FitchRatings

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

Fitch Ratings-Rio de Janeiro-06 May 2019: 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)'. The Rating Outlook for the corporate ratings is Stable. A full list of rating actions follows at the end of this release.

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 that have significantly lower scale of operations and have 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 maintain pulp production volumes above 90% of nominal capacity.

The ratings also incorporate Fitch's expectation of strong operating cash flow, benefiting from the favourable pulp pricing environment. Pulp prices strengthened in the last 18 months and should remain elevated up to 2020 due to a dearth of new projects. The expected stronger cash flow generation should allow Klabin's balance sheet to comfortably absorb a period of higher investments and the start of a new project, which will further strengthen the company's leading market position in the packaging business.

The ratings incorporate an expectation that net leverage will increase to about 4x during the new investment cycle, considering current price fundamentals remain intact. Net 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 net leverage begins to approach 4.5x. If net leverage ratio exceeds 5.0x, with no expectation of a quick deleverage trend after the start-up of the new production capacity, ratings could be pressured.

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 50%, respectively. In Fitch's opinion, the expansion project is very strategic for Klabin and will add 920 thousand tons of annual production capacity of kraftliner by 2023, positioning the company as the world's third largest kraftliner player. 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 230,000 hectares of plantations it has developed on 501,000 hectares of land it owns; this ensures a competitive production cost structure in the future. During the first quarter of 2019, the company cash cost of production was USD185 per ton, which placed it firmly in the lowest quartile of the cost curve. The accounting value of the land owned by Klabin was about BRL2.1 billion as of Mar. 31, 2019, and the value of the biological assets on its forest plantations was BRL4.5 billion. If needed, some of the forestry assets could be monetized to lower debt and improve liquidity.

Leverage to Increase Due to New Investment Cycle: Fitch expects net leverage to increase to about 4x during the new investment cycle, considering current price fundamentals are preserved. Net debt is expected to peak at around BRL18 billion in 2022, compared with BRL12.8 billion in March 2019. Net 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 begins to approach 4.5x. In the LTM ended March 2019, net debt/EBITDA reduced to 3.0x, benefiting from higher pulp sales volume, higher pulp and kraftliner prices, and real depreciation, after a period of higher leverage due to high investments in the pulp mill. Net leverage average was 5.5x between 2015 and 2017.

EBITDA Projected to Grow: Consolidated EBITDA is expected to be around BRL3.9 billion for 2019 and BRL4.3 billion in 2020. Klabin generated BRL4.3 billion of EBITDA and BRL2.7 billion of cash flow from operations in the LTM ended March 2019. Klabin's EBITDA margin is expected to remain between 37% and 39% in the next couple of years. Klabin's flexibility and product diversification softened the impact of the severe economic downturn in Brazil during the last two years.

Negative Free Cash Flow Projected: Fitch expects negative FCF of about BRL1.8 billion in 2019 and BRL2.5 billion in 2020, due to investments in Puma II project. Fitch's base case incorporates investments of BRL9.1 billion for the expansion project, of which about BRL6 billion will be invested during 2019 to 2021; better pulp prices; and a gradual recovery in demand for packaging products. In 2018, Klabin sold 1.8 million tons of paper and 1.4 million tons of pulp, and Fitch's projections considered 1.9 million tons of paper and packaging, and 1.45 million tons of pulp for 2019. Pulp sales represented 37% of total net revenues in 2018.

Cyclicality of Pulp Prices: The market pulp industry is very cyclical; prices move sharply in response to changes in demand or supply. Market fundaments for pulp producers are favourable although demand from China has softened during the past six months due to the lack of new projects. As a result, Klabin and other pulp producers should be able to build cash positions for new projects or reduce debt accumulated during recent pulp mill projects. China will continue to play a key role in determining if prices climb back to levels seen in the first half of 2018.

Rating Pierces Country Ceiling: Klabin's 'BB+' Foreign Currency IDR is one notch higher than Brazil's 'BB' Country Ceiling due to a combination of the following factors: exports of BRL4.5 billion, approximately BRL550 million of cash held outside of Brazil and the USD500 million unused revolving credit facility. As of Dec. 31, 2018, 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 are viewed to be sustainable. Its business profile is consistent with a rating in the 'BBB' category.

Klabin's leverage is high compared to Latin America peers Suzano (BBB-/Stable), Fibria (BBB-/Stable), Empresas CMPC (BBB/Stable), and Celulosa Arauco (BBB/Stable). 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 leverage should increase to around 4x due to the new investment cycle.

Klabin is more exposed to demand from the local market than Suzano, Fibria, 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, if Klabin would lower its net 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 Its Rating Case for the Issuer
--Paper and packaging sales volume of 1.9 million tons for 2019;
--Pulp sales volume of 1.45 million tons in 2019;
--Average hardwood pulp price delivered to Asia between USD800 and USD825 per ton in 2019 and 2020;
--Average FX rate of 3.80 BRL/USD;
--Investments of BRL9.1 billion for the expansion project, of which about BRL6 billion will be invested during 2019 to 2021;
--Dividends: 20% of EBITDA.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action
--Strong cash generation during 2019 that would result in the company's debt/EBITDA ratio and net debt/EBITDA ratios approaching 3.5x and 2.5x;
--Proactive steps by the company to materially bolster its capital structure in the absence of higher operating cash flow.

Developments That May, Individually or Collectively, Lead to Negative Rating Action
--Expectation that net leverage ratio above 5.0x;
--More unstable macroeconomic environment that weakens demand for the company's packaging products as well as prices;
--Sharp deterioration of market conditions with significant reduction in pulp prices.

LIQUIDITY

Solid Liquidity: Klabin's solid liquidity position and low refinancing risk remain key credit considerations. As of Mar. 31, 2019, the company had BRL7.5 billion of cash and marketable securities and BRL20.2 billion of total debt. Financial flexibility is enhanced by a USD500 million unused revolving credit facility. Klabin plans to finance the expansion project with a combination of new 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. Since December 2018, Klabin successfully closed several transactions, totalling about BRL8 billion, that significantly improved the company's debt amortization profile. As of March 2019, Klabin had about BRL1.3 billion due in the short term, BRL1.2 billion from April to December 2020 and BRL1.1 billion in 2021.

As of March 31, 2019, about 74% of total debt was denominated in US dollars. Debt with BNDES totals BRL3.0 billion (15% of total debt) and is secured by land, buildings, improvements, machinery, equipment and facilities of the plants. Most of the rest of debt is related to export prepayment and export credit notes with banks (33%), debentures (3%), bonds (31%), Agribusiness Receivables Certificate (CRA, 9%) and others (9%).

FULL LIST OF RATING ACTIONS

Fitch has affirmed the following ratings:

Klabin S.A.
--Long-Term Foreign Currency IDR at 'BB+';
--Long-Term Local Currency IDR at 'BB+';
--Long-Term National Scale Rating at 'AAA(bra)'.

The Rating Outlook for the corporate ratings is Stable.

Klabin Finance S.A.
--Senior Unsecured Notes rating, in the amount of USD500 million and due in 2024 at 'BB+';
--Senior Unsecured Notes rating, in the amount of USD500 million and due in 2027 at 'BB+'.

The Senior Notes were issued by Klabin Finance S.A. (Luxembourg) and guaranteed by Klabin S.A.

Klabin Austria Gmbh
--Senior Unsecured Notes rating, in the amount of USD1 billion and due in 2029 and 2049 at 'BB+'.

The transaction was issued by Klabin Austria Gmbh and guaranteed by Klabin.

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Additional information is available on www.fitchratings.com
Applicable Criteria
Corporate Rating Criteria (pub. 19 Feb 2019)
National Scale Ratings Criteria (pub. 18 Jul 2018)
Non-Financial Corporates Exceeding the Country Ceiling Criteria (pub. 17 Jan 2019)

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