

Svenska Cellulosa Aktiebolaget SCA

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Svenska Cellulosa Aktiebolaget SCA

Major Rating Factors

Strengths:

- Well-diversified earnings base.
- Relatively stable hygiene product markets.
- Good market and cost positions, and a high level of vertical integration.
- Good operating cash flow generation over the cycle.

Weaknesses:

- Cyclical markets for publication paper and packaging businesses.
- Exposure to volatile input costs.
- High investment levels.

Corporate Credit Rating

BBB+/Stable/A-2

Nordic National Scale Rating
--/--/K-1

Rationale

The ratings on Sweden-based global hygiene and paper products group Svenska Cellulosa Aktiebolaget SCA (SCA) reflect the group's strong business risk profile, supported by a diverse earnings base, leading positions in core hygiene and packaging markets, high level of integration, and our assessment of the financial risk profile as intermediate. On Sept. 30, 2011, the group had adjusted debt amounting to about Swedish krona (SEK) 40.8 billion.

Key business and profitability developments

SCA said on Nov. 10, 2011 that it had delivered a binding offer to acquire the European tissue operations of U.S.-based Georgia-Pacific LLC (A-/Stable/--) for €1.32 billion (about Swedish krona (SEK) 12 billion). We understand that the acquisition would be debt funded, and that closing would be subject to consultations with employee representatives, as well as approval from the EU competition authorities.

Furthermore, on Nov. 4, 2011, SCA announced that it had established a joint venture in its existing Australasian tissue and personal care business with Pacific Equity Partners (not rated), effectively divesting 50% of its equity stake. SCA said it will receive SEK3.2 billion as a result of the transaction.

If the transactions are closed as planned, we would view the effect on the group's business risk profile as moderately positive. We base this primarily on SCA's strengthened market position in the European tissue sector (well above 30% on a pro forma basis) and, to an extent, the prospects for synergies. We would also view the increased proportion of group sales relating to hygiene products as supportive, because the group's packaging and publication paper businesses are less stable. We view the divestment of 50% of the Australasian business as largely neutral from a business risk perspective.

Key cash flow and capital-structure developments

In our financial base case, we believe that adjusted funds from operations (FFO) to debt on a pro forma basis would drop slightly below 30% (about 33% in the 12 months to Sept. 30, 2011) in 2011, but for a limited period, as we believe the company is inclined to replace acquisition debt funding with strategic financing. We consider a ratio of 30%-35% to be commensurate with the current rating level. We consider the financing of the acquisition to be

aggressive from a financial policy point of view. A mitigating factor is that the group is disposing of assets, thus cushioning the impact of the acquisitions on its credit metrics. As a result, we believe that SCA can maintain average credit measures which are in line with its current intermediate financial risk profile.

A supporting factor in our decision to affirm the ratings on Nov. 11, 2011, was that we believe that SCA can maintain average credit measures which are in line with its current intermediate financial risk profile. We believe, for example, that adjusted FFO to debt will not stay below 30% for any lengthy period.

Liquidity

The short-term rating is 'A-2', reflecting our view that the group's liquidity position is strong. Large backup facilities support liquidity, balancing SCA's substantial exposure to short-term financing. We estimate that the group's ratio of liquidity sources to uses over the next 24 months exceeds 1.5x. We understand that SCA has put in place finance arrangements for the announced acquisition.

As of Sept. 30, 2011, SCA's liquidity position was supported by:

- Cash and cash equivalents of about SEK2.9 billion.
- About SEK21.7 billion of unused long-term committed syndicated and bilateral credit facilities (SEK2.5 billion of these expire in the second quarter of 2013). SCA's main long-term credit facilities consist of a €1 billion facility maturing in 2014 and a €1 billion facility maturing in 2016. The facilities carry no financial covenants or material adverse change clauses that would restrict SCA from drawing under them.
- Operating cash flow generation, which we expect to continue to exceed working capital and capital expenditure needs over the short term. Furthermore, we assume that SCA has a degree of flexibility in terms of capital expenditure, if necessary, to offset any potential liquidity pressure.

These liquidity sources compared with reported short-term debt of about SEK9.6 billion, of which SEK7.1 billion consisted of outstanding commercial paper maturing within 12 months.

Outlook

The stable outlook reflects our expectation that SCA's financial performance will not deteriorate significantly as a result of the announced acquisition, and that the group can maintain a ratio of funds from operations to debt of 30%-35%. It also reflects our belief that the group's medium-term operating performance will benefit from the relatively stable characteristics of a large proportion of hygiene related businesses.

The rating could come under pressure within the next 6-12 months if adjusted FFO were to deteriorate further than slightly below 30%, or if we were to believe that it could remain below our guidance levels for a lengthy period of time. We would, for example, not consider FFO to debt falling significantly below 30% on a pro forma basis to be commensurate with the current rating level. Ratings leeway is currently limited, and we would view sharp increases in outgoings such as spending on further acquisitions, dividends, or capital expenditure as additional triggers for negative rating changes.

Ratings upside over the short term is limited, on the basis of our current assessment of the group's business risk and financial risk profiles. Over the medium term, we could take a positive rating action if SCA were to improve its financial performance on a sustained basis, for example by raising FFO to debt sustainably to 35%-40%.

Business Description

SCA is a leading company in Europe within its main business areas: hygiene products (incontinence, baby diapers, feminine care products, and tissue paper) and packaging (corrugated board and containerboard). The group also produces publication paper (magazine paper and newsprint), and has integrated pulp production and forest and sawn timber operations. SCA's 4.9 million acres of productive forestland make the group the largest private owner of European forest.

In 2010, net sales totaled SEK109 billion (see table 1). Europe accounted for about 75% of sales and North America about 9%, while most of the remainder were in Latin America and the Asia-Pacific region. Germany (14% of total revenue in 2010), the U.K. (9%), and France (8%) are the group's largest markets. SCA is publicly listed, and its largest shareholder is Industrivarden, AB (A/Stable/A-1), with 29% of the voting rights.

Table 1

Svenska Cellulosa Aktiebolaget SCA Reported Operating Statistics By Business Group (Not Adjusted)				
	--Sales (Mil. SEK)*--		--EBITDA margin (%)--	
	2010	2009	2010	2009
Personal care	25,027	25,716	13.9	17.3
Tissue	39,870	41,425	13.3	15.4
Packaging	29,633	28,359	9.2	7.2
Forest products	17,123	16,983	22.0	19.0
Group total	109,142	110,857	13.7	14.2

*Includes some internal sales. SEK--Swedish krona.

Business Risk Profile: Potential For Strengthened Position In Stable Hygiene Industry, But Still Exposed To Volatile Publication Paper And Packaging Markets

The major supports for SCA's "strong" business risk profile are:

- Favorable product and end market diversity. Although the hygiene business accounts for more than 60% of total sales, it is divided into two main segments--tissue and personal care--which in turn include a number of product segments such as incontinence products, baby diapers, feminine hygiene products, consumer tissue, and away-from-home tissue (institutional sales). The markets for hygiene products display generally favorable characteristics, with relatively stable demand and fairly high industry concentration;
- A diverse geographic footprint. The company's biggest market is Europe (about 75% of sales in 2010), where sales are well spread among different countries. Other markets include North America (about 9% of sales), Asia, Australia, New Zealand, and Latin America;
- Leading market positions. SCA is well placed as one of the largest groups within the European hygiene products and packaging industry, with high market shares in different segments and countries. The market position could be further strengthened if the recently announced acquisition of Georgia-Pacific's tissue operations in Europe closes.
- Good integration which reduces volatility in SCA's cost base. About 50% of SCA's virgin fiber requirements are fulfilled by SCA's own forest resources, and the group collects about 36% of recycled fibers through its internal recovered-paper unit.

- Although the group's expansion in the hygiene business has gradually increased exposure to market prices for pulp, self-sufficiency in pulp is still at about 41%. This may decline if the recently announced acquisition closes, although SCA plans to increase its own pulp production capacity.
- SCA has formed a joint venture with Norway-based power utility Statkraft AS (A-/Stable/A-2) to invest in wind power farms located on SCA land in northern Sweden. In connection with this agreement, SCA has finalized a competitive long-term electricity supply contract with Statkraft. SCA's own electricity production accounts for about 25% of the group's overall consumption; and
- A competitive cost position that benefits from the group's overall use of modern machinery, good level of vertical integration, and a good geographic balance between production and sales. Furthermore, SCA has implemented major rationalization programs in recent years. Cost-saving measures have included major staff reductions, plant closures and relocation of production, and investments to improve the quality and efficiency of assets.

These supports are partly offset by:

- Exposure to cyclicalities in SCA's publication paper business. Publication paper is a more cyclical operation than SCA's main businesses. Market growth for publication paper in Europe is on average low to modest, with elements of structural demand decline in certain grades, such as newsprint. Market balance is often disturbed by large capacity additions, and prices tend to fluctuate over time;
- Exposure to cyclical supply patterns in the packaging markets. Although industry consolidation has improved over the past five years, there is still a wide range of midsize producers that from time to time add new production capacity to the market and disturb the supply and demand balance;
- A high degree of competition in key markets, such as the European consumer tissue markets, primarily reflecting price pressure from large retail chains (especially discount retailers) and competitors. Marketing costs are consequently high and consumer price awareness has increased as a result of the weak economic environment, a factor which may have a negative effect on SCA's product mix and profitability;
- Margins in the packaging division that are weaker than those of the main peer in this segment, Smurfit Kappa Group PLC (BB-/Positive/--). This is partly due to Smurfit Kappa's high margins in its Latin American businesses, but we see that SCA's packaging margins are still weaker than Smurfit Kappa's European business. Profitability has improved, however, owing to improving market conditions and SCA's rationalization efforts;
- Volatile input costs, such as for pulp. The group's tissue operations are particularly sensitive in this respect, although SCA has in the past been successful in passing on increases in input costs in this segment; and

Financial Risk Profile: High Spending Levels And Acquisition Debt Temper Good Operating Cash Flows Over The Cycle

The main strengths of SCA's "intermediate" financial risk profile are:

- Strong operating cash flow generation over the cycle. The group has historically benefited from strong operating cash flows, which have sufficiently covered current and strategic capital expenditures and dividend payments;
- A strong liquidity position, supported by large back-up facilities that balance SCA's exposure to substantial short-term debt;
- Moderate financial policies. The group's long-term financial targets include a debt-to-equity ratio of 0.7x (0.5x on Dec. 31, 2010). SCA targets dividends over the cycle corresponding to one-third of operating cash flows (after tax and interest). We expect acquisition activity other than recently announced transactions to be low; and

- Extensive forestland holdings. At the end of 2010, SCA valued its forestland at about SEK26 billion. Although forestland is a core asset, providing a large part of the company's fiber needs, disposal of part of it could provide an alternative source of liquidity in a distressed situation. The company's land ownership enables its joint venture with Statkraft, in which SCA's primary contribution is to provide land for wind farms, demonstrating the additional debt protection these assets offer.

These strengths are moderated by:

- The likelihood that credit metrics will temporarily weaken from current levels, because of the aggressive financing of the Georgia-Pacific European tissue operations. We still believe, however, that SCA can maintain an average performance which is in line with the current intermediate financial risk profile;
- Investment levels that are likely to remain high as a result of the group's growth ambitions in its hygiene products segments. The group is continually investing heavily in upgrading existing assets and in new assets, with capital expenditures normally at about 7%-8% of sales; and
- Some exposure to fluctuations of the Swedish krona to the euro, primarily in the Forest Products division.

Financial Statistics/Adjustments

SCA has reported under International Financial Reporting Standards since Jan. 1, 2005.

As surplus cash, we consider only cash balances and equivalents. Although other potential liquid means, such as listed shares, are not included as surplus cash, these assets support full surplus cash treatment. In our adjustments to SCA's reported financial statements in 2010, we have deducted reported cash and cash equivalents of SEK1.9 billion to arrive at adjusted debt.

Table 2

Reconciliation Of Svenska Cellulosa Aktiebolaget SCA Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. SEK)							
--Fiscal year ended Dec. 31, 2010--							
Svenska Cellulosa Aktiebolaget SCA reported amounts							
	Debt	Shareholders' equity	Revenues	EBITDA	Operating income	Interest expense	Cash flow from operations
Reported	36,506.0	67,255.0	109,142.0	15,119.0	8,677.0	1,237.0	11,015.0
Standard & Poor's adjustments							
Operating leases	4,013.0	--	--	206.7	206.7	206.7	817.3
Postretirement benefit obligations	1,751.0	(13.0)	--	(73.0)	(73.0)	--	624.0
Surplus cash and near cash investments	(1,866.0)	--	--	--	--	--	--
Capitalized interest	--	--	--	--	--	44.0	(44.0)
Capitalized development costs	--	--	--	(5.0)	28.0	--	(5.0)
Reclassification of nonoperating income (expenses)	--	--	--	--	59.0	--	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	--	--

Table 2

Reconciliation Of Svenska Cellulosa Aktiebolaget SCA Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. SEK) (cont.)							
Minority interests	--	566.0	--	--	--	--	--
Debt - Accrued interest not included in reported debt	132.0	--	--	--	--	--	--
Debt - Derivatives	(884.0)	--	--	--	--	--	--
EBITDA - Income (expense) of unconsolidated companies	--	--	--	(111.0)	(111.0)	--	--
EBITDA - Restructuring costs	--	--	--	868.0	868.0	--	--
D&A - Impairment charges/(reversals)	--	--	--	--	118.0	--	--
EBIT - Income (expense) of unconsolidated companies	--	--	--	--	111.0	--	--
FFO - Restructuring Costs	--	--	--	--	--	--	482.0
Total adjustments	3,146.0	553.0	0.0	885.7	1,206.7	250.7	1,874.3
Standard & Poor's adjusted amounts							
	Debt	Equity	Revenues	EBITDA	EBIT	Interest expense	Cash flow from operations
Adjusted	39,652.0	67,808.0	109,142.0	16,004.7	9,883.7	1,487.7	12,889.3

Table 3

Svenska Cellulosa Aktiebolaget SCA -- Peer Comparison				
	Svenska Cellulosa Aktiebolaget SCA	Kimberly-Clark Corp.	Georgia-Pacific LLC	Holmen AB
Rating as of Nov. 25, 2011	BBB+/Stable/A-2	A/Stable/A-1	A-/Stable/--	BBB/Stable/A-2
--Average of past three fiscal years--				
(Mil. \$)				
Revenues	15,255.1	19,425.3	18,025.3	2,566.3
EBITDA	2,165.6	3,903.5	3,345.0	369.0
Net income from cont. oper.	733.5	1,808.3	1,098.0	109.0
Funds from operations (FFO)	1,791.3	2,945.6	2,081.7	313.0
Capital expenditures	1,113.4	1,063.8	676.7	167.7
Free operating cash flow	779.7	2,146.4	1,497.4	149.3
Discretionary cash flow	399.2	1,145.8	1,497.4	41.9
Cash and short-term investments	0.0	679.3	540.7	26.5
Debt	6,259.2	8,190.7	13,904.8	923.3
Equity	9,367.5	6,032.8	11,149.3	2,270.2
Adjusted ratios				
EBITDA margin (%)	14.2	20.1	18.6	14.4
EBITDA interest coverage (x)	7.6	11.1	3.4	8.6
EBIT interest coverage (x)	4.5	9.1	2.2	4.5
Return on capital (%)	7.6	22.3	7.5	5.0
FFO/debt (%)	28.2	36.0	15.0	33.8
Free operating cash flow/debt (%)	12.0	26.2	10.8	16.0
Debt/EBITDA (x)	2.9	2.1	4.2	2.5
Total debt/debt plus equity (%)	40.2	57.6	55.5	29.1

Table 4

Svenska Cellulosa Aktiebolaget SCA -- Financial Summary					
--Fiscal year ended Dec. 31--					
	2010	2009	2008	2007	2006
Rating history	BBB+/Stable/A-2	BBB+/Negative/A-2	BBB+/Negative/A-2	BBB+/Stable/A-2	BBB+/Stable/A-2
(Mil. SEK)					
Revenues	109,142.0	110,857.0	110,449.0	105,913.0	101,439.0
EBITDA	16,004.7	16,071.7	14,705.7	15,317.3	14,087.4
Net income from continuing operations	5,552.0	4,765.0	5,578.0	7,138.0	5,437.0
Funds from operations (FFO)	13,931.3	13,404.8	11,213.3	12,749.2	11,870.6
Capital expenditures	6,895.3	8,087.9	9,449.2	8,042.6	7,556.9
Free operating cash flow	5,994.0	8,623.9	1,745.2	3,407.6	3,519.7
Discretionary cash flow	3,337.0	6,125.9	(1,382.8)	468.6	894.7
Cash and short-term investments	0.0	0.0	0.0	0.0	0.0
Debt	39,652.0	45,175.9	51,680.8	42,201.0	40,673.6
Equity	67,808.0	67,832.0	67,163.0	64,200.0	58,877.0
Adjusted ratios					
EBITDA margin (%)	14.7	14.5	13.3	14.5	13.9
EBITDA interest coverage (x)	10.8	7.3	5.9	7.3	7.9
EBIT interest coverage (x)	6.6	4.3	3.5	2.8	4.5
Return on capital (%)	8.2	7.5	7.1	5.1	7.3
FFO/debt (%)	35.1	29.7	21.7	30.2	29.2
Free operating cash flow/debt (%)	15.1	19.1	3.4	8.1	8.7
Debt/EBITDA (x)	2.5	2.8	3.5	2.8	2.9
Debt/debt and equity (%)	36.9	40.0	43.5	39.7	40.9

Related Criteria And Research

- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- 2008 Corporate Criteria: Ratios And Adjustments, April 15, 2008
- Key Credit Factors: Criteria For Rating The Forest Products Industry, Dec. 11, 2009
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011

Ratings Detail (As Of November 25, 2011)	
Svenska Cellulosa Aktiebolaget SCA	
Corporate Credit Rating	BBB+/Stable/A-2
<i>Nordic National Scale Rating</i>	--/--/K-1
Commercial Paper	
<i>Nordic National Scale Rating</i>	K-1
Senior Unsecured (6 Issues)	BBB+
Corporate Credit Ratings History	
27-Sep-2010	BBB+/Stable/A-2
29-Oct-2008	BBB+/Negative/A-2

Ratings Detail (As Of November 25, 2011) (cont.)		
17-Oct-2006		BBB+/Stable/A-2
18-Oct-2010	<i>Nordic National Scale Rating</i>	--/--/K-1
Business Risk Profile		Strong
Financial Risk Profile		Intermediate
*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.		

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