

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 company Svenska Cellulosa Aktiebolaget SCA (SCA) reflect the group's diverse earnings base, leading positions in its core hygiene and packaging markets, high level of integration, and Standard & Poor's Ratings Services assessment of SCA's "intermediate" financial risk profile.

Key business and profitability developments

SCA's 12-month adjusted operating margin reached 15.3% as of Sept. 30, 2010, down from the 15.5% recorded for the 12 months ended June 30, 2010, but a quarter-on-quarter increase to 16.2% from 15.7%. SCA's performance in the first three quarters of 2010 demonstrated a continuation of the improvement that began in the first quarter of 2009, at which time the 12-month operating margin stood at 13.8%. Furthermore, we think that SCA's current operating margin compares well with historical highs of the past five years and our base-case assumption that incorporates a better operating performance in 2010.

Higher marketing and raw material costs have dampened the profitability of SCA's hygiene product divisions (incontinence, baby diapers, and feminine care products, and tissue paper) in 2010. The packaging division, however, has performed strongly, thanks to higher selling prices and volumes, as well as cost savings from an ongoing restructuring program. In the forest products division, high input costs and lower selling prices for publication paper have pushed down profits, although higher pulp and sawn timber prices have helped boost the division's margins.

We continue to believe that SCA's hygiene product divisions will perform well over the medium term. We view the noncyclical demand patterns for hygiene products, as well as SCA's established position in emerging markets, as favorable factors in this respect. Furthermore, we assume that the group's packaging division will continue to reap near-term benefits of improved market conditions and implemented cost-saving measures. Currently high input costs (mainly for pulp and recovered paper), however, may create near-term challenges and could temper profitability increases unless the group can continue to raise its selling prices.

Key cash flow and capital-structure developments

SCA achieved adjusted funds from operations (FFO) to debt of about 32% for the 12 months ended Sept. 30, 2010, in line with our guidance of 30%-35% for the rating. In the same period, free operating cash flow (FOCF) amounted to Swedish krona (SEK) 5.8 billion, which was lower than the SEK7.9 billion recorded for the corresponding period in 2009, primarily due to a substantial outflow of working capital. Adjusted debt as of Sept. 30, 2010, was an estimated SEK43 billion compared with SEK45.2 billion at year-end 2009.

We currently forecast a steady or improved financial performance in 2010 and 2011, primarily based on continued positive free operating and discretionary cash flow generation, which could lead to a reduction of adjusted debt and improved credit measures. Besides operating challenges and macroeconomic risk, we believe that downside risk to SCA's financial performance could result from fluctuations of the Swedish krona against the euro (or, less directly, the U.S. dollar), which may cause volatility in the group's debt levels, profitability, and cash flow.

Although not currently expected over the near term, we would view a major debt-funded acquisition as incommensurate with the current rating.

Short-term credit factors

The short-term rating is 'A-2', reflecting our view that the group's liquidity position is adequate to strong. Large backup facilities support liquidity, balancing SCA's substantial exposure to short-term financing.

As of June 30, 2010, SCA's liquidity position was supported by:

- Liquid funds of about SEK4 billion;
- About SEK31 billion of unused long-term committed syndicated and bilateral credit facilities (SEK2.6 billion of these expire in the fourth quarter of 2010). SCA's main long-term credit facilities consist of a €1.1 billion facility maturing in 2012, a €1 billion facility maturing in 2014, and bilateral credit facilities totaling about SEK8 billion, the majority of which expire in 2010, 2011, and 2013. The facilities have no financial covenants or material adverse change clauses that would restrict SCA from drawing under them; and
- 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 SEK17.9 billion, of which SEK6.9 billion consisted of outstanding commercial paper with maturities of up to five months. The remainder related to maturities in 2010 and 2011, which totaled about SEK11.5 Billion. Debt maturities in 2012 and 2013 are about SEK1.6 billion and SEK4.1 billion, respectively.

In November 2010, SCA issued SEK2 billion of fixed and floating-rate notes maturing in February 2016.

Outlook

The stable outlook reflects our expectation of a continued improvement in SCA's operating performance and credit measures over the medium term. For example, we expect FFO to adjusted debt to average 30%-35%.

Downside rating pressure would primarily arise from a deteriorating operating performance as a result of, for example, macroeconomic pressure. Increased outgoings beyond those we currently expect for expansionary capital

expenditure, shareholder dividends, or spending on acquisitions, would create additional rating pressure.

Upside rating potential is currently limited and would require a recovery in operational performance combined with a strengthening of the group's financial profile beyond our current expectations. Given the group's existing business risk profile, FFO to adjusted debt would need to average about 35%-40% on a sustainable basis for us to consider an upgrade.

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 one of the largest private owners of European forest.

In 2009, net sales totaled SEK111 billion (see table 1). Europe accounted for about 75% of sales and North America about 12%, while most of the remainder were in Latin America and the Asia-Pacific region. Germany (14% of total revenue in 2009), 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.

Business Risk Profile: Strong Position In Stable Hygiene Industry, But Exposed To Cyclical 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 about 55%-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 2009), where sales are well spread among different countries. Other markets include North America (about 10% 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;
- Good integration which reduces volatility in SCA's cost base. About 44% of SCA's virgin fiber requirements are fulfilled by SCA's own forest resources, and the group collects about 37% 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 40%. 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 cyclical 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-/Stable/--). 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 is improving, 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
- Exposure to currency fluctuations, primarily relating to translation exposure in the krona-euro exchange rate because a large part of the cost base is in krona while many sales are in euros.

Financial Risk Profile: High Spending Levels 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;
- Adequate to strong liquidity, 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 (0.6x on Dec. 31, 2009). SCA targets dividends over the cycle corresponding to one-third of operating cash flows (after tax and interest). Furthermore, we expect acquisition activity to be low in the near term; and
- Extensive forestland holdings. At the end of 2009, SCA valued its forestland at about SEK25 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:

- 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. Currency volatility can also give rise to a timing difference between the effects on reported cash flows and reported debt because the group reports cash flows using average exchange rates and debt using closing date rates. This is, however, primarily a translation exposure; SCA matches foreign currency debt with assets and cash flows in the same currency to a large extent.

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 2009, we have deducted reported cash and cash equivalents of SEK5.1 billion to arrive at adjusted debt.

Table 1

Svenska Cellulosa Aktiebolaget SCA--Reported Operating Statistics By Business (Unadjusted)				
Business segment	--Sales (Mil. SEK)*--		--EBITDA margin (%)--	
	2009	2008	2009	2008
Personal care	25,716	23,331	17.3	16.9
Tissue	41,425	38,380	15.4	11.6
Packaging	28,359	33,441	7.2	9.2
Forest products	16,983	16,710	19.0	17.2
Group total	110,857	110,449	14.2	12.6

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

Table 2

Reconciliation Of Svenska Cellulosa Aktiebolaget SCA Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. SEK)*

--Fiscal year ended Dec. 31, 2009--									
Svenska Cellulosa Aktiebolaget SCA reported amounts									
	Debt	Shareholders' equity	Operating income (before D&A)	Operating income (before D&A)	Operating income (after D&A)	Interest expense	Cash flow from operations	Cash flow from operations	Capital expenditures
Reported	44,104.0	67,156.0	15,618.0	15,618.0	8,190.0	1,644.0	15,281.0	15,281.0	7,215.0
Standard & Poor's adjustments									
Operating leases	4,255.9	--	997.5	206.7	206.7	206.7	790.8	790.8	1,034.9
Postretirement benefit obligations	2,803.0	(53.3)	313.0	313.0	313.0	231.0	218.2	218.2	--
Accrued interest not included in reported debt	163.0	--	--	--	--	--	--	--	--

Table 2

Reconciliation Of Svenska Cellulosa Aktiebolaget SCA Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. SEK)* (cont.)									
Surplus cash and near cash investments	(5,148.0)	--	--	--	--	--	--	--	--
Capitalized interest	--	--	--	--	--	131.0	(131.0)	(131.0)	(131.0)
Capitalized development costs	--	--	(31.0)	(31.0)	11.0	--	(31.0)	(31.0)	(31.0)
Reclassification of nonoperating income (expenses)	--	--	--	--	142.0	--	--	--	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	--	--	(3,307.0)	--
Minority interests	--	750.0	--	--	--	--	--	--	--
Derivatives	(1,002.0)	--	--	--	--	--	--	--	--
Earnings from associated companies	--	--	(35.0)	(35.0)	--	--	--	--	--
Impairment charges	--	--	--	--	600.0	--	--	--	--
Restructuring charges	--	--	--	--	--	--	499.0	499.0	--
Total adjustments	1,071.9	696.7	1,244.5	453.7	1,272.7	568.7	1,346.0	(1,961.0)	872.9

Standard & Poor's adjusted amounts

	Debt	Equity	Operating income (before D&A)	EBITDA	EBIT	Interest expense	Cash flow from operations	Funds from operations	Capital expenditures
Adjusted	45,175.9	67,852.7	16,862.5	16,071.7	9,462.7	2,212.7	16,627.0	13,320.0	8,087.9

*Please note that two reported amounts (operating income before D&A and cash flow from operations) are used to derive more than one Standard & Poor's-adjusted amount (operating income before D&A and EBITDA, and cash flow from operations and funds from operations, respectively). Consequently, the first section in some tables may feature duplicate descriptions and amounts. SEK--Swedish krona.

Table 3

Svenska Cellulosa Aktiebolaget SCA--Peer Comparison*				
	Svenska Cellulosa Aktiebolaget SCA	Kimberly-Clark Corp.†	Holmen AB	Mondi Group
Corporate credit rating as of Dec. 3, 2010	BBB+/Stable/A-2	A/Stable/A-1	BBB/Negative/A-3	BB+/Stable/--
(Mil. \$)	--Fiscal year ended Dec. 31, 2009--			
Revenues		15,525.4	19,115.0	2,556.9
Net income from continuing operations		667.3	1,884.0	140.9
Funds from operations (FFO)		1,860.1	2,930.4	313.6
Capital expenditures		1,180.7	1,049.7	108.8

Table 3

Svenska Cellulosa Aktiebolaget SCA--Peer Comparison* (cont.)				
Free operating cash flow	1,142.6	2,985.7	299.7	145.9
Discretionary cash flow	792.7	1,999.7	193.8	77.1
Debt	6,326.8	8,054.8	848.6	2,936.3
Equity	9,502.7	6,222.9	2,311.3	4,076.2
Adjusted ratios				
Operating income (before D&A)/revenues (%)	15.2	22.2	16.0	13.2
EBIT interest coverage (x)	4.3	8.8	5.2	1.7
EBITDA interest coverage (x)	7.3	10.8	9.2	3.6
Return on capital (%)	7.5	23.9	5.8	6.1
FFO/debt (%)	29.5	36.4	37.0	23.0
Free operating cash flow/debt (%)	18.9	37.1	35.4	5.4
Debt/EBITDA (x)	2.8	1.9	2.1	3.1
Total debt/debt plus equity (%)	40.0	56.4	26.9	41.9

*Fully adjusted (including postretirement obligations). Excess cash and investments netted against debt. †Excess cash and investments not netted against debt.

Table 4

(Mil. SEK)	12 months to Sept. 30		--Fiscal year ended Dec. 31--		
	2010	2009	2008	2007	2006
Revenues	109,085.0	110,857.0	110,449.0	105,913.0	101,439.0
Net income from continuing operations	5,092.0	4,765.0	5,578.0	7,138.0	5,437.0
Funds from operations (FFO)	13,658.0	13,320.0	11,058.5	12,660.2	11,700.4
Capital expenditures	7,153.9	8,087.9	9,449.2	8,042.6	7,556.9
Free operating cash flow	5,848.1	8,539.1	1,590.3	3,318.6	3,349.4
Discretionary cash flow	3,215.1	6,041.1	(1,537.7)	379.6	724.4
Debt	42,999.9	45,175.9	51,680.8	42,201.0	40,673.6
Equity	64,491.7	67,852.7	67,187.9	64,222.1	58,901.1
Adjusted ratios					
Operating income (before D&A)/revenues (%)	15.3	15.2	14.0	15.2	14.6
EBIT interest coverage (x)	5.8	4.3	3.5	2.8	4.5
EBITDA interest coverage (x)	9.5	7.3	5.9	7.3	7.9
Return on capital (%)	8.9	7.5	7.1	5.1	7.3
FFO/debt (%)	31.8	29.5	21.4	30.0	28.8
Free operating cash flow/debt (%)	13.6	18.9	3.1	7.9	8.2
Debt/EBITDA (x)	2.7	2.8	3.5	2.8	2.9
Debt/debt and equity (%)	40.0	40.0	43.5	39.7	40.8

*Fully adjusted (including postretirement obligations). Excess cash and investments netted against debt.

Related Criteria And Research

- Improving Demand For European Forest Products Offset By Higher Input Costs And Mixed Pricing Prospects, June 1, 2010

- Key Credit Factors: Criteria For Rating The Forest Products Industry, Dec. 11, 2009

Ratings Detail (As Of December 3, 2010)*	
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
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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