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Research Update:

Swedish Forest Products Group Holmen AB 'BBB+/A-2' Ratings Affirmed; Outlook Stable

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Overview

- Holmen AB's (Holmen, or the group) solid profitability and strong cash flow generation have further strengthened its credit metrics.
- Although the group's financial policy provides significant leeway to increase leverage, we recognize the meaningful headroom in the metrics and believe that the group will continue to invest prudently.
- We are therefore affirming our issuer credit ratings on Holmen at 'BBB+/A-2'.
- The stable outlook reflects our view that Holmen's strong credit metrics provide it with a good degree of headroom to weather difficult operating conditions and potentially fund material investments.

Rating Action

On July 26, 2018, S&P Global Ratings affirmed its 'BBB+/A-2' long- and short-term issuer credit ratings on Holmen AB (Holmen, or the group). We also affirmed the 'K-1' short-term Nordic regional rating.

Rationale

We are affirming the rating on Holmen because the company continues to generate strong cash flows and reduce debt. Holmen is a diversified, integrated forest products company with large forestland holdings and energy production assets. The company owns 1.3 million hectares of forestland in Sweden (a little over 1.0 million hectares of which are productive). Holmen produces paper, paperboard, timber, and wood, and offers energy services. In 2017, the company generated Swedish krona (SEK) 17.3 billion revenues and SEK2.8 billion EBITDA.

Holmen's satisfactory business risk profile is supported by its strong position in the relatively stable virgin fiber-based paperboard market, which enjoys steady end-user demand from consumer packaging applications such as frozen goods, confectionary, and pharmaceuticals. Holmen is vertically well integrated--it is self-sufficient in pulp, 60% self-sufficient in wood, and almost 50% self-sufficient in energy. Its margins are thereby somewhat better than Stora Enso Oyj's or Metsa Board Corp's. Our business risk assessment also reflects Holmen's conservative investment strategy, which favors smaller bolt-on investments rather than large projects with higher execution risks. We

believe that the company is managing the downturn in newsprint and publication paper well; it is reducing its exposure to that segment and increasing its focus on niche segments (magazine and book paper), which now account for almost 90% of paper sales. Despite this, exposure to the cyclical and structurally declining paper markets constrains the business risk profile. Other constraints include the volatility in its sawn timber business, its relatively small size and scope, and its limited geographic diversity.

Our financial risk assessment reflects our expectation that Holmen's credit metrics will remain strong in 2018 and 2019. Although cost increases weighed on EBITDA margins in 2017, we believe that market fundamentals remain strong. We expect product mix improvements and successful sales price increases will improve EBITDA margins in 2018 and 2019. Holmen has historically used excess cash flows to repay debt and thereby improve its credit metrics. At year-end 2017, S&P Global Ratings' adjusted debt to EBITDA was 1.1x and funds from operations (FFO) to debt was 73.6%. In the next two years, we forecast adjusted FFO to debt to exceed 60% and debt to EBITDA to remain well below 1.5x.

We expect Holmen's credit metrics will remain strong for the current rating, despite the ample headroom under its financial policy. Since 2014, Holmen has aimed to cap its gearing at 0.5x. Its reported debt-to-equity ratio has consistently been well below this threshold, falling to just 0.13x by year-end 2017. The headroom under this gearing cap enables the group to make much larger (potentially debt-funded) investments and dividend payments than we assumed under our base case. We therefore view Holmen's financial policy as inconsistent with further deleveraging on a sustainable basis. While we do not anticipate any significant increases in debt under our base case, this relatively loose, publicly stated gearing target constrains further ratings upside. Credit metrics consistent with a higher rating would be unlikely to be sustainable without a tightening of financial policy guidelines.

Our base case assumes:

- Revenue growth of about 2.5% in 2018 and modest revenue growth thereafter.
- Adjusted EBITDA margins of 16.7% in 2018 (up from 16.2% in 2017) and 17.5% in 2019, on the back of expected cost controls in paperboard and sales price increases in wood and timber.
- Annual capital expenditure (capex) of about SEK800 million (including SEK400 million of maintenance capex).
- Annual dividends of about SEK1.1 billion in 2018 and 2019.
- While we believe the company will have financial headroom for large extraordinary shareholder returns and additional acquisitions, we view any such large-scale activities as highly unlikely.

Based on these assumptions, we arrive at the following credit measures:

- FFO to debt of about 98% in 2018 and 110%-115% in 2019; and

- Debt to EBITDA of about 0.9x in 2018 and 0.7x in 2019.

Liquidity

We assess Holmen's liquidity as adequate, supported by back-up facilities that counterbalance its substantial exposure to short-term financing. We estimate that the company's liquidity sources will exceed uses over the next 12 months by a little more than 1.5x.

We estimate that Holmen's principal liquidity sources over the next 12 months will comprise:

- A cash balance of SEK252 million as of March 31, 2018;
- Forecasted unadjusted FFO about SEK2.5 billion for next 12 months; and
- Access to about SEK4 billion of bank facilities in the form of a €28 million revolving credit facility maturing in June 2020 and €372 million facilities maturing in June 2021.

We estimate that Holmen's principal liquidity uses over the same period will comprise:

- About SEK2.2 billion in short-term debt as of March 31, 2018, most of which relates to commercial paper that we expect the company to roll over;
- Up to SEK1 billion in capex over the next 12 months; and
- Dividends of just under SEK1.1 billion for 2018 (paid in April 2018).

Outlook

The stable outlook reflects our view that Holmen's credit metrics will remain strong over the next two years, supported by positive market trends and a strong balance sheet. We expect this will provide the group with headroom to fund potential material investments, weather difficult operating conditions, or return cash to shareholders (in the form of higher dividends or share buybacks), while maintaining a comfortable liquidity profile.

Downside scenario

We believe the downside risk to the ratings remains remote, given the current strength of credit metrics and significant headroom in the rating. Nevertheless, we could lower the rating if Holmen materially increased its leverage from the current levels to above 2x, with FFO to debt falling below 45% for a prolonged period. This could occur as a result of significantly debt-funded capex, large acquisitions, or significantly deteriorating operational performance with EBITDA margins falling well below 15%. We could also lower the ratings if the company's financial policy became less stringent, for example, through excessive reliance on short-term funding, a weakening liquidity profile, or a more aggressive change to its approach to shareholder remuneration.

Upside scenario

While current credit metrics support a potentially higher rating, we believe the material headroom in the group's public financial gearing cap of 0.5x constrains upside to the rating. This leads us to believe that these metrics are not sustainable without a tightening of financial policy. An upgrade would also depend on the company maintaining solid EBITDA margins and a prudent financial policy regarding investments, dividends and possible share buybacks.

Other Credit Considerations

Because Holmen currently has strong cash flow generation and a low level of debt, we assess its financial risk profile as minimal. However, if Holmen does not find suitable growth opportunities in the next two years, its financial policy allows it to make further shareholder returns (via dividend payments or share buybacks) or large investments. The company's financial policy allows it to reach a maximum gearing of approximately 0.5x.

We therefore apply a negative financial policy modifier that revises our 'a-' anchor for Holmen downward by two notches to 'bbb', reflecting that leverage could increase materially from the level assumed in our base case.

Group Influence

We view Holmen as a moderately strategic subsidiary of majority shareholder, L E Lundbergforetagen AB. Although L E Lundbergforetagen AB only holds 32.9% of the capital, it holds 61.6% of the votes and has a significant influence over Holmen's financial policy and strategic agenda. We believe that Lundberg's influence has resulted in a reliable track record of strong credit metrics, even when the rest of the industry was struggling. This assessment results in a one-notch uplift from the stand-alone credit profile of 'bbb' to arrive at the 'BBB+' issuer credit rating.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Stable/A-2

Business risk: Satisfactory
- Country risk: Very low
- Industry risk: Moderately high
- Competitive position: Satisfactory

Financial risk: Minimal

- Cash flow/leverage: Minimal

Anchor: a-

Modifiers
- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Negative (-2 notches)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb
- Group credit profile: A+ (rating on L E Lundbergforetagen AB)
- Entity status within group: Moderately strategic (+1 notch)

Related Criteria

- 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
- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Group Rating Methodology, 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

Related Research

- European Forest And Paper Companies Harvest Upgrades, Oct. 19, 2017

Ratings List

Ratings Affirmed

Holmen AB	
Issuer Credit Rating	BBB+/Stable/A-2
Nordic Regional Scale	--/--/K-1

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.