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**Summary:**

# Svenska Cellulosa Aktiebolaget SCA

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## Summary:

# Svenska Cellulosa Aktiebolaget SCA

**Credit Rating:** BBB+/Negative/A-2

## 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 financial risk profile as intermediate.

### Key business and profitability developments

As we expected, SCA's operating performance continues to suffer from challenging market conditions, primarily in its packaging operations, which contributed 30% of revenues in 2008. Still-high inventory levels and falling liner prices have depressed selling prices for corrugated board. At the same time, demand is decreasing in the wake of the global economic decline, and we understand that large capacity additions in the industry are planned over the next two years, which could put prices under further pressure. Consequently, we maintain our view that SCA's exposure in this sector could lead to continued underperformance against our rating requirements in 2009. However, we expect the good performance of SCA's core hygiene businesses to continue and believe that SCA could benefit from incremental input cost deflation.

SCA's operating margin for the 12 months ended March 31, 2009, declined to about 13.1% from 15% the previous year. This was despite strong results in the Tissue division, where SCA has been able to raise prices and benefit from lower input costs. In the Forest Products division, recent price increases and higher exports of publication paper were offset by weaker margins in the sawn-timber operations. Demand for SCA's incontinence products and baby diapers remains stable, but competition is intense, and there are indications of higher price sensitivity among customers. Raw material costs in this segment have remained high, but could, in our view, gradually decrease in 2009.

We believe that SCA can improve its operating performance in the near to medium term, mainly because we expect the healthy performance of the hygiene businesses to continue. We note, however, that a strengthening of the Swedish krona (SEK) against major currencies could affect SCA's profitability adversely. So far in 2009, the weak krona has had positive transaction and translation effects on the group's profitability.

Our main concern remains the near-term development of the European packaging industry. We will continue to closely monitor the industry supply-demand balance and SCA's announced cost-saving measures, which include headcount reductions, the closing of 11 corrugated board plants, and the earlier-than-planned closure of SCA's 260 kiloton New Hythe testliner mill in the U.K.

### Key cash flow and capital-structure developments

SCA's credit measures remained under pressure at the beginning of 2009, with adjusted funds from operations estimated at 20.6% for the 12 months ended March 31, down from 28% for the corresponding period of 2008. In our view, this ratio is very weak relative to our near-term requirements of 30% for the current rating, and we

believe it reflects a combination of lower operating cash flows and higher adjusted debt, the latter partly due to currency exchange effects. Still, we note that an unusual first-quarter working capital release helped free operating cash flow remain positive.

In our base-case scenario, SCA is likely to improve its financial performance in 2009, primarily through improved operating cash flows. However, we see considerable downside risks, mainly relating to global economic developments. On a positive note, SCA has lowered dividends in 2009, which could boost discretionary cash flow generation somewhat. Nonetheless, continued high expansionary capital expenditure will likely limit any material debt reduction. In addition, further weakening of the krona to the euro or U.S. dollar could cause debt levels to increase, but would also strengthen profitability and cash flows. We expect SCA's acquisition activity to be very limited in the near term.

### Short-term credit factors

The short-term rating on SCA is 'A-2', reflecting our view that the group's liquidity position is adequate. Liquidity is supported by large backup facilities, which balance SCA's substantial exposure to short-term financing. On March 31, 2009, short-term debt amounted to SEK12.7 billion, of which SEK8.6 billion consisted of outstanding commercial paper with maturities of up to five months. The remaining SEK4.1 billion related to financial leases, subsidiary funding, and other short-term portions of long-term debt. Short-term borrowings are backed by committed syndicated and bilateral credit facilities totaling about SEK32.6 billion, of which SEK20.5 billion were available on March 31, 2009. In addition, the group had about SEK4.9 billion in liquid funds.

SCA's main long-term credit facilities are a €1.1 billion facility maturing in 2012, a €1 billion facility due in 2014, and bilateral credit facilities totaling SEK8 billion (the majority expiring in 2010, 2011, and 2013). These facilities have no financial covenants or material adverse change clauses that would restrict SCA from drawing under them.

Excluding commercial paper, SCA's debt-maturity profile is relatively long dated. In addition, in April 2009, SCA signed an agreement for a new SEK5 billion loan with a five-year maturity. As of March 31, 2009, the group's debt maturities in 2009 and 2010 amounted to about SEK2.9 billion and SEK5.2 billion, respectively. Debt maturities in 2011 and 2012 were about SEK8.4 billion and SEK6 billion.

Over the short term, operating cash flow generation is likely to continue to exceed working capital and capital expenditure needs. Furthermore, we assume that SCA has a degree of flexibility in terms of capital expenditure, if necessary, to mitigate liquidity pressure.

## Outlook

The negative outlook reflects our assessment that there is minimal room for further deterioration of SCA's financial performance at the current rating level. The negative outlook also reflects the possibility that we would lower the ratings if SCA's operating cash flows and credit measures failed to recover meaningfully over the near to medium term, owing to weaker market conditions. This means, for example, that we would expect adjusted funds from operations to debt to improve toward 30% in 2009. Although not currently expected, any major debt-financed acquisition would also create downside risk for the ratings.

The outlook could be revised to stable if SCA is successful in strengthening its operating performance through price increases and/or cost reductions to restore margins and cash flows and maintain what we regard as an intermediate financial risk profile, with funds from operations to adjusted debt of about 30%-35%.

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