic environment that weakens demand for the company's packaging products as well as prices.

Best/Worst Case Rating Scenario

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

Liquidity and Debt Structure

Solid Liquidity: Klabin's solid liquidity position and low refinancing risk remain key credit considerations. As of Dec. 31, 2019, the company had BRL9.7 billion of cash and marketable securities and BRL24.2 billion of total debt, of which BRL1.4 billion is due in the short term. Financial flexibility is enhanced by a USD500 million unused revolving credit facility. Klabin plans to finance the expansion project with a combination of debt and operating cash flow.

Fitch expects Klabin to continue to preserve an extended debt amortization profile and strong liquidity, conservatively positioning it for the price and demand volatility, which is an inherent risk of the packaging industry. During 2019, Klabin successfully concluded its liability management, issuing about BRL23.0 billion of debt and prepaid approximately BRL6.3 billion, that significantly improved the company's debt amortization profile and enhanced liquidity to finance high investments. In first-quarter 2020, the company also concluded the reopening of its 2049 bond, in the amount of USD200 million. As of December 2019, Klabin had about BRL1.4 billion due in the short term, BRL420 million in 2021 and BRL1.2 billion in 2022.

As of Dec. 31, 2019, about 71% of total debt was denominated in U.S. dollars. Total debt of BRL24.2 billion consisted of bonds (34%), export prepayment (24%), Agribusiness Receivables Certificate (CRA, 16%), export credit notes (12%), debentures (8%), BNDES (3%) and others (3%).

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING
The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations
The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

Klabin Finance S.A.
----senior unsecured; Long Term Rating; Affirmed; BB+
Klabin S.A.; Long Term Issuer Default Rating; Affirmed; BB+; RO:Sta
; Local Currency Long Term Issuer Default Rating; Affirmed; BB+; RO:Sta
; National Long Term Rating; Affirmed; AAA(bra); RO:Sta
Klabin Austria Gmbh
----senior unsecured; Long Term Rating; Affirmed; BB+

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Additional information is available on www.fitchratings.com

Applicable Criteria

Corporate Rating Criteria - Effective from 27 March 2020 to 1 May 2020 (pub. 27 Mar 2020) (including rating assumption sensitivity)
National Scale Ratings Criteria (pub. 18 Jul 2018)
Non-Financial Corporates Exceeding the Country Ceiling Rating Criteria (pub. 25 Feb 2020)

Applicable Model

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).
Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
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