Industry Top Trends 2016
Forest And Paper Products

DIVERGING OUTLOOK AMONG GLOBAL FOREST AND PAPER COMPANIES

- **Rating Trends.** Although outlooks are mostly stable, there is a negative bias mostly relating to poorly performing publication paper markets and large capital expenditure (capex) projects among pulp producers in Latin America.

- **Diverging Operating Trends.** We think that the sector will benefit from a further pick-up in economic growth in 2016, although performance will diverge among sub-segments and regions. We think that a strong U.S. dollar will continue to benefit exporting companies in Europe, Latam, and Canada, but see a risk of falling hardwood pulp prices as new supply comes online and emerging markets slow down.

- **Paper Products Continue To Decline, But Packaging Paper To Remain Stable.** As demand for publication paper continues to decline, issuers will continue their strategic shift toward packaging paper and tissue products, for which demand is more stable. Pulp demand will continue to benefit from demand growth in emerging markets.

- **Credit Metrics To Improve, Despite High Capex.** We think it is likely that credit metrics will improve slightly for the sector as a whole, supported by growth investments, the closure of unprofitable paper capacity, improving economic conditions, and relatively conservative financial policies, although high capex could pressure some issuers.

- **Downside Risks.** The sector is still highly competitive and commoditized and remains sensitive to factors such as U.S. housing starts, consumer confidence, currency rates, and the impact on the pricing and timing of new investments.

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Although the majority of ratings are on stable outlook, there is a clear negative bias. This is due to a number of factors. Due to their commoditized and cyclical nature, many forest and paper products are subject to intense price competition and periods of overcapacity, which put pressure on profitability. Currently, products such as newsprint and magazine paper, specialty cellulose, and palm oil are under price pressure, leading to a weakening of cash flows and credit metrics. A couple of newsprint and magazine issuers are even in discussions with lenders to restructure their capital structures, which could result in defaults. The other reasons for negative outlooks include high capex programs and high exposure to weak economic conditions in countries such as Argentina and Venezuela.
Our base-case forecast for the sector takes into account increasing sales in 2016 as companies benefit from an expanding economy and favorable sales prices. We think that publication paper producers will continue to face a challenging operating environment as digital substitution persists. We expect margins to improve across the sector as loss-making paper capacity is phased out, while growth investments in more profitable segments come online. While capex will peak in 2015, we forecast it will slowly decrease in 2016, which will improve credit metrics.
## KEY INDUSTRY ASSUMPTIONS

### INDUSTRY WIDE

<table>
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<th>Mixed Economic Growth</th>
<th>Paper Demand Decline Continues</th>
<th>A Strong U.S. Dollar Continues To Boost Non-U.S. Exporters</th>
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We expect economic growth in Europe and North America to provide a boost to the sector in 2016. This will not only benefit issuers based in those regions, but will also be largely beneficial to Latam-based players, which direct a large part of their sales there. We expect economic growth to slow in emerging markets, notably in Brazil and China, although this will likely have a limited impact on the sector as a whole as exposure to these regions is relatively low.

### NORTH AMERICA

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<th>Housing Starts Pick Up</th>
<th>Pulp Pricing Is Mixed</th>
<th>Paper Prices Remain Stable</th>
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Our economists project 1.3 million new U.S. home starts in 2016, plus another 0.2 million in Canada. This bodes well for timber and wood products producers, as higher demand should support better pricing. However, continued strength in the U.S. dollar could mute price increases for U.S. producers.

### EMEA

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<th>Strategic Shift Continues</th>
<th>Profitability To Increase</th>
<th>Capex Is Selective</th>
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EMEA forest and paper firms continue to balance the decline in publication paper with growth in other areas such as packaging paper, pulp, and tissue production. Most companies are carefully managing operating costs and keeping investments low while investing cash flow elsewhere. However, a few firms are stuck in publication paper, with little financial flexibility to move away.

We expect profitability to gradually increase for issuers based in EMEA. Besides positive regional economic growth, we expect closures and disposals of paper assets, and the ramp-up of new projects in the pulp and packaging paper space, to have a positive impact on margins. We think that publication paper producers will remain under pressure unless the industry structure changes as a result of widespread closures or consolidation.

After peaking at around €3.5 billion in 2015, we think that capex for EMEA-based issuers will fall in 2016 to about €3.1 billion. Nevertheless, this is still higher than the 2014 level of €3.0 billion. The largest investments are in pulp mills, paperboard machines, and the conversion of publication paper to packaging grades. We also see increasing capex on related forest products businesses, including bioenergy, biofuels, and pellets, albeit on a smaller scale.

The appreciating U.S. dollar has led to large gains for forest and paper products companies with cost bases in other currencies, for example Canadian lumber producers and Brazilian and European pulp producers. Hedging varies in the sector, and several U.S. dollar sellers also have a large part of their debt denominated in U.S. dollars, which to an extent neutralizes the benefit of the appreciating dollar on their credit metrics.
### LATIN AMERICA

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<th>Slowdown In The Regional Economy</th>
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<td>Although several of our rated issuers have large exposure to Brazil, we think that the slowdown in many Latam economies will have a limited effect on pulp producers because they export the vast majority of their sales outside the region. The main effects will be on the local paper and wood panel producers, which could face lower demand and pressure on profitability.</td>
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<th>Hardwood Pulp Prices To Come Under Pressure</th>
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<td>The hardwood pulp price has been very strong throughout 2015 and is currently just above US$800 per ton. We think that there is some downside to this level due to new capacity coming online in Latam in 2016 and 2017. This could create a period of oversupply before high-cost producers close capacity and demand growth catches up. As a result, we forecast a price of US$730-US$750 per ton to take into account a price decline.</td>
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<th>Large Capex Projects Ramp Up</th>
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<td>The majority of the rated companies in the region carried out sizable investments in 2014 and 2015. We expect those projects to be completed in 2016, and companies to benefit from increased operating cash flows and stronger credit metrics in the short term. If projects do not complete on time and budget, this could possibly trigger negative rating actions.</td>
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KEY INDUSTRY RISKS AND OPPORTUNITIES

NORTH AMERICA

1 | Lackluster Housing Starts
U.S. housing starts (single family homes in particular) fall short of our expectations, which could be the result of harsh weather conditions or weak economic conditions in the U.S. With lackluster home construction activity next year, industry operating rates may remain low and put downward pressure on log and lumber prices and volumes. Given the high operating leverage of some of the lumber producers we rate, and generally weak operating results in 2015, we may see some negative rating actions in this scenario.

2 | Economic Slowdown In China
China is a key market for pulp producers due to the large base of tissue producers. Tissue production has grown significantly over the past decade, and has more than offset the decline in demand for pulp from printing and writing paper producers. If economic conditions remain weak in China, pulp demand may not grow fast enough to absorb the increased capacity, and we may see pricing pressure continue through 2016.

3 | Foreign Exchange Rates
During 2015, the strengthening U.S. dollar gave Canadian and Latam producers a competitive edge as exports to the U.S. could be priced lower than domestic U.S. product. U.S. producers were hurt by the lower pricing, and earnings from wood products dropped significantly for most U.S. producers. If the U.S. dollar remains strong in 2016, exporters to the U.S. could retain their price advantage. Alternatively, U.S. producers may regain their price advantage if the U.S. dollar weakens.

EMEA

1 | Disappointing Economic Growth
The biggest risk for companies in EMEA is another year of disappointing economic growth, which would hamper demand and pricing for most products. The industry remains cyclical, and disappointing growth could accelerate negative trends such as digitalization and thereby worsen prospects for paper companies.

2 | Project And Execution Risks
Most issuers are taking a conservative approach to growth investments, focusing on improving their cost positions and increasing capacity through bottleneck investments. However, a few issuers are undertaking large expansionary investments, where delays or cost overruns can weaken credit metrics.

3 | Capacity Closures In Paper
The publication paper markets in Europe are depressed, with demand and pricing for newsprint down by almost 10% in 2015. The market is characterized by high fragmentation and structural oversupply. The market would benefit from widespread capacity closures, which would allow for price increases even if the closures were temporary. Over the longer term, consolidation is needed.

LATIN AMERICA

1 | Falling Pulp Prices
Although our base-case forecast takes into account falling pulp prices in 2016 and 2017, we think that a more rapid decline in prices could put pressure on credit metrics for certain issuers. Besides new projects coming online, a sharp slowdown in Chinese economic growth could spill over to pulp demand and intensify the price correction.

2 | Weaker Local Demand
We think that a prolonged recession in Brazil could lead to structural pressure on certain forest products such as uncoated freesheet (office paper), wood panels, and paperboard grades. There are various degrees of economic weakness in other countries such as Chile, Argentina, and Venezuela, which implies higher operating risks for issuers with exposure to those countries.

2 | Consolidation Opportunity
We think that consolidation remains an opportunity for several Latam-based companies as industry structures for products such as pulp and wood panels remain relatively fragmented. Industry consolidation could lead to a more stable operating environment and cost benefits.
MIXED TRENDS ACROSS THE SECTOR

CHART 11 | PULP PRICES

The long fibre NBSK pulp has been trending down in Europe and the U.S. and the gap to short fibre BHKP is now at record lows, indicating some downside to BHKP.

CHART 12 | EUROPEAN GRAPHIC PAPER DEMAND

Demand for publication-paper remains in a secular decline and we do not expect this trend to reverse.

CHART 13 | FX RATE CHANGES (JAN 2013=100)

The appreciation of the U.S. dollar against the euro, Brazilian real, and Canadian dollar has put downward pressure on U.S. dollar pricing for most products within the industry.

CHART 14 | U.S. HOUSING STARTS

Housing starts were weaker than we had expected this year, due in part to labor shortages and poor weather conditions.

FINANCIAL POLICY

We believe that most companies in the industry have robust pipelines of growth capex projects that should translate into higher capex in the next couple of years. We expect most of this growth to come from pulp and paper producers looking to diversify into the production of tissue paper or containerboard. We also expect some pulp producers to invest in the vertical integration of their operations to improve profitability, or enhance production capacity in anticipation of demand growth.

The majority of the companies in the industry have adequate or strong liquidity profiles. This incorporates our expectation that operating cash flows will generally improve across the industry over the next few years. If liquidity remains solid and capex investments slow, we may see more shareholder friendly initiatives such as acquisitions, dividends, and share repurchases.
GLOBAL FORESTRY AND PAPER: CASH, DEBT AND RETURNS

CHART 15 | CASH & EQUIVALENTS / TOTAL ASSETS

CHART 16 | TOTAL DEBT / TOTAL ASSETS

CHART 17 | FIXED VS VARIABLE RATE EXPOSURE

CHART 18 | LONG TERM DEBT TERM-STRUCTURE

CHART 19 | CASH FLOW AND PRIMARY USES

CHART 20 | RETURN ON CAPITAL EMPLOYED

Source: S&P Capital IQ, S&P Ratings calculations
RELATED RESEARCH

- Mercer International Inc. Outlook Revised To Positive From Stable On Improved Liquidity; Affirmed At 'B+', Nov. 30, 2015
- EMEA Forest And Paper Firms' Strategic Shift From Publication To Packaging Is Improving Profits, Sep. 23, 2015
- Weyerhaeuser Co. Ratings On CreditWatch Negative On Planned Plum Creek Timber Inc. Merger, Nov. 9, 2015
- Fibria Celulose S.A. Upgraded To Investment Grade On Stronger Financial Risk Profile And Liquidity, Outlook Stable, Apr. 30, 2015
- Suzano Papel e Celulose S.A. Upgraded To 'BB+' From 'BB' On Stronger Financial Performance, Outlook Stable, Aug. 26, 2015

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