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Research Update:

Suzano Papel e Celulose Outlook Revised To Positive On Leverage Reduction, 'BB+' Ratings Affirmed

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Overview

- Brazilian pulp and paper producer Suzano continues to deleverage, given that its heavy investment cycle was completed and cash flow generation benefits from a sound pulp market.
- In our view, the company's disclosure of a clearer financial policy could point to its commitment to maintain leverage boundaries consistent with investment-grade levels.
- We're therefore revising our outlook on Suzano to positive from stable and affirming our global scale rating on the company at 'BB+' and our Brazilian national scale rating at 'brAA+'. We're also affirming our issue level rating at 'BB+'.
- The outlook revision indicates that we could raise the ratings in the next 12-18 months if we're confident that the leverage metric won't deteriorate from the current level of 2.5x-3.0x, according to company's financial policy.

Rating Action

On Aug. 7, 2017, S&P Global Ratings revised its outlook on Suzano Papel e Celulose S.A. (Suzano) to positive from stable. We also affirmed our 'BB+' global scale and 'brAA+' national scale corporate credit ratings on the company. At the same time, we affirmed the 'BB+' issue-level ratings on financing vehicles, Suzano Austria GmbH and Suzano Trading Ltd., which Suzano guarantees. We also kept our '3' recovery rating on the senior unsecured debt, indicating our expectation of meaningful (65%) recovery of the notes under a hypothetical default scenario, unchanged.

Rationale

The outlook revision reflects Suzano's solid cash flow generation stemming from a sound pulp market and a reduced capex level after the full ramp-up of the Maranhão plant. In 2013, the company's adjusted net debt to EBITDA peaked at 5.5x, which dropped to 2.9x in June 2017. According to the recently published financial policy, Suzano intends to maintain the target of 2.0x-3.0x in the coming years, potentially temporarily reaching 3.5x in case of an expansion cycle. Even though this policy is new, we expect a commitment to it over the next 12-18 months, under which we could see pulp price and currency volatility and movements towards industry consolidation.

In line with our expectation, Suzano's competitive cost structure remains favorable compared with those of global peers, due to the access to highly productive forests, vertically integrated facilities, and its own supply of wood and energy. Suzano competes globally with top players in the pulp industry, with one of the lowest cash costs worldwide. At the same time, because of its large presence in domestic uncoated and coated printing and writing paper and paperboard markets, Suzano captures synergies from the integration with pulp production while holding shares in resilient markets that help mitigate exposure to volatile international pulp markets and stabilize overall margins over economic cycles.

We believe the company will benefit from the further reduction of costs, thanks to the improvement of the wood supply, streamlining the production lines, and expansion of the product mix, such as Eucafluff and Tissue, which could further strengthen Suzano's competitive position and reduce exposure to commodity volatility and cash flow swings.

Our base-case scenario for Suzano includes the following assumptions:
- Brazil's GDP growth of 0.5% in 2017 and 2.0% in 2018, leading to paper and printing volumes sold in Brazil at around 820 million tons and 850 million, , respectively, and paper exports of 380 million tons and 400 million tons.
- Annual pulp production of 3.6 million tons per year in the next two years.
- Brazil's inflation of 3.6% in 2017 and 4.2% in 2018, affecting expected costs and paper prices in the domestic market.
- Average exchange rates of R$3.25 per $1 in 2017 and R$3.35 per $1 in 2018, and average benchmark prices for BEKP of $750 per ton in 2017 and $720 per ton in 2018, given the average discounts in the 25%-30% range. Due to these factors, we base our expectations for revenue of R$10 billion in 2017 and R$10.6 billion in 2018.
- Cash costs of R$620–R$630 per ton in 2017 (including maintenance), going down to R$580–R$600 per ton in 2018 thanks to the cost-reduction measures such as the drop in average distance from forest to the mill and a higher proportion of owned land.
- Capital expenditures (capex) of R$1.8 billion in 2017 and R$1.6 billion in 2018. From these amounts, maintenance capex of R$1.1 billion in 2017 and R$1.2 billion in 2018, and for expansion and modernization of R$800 million in 2017 and R$400 million in 2018.
- Dividend payout ratio at the minimum 25% of net income.

Based on these assumptions, we arrive at the following credit measures and metrics:
- EBITDA margins of 40%-42% in 2017 and 2018;
- Net debt to EBITDA of 2.6x-2.8x in 2017 (including commitments of asset acquisition as part of the debt), dropping to 2.2x in 2018; and
- Funds from operations (FFO) to net debt of around 30% in 2017 and 35% in 2018.
- Free operating cash flow of R$1.1 billion in 2017 and R$1.6 billion in 2018 that we expect the company to partly use for small and strategic M&A

activities primarily to develop tissue and branded products and/or additional dividend payment.

Ratings above the sovereign

The long-term corporate credit global scale rating on Suzano is one notch above the 'BB' foreign currency rating on Brazil, reflecting our view that there's an appreciable likelihood that the company won't default even in the simulated stress scenario of a sovereign default.

We believe that Suzano operates in an industry with a moderate sensitivity to Brazil, given its partly export-oriented business model and flexibility to redirect paper products to international markets in order to mitigate the impact of the domestic downturn. As a result, we currently believe Suzano could have a rating up to three notches above the sovereign rating, subject to the company's ability to pass a stress test related to the restrictions on access to foreign exchange to satisfy its operating and financial needs (which is translated in the sovereign's transfer and convertibility assessment, currently at 'BBB-').

We stressed the company under a sovereign default scenario for the next 12 months, using the following assumptions:

- GDP to decline 10% in 2017 and none in 2018, which would dent volumes in the local market;
- The company would reduce capex to maintenance levels of about R$1.2 billion;
- The Brazilian real's 50% depreciation would erode Suzano's liquidity by affecting realized price for pulp, as well as for paper exports in local currency, while having a lesser impact on production costs. Finally, it would elevate debt.
- Doubling of inflation. The inflation rate directly affects domestic price for paper products, as well as the domestic components of the production cost.
- Pulp prices to drop to $550 per ton (BEKP delivered in Europe, at a low three-month average by mid-2009), from the base-case level of $750 and $720 per ton for 2017 and 2018, respectively.
- Haircut of 10% applied to bank deposits and 70% of face value for securities denominated in local currency, which is the bulk of Suzano's cash and cash equivalents.
- No dividend distribution in the period.

Under this hypothetical scenario, the company would maintain liquidity sources over uses of more than 1x in the first 12 months.

Liquidity

We changed our assessment of Suzano's liquidity to strong from adequate, following the improvement of the company's cash flow generation coupled with high cash holdings, reduced cost of debt, an extended amortization profile, and lack of sizable investment plans. We expect the company to maintain the sources-to-uses ratio above 1.5x and to maintain it above 1.0x over the subsequent 12-month period, even considering a peak historical working capital outflow, as seen in past years. Also, we believe that Suzano has certain cushion that allows it post a positive sources-to-uses ratio even if EBITDA is to drop by 30%, as well as ability to absorb high-impact events without refinancing.

Moreover, the company has access to several banks, and its standing in credit markets is perceived as positive for the rating level, considering current bond yields. Finally, Suzano has been recently benefiting from prudent risk management, as seen in high cash amount held to overcome market volatility and company's constant prudent liability management.

Principal liquidity sources:

- Cash reserves of R$3.6 billion as of June 30, 2017; and
- Annual FFO between R$3.2 billion and R$3.5 billion.

Principal liquidity uses:

- Short-term debt maturities of R$2 billion as of June 30, 2017;
- Annual capex of R$1.5 billion to R$1.7 billion;
- Working capital outflows peaking at R$400 million; and
- Annual dividend payments ranging between R$350 million and R$400 million.

Outlook

The positive outlook indicates that we could raise the long-term rating to 'BBB-' in the coming 12-18 months if we are confident that Suzano's credit metrics won't deteriorate following the company's recently released financial policy. In our understanding, over that period, we could see the management's commitment to the leverage targets given our expectation for M&A activities in the industry (both in pulp and paper-related segments) and price volatility (either by the entrance of new supply or potential currency movements). Disciplined investments, shareholders remuneration, and a cautious stance on acquisitions could reinforce the sustainability of Suzano's credit metrics within the boundaries for an investment-grade rating.

Downside scenario

We could revise the outlook to stable if Suzano's credit metrics were to deteriorate from the current levels, such that net debt-to-EBITDA rises to more than 3.0x and FFO to debt falls below 25%-30%. This could be the result of a large acquisition or increasing capex in combination with an eroding business performance. We could also revise the outlook to stable if the company doesn't demonstrate financial flexibility to overcome currency or pulp prices movements that could negatively impact its cash flow generation, which would mean that credit metrics at current levels are not deemed to be sustainable in the long run.

Upside scenario

For a higher rating, we would expect Suzano to maintain adjusted net debt to EBITDA below 3.0x and FFO to net debt above 30% in the next 18 months. We would also expect the company to strengthen its business position in less volatile markets as well as maintain a conservative approach with limited acquisitions and a careful approach to expansionary investments.

Ratings Score Snapshot

Corporate Credit Rating:

- Global Scale Rating: BB+/Positive/--
- National Scale Rating: brAA+/Positive/--

Business risk: Satisfactory

- Country risk: Moderately High Risk
- Industry risk: Moderately High Risk
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bbb-

Modifiers

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

Recovery Analysis

Key analytical factors

- The issue-level rating on Suzano's senior unsecured notes is 'BB+'.
- The recovery rating of '3' indicates our expectation of a recovery of 65% for unsecured lenders under a hypothetical default scenario.
- In our default scenario, EBITDA would decline by about 65% due to deteriorating market conditions stemming from lower pulp prices and a stronger Brazilian real, impairing the company's margins.
- We have valued the company on a going-concern basis, using a 5.0x multiple applied across the industry to our projected emergence-level EBITDA, which results in an estimated gross emergence value (EV) of R$11.5 billion.
- Our recovery analysis assumes that under a hypothetical default scenario, the senior unsecured notes would rank pari passu to the company's existing and future senior unsecured debt, which is also subjected to statutory priorities as tax and labor obligations.

Simulated default assumptions

- Simulated year of default: 2022
- EBITDA at emergence: R$2.3 billion
- Implied EV multiple: 5.0x
- Estimated gross EV at emergence: R$10.9 billion

Simplified waterfall

- Net EV after 5% administrative costs: R$10.9 billion
- Secured debt: R$4 billion
- Unsecured debt: R$10 billion
- Recovery expectations of the existing unsecured senior notes: 65%

Related Criteria

- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, July 27, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Forest And Paper Products Industry, Feb. 12, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Suzano Papel e Celulose S.A.		
Corporate Credit Rating		
Global Scale	BB+/Positive/--	BB+/Stable/--
Brazil National Scale	brAA+/Positive/--	brAA+/Stable/--

Suzano Austria GmbH		
Senior Unsecured	BB+	
Recovery Rating	3(65%)	3(50%)
Suzano Trading Ltd.		
Senior Unsecured		
Local Currency	BB+	
Recovery Rating	3(65%)	3(50%)