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Research Update:

Finland-Based Paperboard Producer Metsa Board Corp. Upgraded To 'BBB-/A-3' On Strong Performance; Outlook Stable

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Overview

- Paperboard producer Metsa Board Corp. showed strong performance in 2017, due to recent investments, improved paperboard operations, and favorable soft wood pulp prices.
- Although we consider that soft wood pulp prices in Europe could fall in the near term and acknowledge there is still spare capacity at the Husum plant, we believe that the company has completed the bulk of its investments and expect it to continue to generate strong cash flows.
- We are therefore raising our issuer credit ratings on Metsa Board to 'BBB-/A-3' from 'BB+/B'. We are also raising our issue ratings on the senior unsecured debt instruments to 'BBB-' and withdrawing our recovery ratings on this debt.
- The stable outlook reflects our expectation that Metsa Board will continue to capitalize on its solid client positions and leading positions in its main markets.

Rating Action

On Feb. 28, 2018, S&P Global Ratings raised its long- and short-term issuer credit ratings on Metsa Board Corp. to 'BBB-/A-3' from 'BB+/B'.

At the same time, we raised our issue ratings on the senior unsecured notes issued by Metsa Board to 'BBB-' from 'BB+'. Given that the issuer now has an investment-grade rating, we have withdrawn our recovery ratings on these debt instruments.

Rationale

The upgrade follows the completion of Metsa Board's folding boxboard and white kraftliner capacity additions at Husum, its strong performance in 2017, and our expectation that this trend will be maintained in the next 24 months. Metsa Board has now become a pure integrated paperboard producer (although it remains long in soft wood pulp production), and the large investments at Metsa Fibre's pulp mill have been completed.

Its paperboard, primarily folding boxboard and white linerboards, are used in various packaging applications for consumer goods, retail, and food services. Demand is supported by the ongoing urbanization of the population and the sustainable nature of its products.

In 2017, sales growth of around 7.5% was fueled by higher paperboard volumes, as well as higher paperboard and soft wood pulp prices. Combined with the discontinuance of the historical paper operations, this improved S&P Global Ratings-adjusted EBITDA margins for Metsa Board to 14.3% from 12.3% in 2016 and more than offset the negative impact of higher latex prices in the first half of 2017. The operational issues at Husum have now been resolved. The mill was operating at 71% capacity in 2017 and the company expects to operate the mill at full capacity in 2018. We do not expect any further capital outlays for Metsa Fibre's bioproduct mill, which was built on time and on budget in 2017. The mill is expected to operate at full capacity from the second half of 2018 onward. This results in adjusted funds from operations (FFO) to debt of 55.3% and adjusted debt to EBITDA of 1.4x for 2017. These credit metrics are very close to our expectations (52.7% and 1.5x, respectively).

We expect additional increases in paperboard prices in 2018, as well as favorable soft wood pulp price movements in the first half of 2018. Combined with the ramp-up of production at Husum, this should support revenue growth and profitability. Nevertheless, we assume flat EBITDA margins for 2018 to reflect a possible decline in soft wood pulp prices in the second half of 2018, as well as an increase in wood costs caused by bad weather conditions in 2017.

We think that Metsa Board's financial risk profile will further improve in 2018, as annual capital expenditure (capex) normalizes at €70 million-€75 million and dividends increase only marginally. In our base case, we expect leverage to improve marginally in 2018. FFO to debt could deteriorate slightly (but remain above 45%) if the company made sizable strategic investments (we modeled hypothetical investments of around €200 million). In the following years, credit metrics could improve further, unless Metsa Board made unexpected mergers and acquisitions (M&A) or large one-off dividend distributions. As a result, we think that the company will maintain strong credit metrics in the coming three years, with FFO to debt above 45% and debt to EBITDA well below 1.7x, which we view as consistent with the modest financial risk profile. This is despite financial policy guidance publicly communicated in June 2017 that suggests higher reported leverage tolerance of up to 2.5x (approximately 2.5x-3.0x on an S&P Global Ratings-adjusted basis).

Our business risk assessment still takes into account Metsa Board's relatively small size, narrow product, and geographical scope, compared with larger forest and paper groups such as Mondi Group, Stora Enso, and UPM-Kymmene. Although growth prospects for paperboard are favorable, we think that its narrow focus makes Metsa Board particularly exposed to adverse market developments, such as overcapacity and potential changes in customer preferences. In our view, increasing sales in markets outside of Europe would improve the business risk profile; we could revise our assessment if the company realizes its planned U.S. expansion. We think that Metsa Board's satisfactory profitability in its paperboard operations, the positive demand trend for paperboard, its strong market share in Europe, and its strong backward integration into key raw materials are supporting factors for the business risk.

In our base case for Metsa Board, we assume:

- Eurozone GDP growth of 2% in 2018 and 1.7% in 2019 and U.S. growth of 2.8% for 2018, supporting demand growth for paperboard.
- Revenue growth of 3.5% in 2018 due to rising prices for paperboard and an increase in volumes sold on the back of the additional paperboard capacity at the Husum mill.
- Flat EBITDA margins as the impact of higher soft wood pulp prices in the first half of 2018 is offset by lower soft wood pulp prices in the second half of 2018. We also expect that price increases will be offset by a slight increase in wood input costs.
- Capex in 2018 of approximately €70 million of which €50 million will be for maintenance and €20 million for expansion.
- Dividend payments increasing in line with profits and dividend policy.
- €200 million in strategic investments in 2018. No M&A transactions or share buybacks thereafter.

Based on these assumptions, we arrive at the following S&P Global Ratings-adjusted credit measures for the company:

- FFO to debt of clearly of 47.5% in 2018 and well above 50% thereafter.
- Debt to EBITDA of 1.6x in 2018 and 1.2x in 2019.
- Free operating cash flow to debt above 45% in 2018 and 2019.

Liquidity

We assess Metsa Board's liquidity as strong, supported by large cash balances, full access under its €100 million revolving credit facility (RCF), our expectation of strong operational cash flow generation, and manageable debt maturities in 2018. We think that the company's liquidity sources can comfortably cover its liquidity uses by 1.5x over the coming 12 months. We also view positively the company's access to multiple funding sources, its well-established and solid relationship with banks, and its satisfactory standing in the credit markets.

We anticipate the company will have the following principal liquidity sources over the next 12 months:

- About €215 million in cash and cash equivalents as of Dec. 31, 2017. This takes into account about €200 million of cash deposited with Metsa Group's internal bank, Metsa Group Treasury, under a cash-pooling system among entities within Metsa Group. We understand that Metsa Board has access to these funds at short notice.
- An unused €100 million RCF expiring in March 2020. We also understand that Metsa Board has access to a credit line of €150 million from Metsa Group Treasury, though this depends on cash deposits from other group companies and thus would be an uncertain source of liquidity under a stress scenario.
- Access to loans from pension funds of about €134 million.
- Expected FFO of about €250 million in 2018.

We anticipate the company will have the following principal liquidity uses over the same period:

- Strategic investments of €200 million;
- Dividend payments of about €75 million;
- Debt amortization of about €42.5 million; and
- Capex of about €70 million;

The combination of a fair business risk profile and a modest financial risk profile results in a 'bbb-' anchor for Metsa Board.

We apply our group rating methodology to take into account the impact of Metsa Board's close integration into Metsa Group. In our view, Metsa Board cannot be rated higher than our assessment of the creditworthiness of its parent, Metsa Group, which we currently assess at 'bbb-'. We consider Metsa Board to be a highly strategic subsidiary for the Metsa Group, the parent company of which is Metsaliitto Cooperative. This is because:

- The group is unlikely to sell Metsa Board in the near term, in our view, given that it provides forward integration in the forest and paper products value chain;
- The group's senior management has a track record and long-term commitment of support for the company;
- Metsa Board accounts for about 27% of group sales; and
- Its reputation, brand, name, and treasury management is closely tied to that of Metsa Group.

We assess Metsa Group's group credit profile (GCP) as 'bbb-'. This is supported by low consolidated leverage, favorable growth prospects among its paperboard and pulp segments, and strong product diversification. However, we think that these strengths are offset by exposure to cyclical and volatile pulp and sawn timber segments, tissue operations with below-average profitability, and the fact that there are large minority shareholders across the Metsa Group structure, which somewhat distorts consolidated financials. The GCP also reflects the successful completion of the Metsa Fibre's €1.2 billion pulp mill project in Aanekoski. Operations at the mill started in August 2017 and the mill is expected to reach full capacity by August 2018.

Outlook

The stable outlook reflects our expectation that Metsa Board will continue to capitalize on its solid client positions and leading positions in its main markets. Sales growth should support Mesta Board in maintaining materially positive FOCF and a weighted average adjusted leverage of around 1.5x over the next 24 months.

Downside scenario

We could lower our rating if Metsa Board's operational performance weakened, for example, due to a significant fall in prices for paperboard or a material increase in wood prices. A downgrade could also result if operational issues led to pressure on margins. We could lower the rating if we no longer anticipated that Metsa Board could maintain net debt to EBITDA below 2.0x on a weighted average basis over a sustained period.

Upside scenario

We view an upgrade as unlikely, as it would require Metsa Board to publicly commit to a more conservative financial policy that includes a cap on debt to EBITDA of 1.5x. In addition to this, we would expect FFO to debt exceed 60% on a sustainable basis for an upgrade.

Raising the rating would also depend on an upward revision of Metsa Group's GCP to 'bbb' or higher. This could occur if we saw only a low risk of leverage increasing from the current levels--for example, through major new investments--and our current assessment of the business risk profile remained unchanged.

Ratings Score Snapshot

Corporate Credit Rating: BBB-/Stable/A-3

Business risk: Fair
- Country risk: Low
- Industry risk: Moderately high
- Competitive position: Fair

Financial risk: Modest
- Cash flow/Leverage: Modest

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 ratings analysis: Neutral (no impact)

Stand-alone credit profile: bbb-
- Group credit profile: bbb- (no impact)
- Entity status within group: Highly strategic (no impact)

Issue Ratings--Subordination Risk Analysis

We have not identified any factors leading to material subordination of the senior unsecured debtholders at Metsa Board Corp.

Capital structure

As of Dec. 31, 2017, Metsa Board's capital structure comprised around €475 million in unsecured debt issued by Metsa Board, which is subordinated to €95 million in pension loans, nonrecourse financing (€65 million) and €7.9 million finance lease obligations.

Analytical conclusions

The unsecured €100 million RCF, €61.6 million unsecured notes due 2019, €150 million unsecured term loan, and €250 million unsecured fixed-rate notes due 2027 issued by Metsa Corp. are rated 'BBB-', the same as the issuer credit rating, as no sources of significant subordination have been identified.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- 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
- Criteria - Corporates - Industrials: Key Credit Factors For The Forest And Paper Products Industry, Feb. 12, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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

Upgraded; CreditWatch/Outlook Action

	To	From
Metsa Board Corp.		
Corporate Credit Rating	BBB-/Stable/A-3	BB+/Positive/B

Upgraded; Recovery Rating Withdrawn

	To	From
Metsa Board Corp.		
Senior Unsecured	BBB-	BB+

Recovery Rating	NR	3(65%)

NR--Not rated.

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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 the 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.