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**Research Update:**

## Ratings On Portugal-Based Paper And Pulp Producer The Navigator Company Affirmed At 'BB/B'; Outlook Stable

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### Table Of Contents

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Overview

Rating Action

Rationale

Outlook

Ratings Score Snapshot

Related Criteria And Research

Ratings List

## Research Update:

# Ratings On Portugal-Based Paper And Pulp Producer The Navigator Company Affirmed At 'BB/B'; Outlook Stable

## Overview

- Portugal-based pulp and paper group The Navigator Company (previously Portucel) continues to perform in line with our expectations, supported by a weakening euro and resilient performance in its highly efficient paper operations.
- Although we expect its credit metrics to weaken further, we think that this will be balanced by its majority owner Semapa's credit profile gradually improving.
- We are therefore affirming our ratings on The Navigator Company, including our 'BB' long-term and 'B' short-term corporate credit ratings.
- The stable outlook reflects our expectation that The Navigator Company will continue to benefit from strong operating performance at its mills in Portugal and that high dividend payments will not severely weaken its financial profile.

## Rating Action

On May 31, 2016, S&P Global Ratings affirmed its 'BB' long-term and 'B' short-term corporate credit ratings on Portugal-based pulp and paper group The Navigator Company. The outlook is stable.

At the same time, we withdrew our 'BB' issue rating on The Navigator Company's €350 million senior unsecured notes due 2020 following the company's announcement that the notes were redeemed in full on May 17.

## Rationale

The affirmation reflects our expectation that The Navigator Company will continue its strong operational performance and that this will offset an ongoing gradual weakening in its financial profile due to high shareholder distributions. The affirmation also reflects that the company's improved liquidity profile has led us to revise the stand-alone credit profile to 'bb+', although that the issuer credit rating continues to be constrained by higher leverage at its parent, Semapa.

The Navigator Company benefitted from high pulp prices and price increases for uncoated woodfree (UWF) paper in 2015, which resulted in a sales increase of 5.6% and a reported EBITDA margin of 24%. We think that the company will be

able to keep growing its topline, despite slightly declining demand for its core UWF paper segment, due to its position as the most cost-competitive UWF producer in Europe. We also think that new pulp, tissue, and pellets capacity will add to sales in 2016 and 2017 but that this new capacity, combined with lower pulp prices, could lead to somewhat lower margins in 2016 and 2017 compared with 2015.

We understand that management will maintain high capital expenditure (capex) in 2016 and 2017 as it invests beyond UWF paper. A large part of the growth capex will go into new tissue capacity at the Cacia site in Portugal. We think that these investments are positive for the company's business risk profile as it increases diversification and enables long-term growth outside the UWF paper segment. However, we believe these investments, combined with continued high dividend payments, will weaken credit metrics over 2016 and 2017. While we understand the 2015 €440 million shareholder distribution was due to a timing issue, we expect dividend payments to remain high in 2017 and beyond because leverage at the parent company Semapa is still relatively high. We factor this into our 'BB' rating.

Our assessment of The Navigator Company's business risk profile is constrained by exposure to the highly competitive European forest and paper products markets and the company's relatively small size, scope, and limited diversification. The Navigator Company is heavily focused on UWF paper; more than 75% of its sales are of office copy paper. The rest is sales of pulp, tissue, and energy. Business diversification could improve over time with the announced investments in the production of wood pellets and tissue paper. Similarly, we currently view asset concentration as a constraint given that, excluding the announced expansion plans, the group has a limited number of production sites and all are in Portugal.

These negatives are offset by the group's market position as the largest UWF paper producer in Europe and the high profitability it has sustained over the last few years. The group derives its strong margins from having a well-invested modern asset base, high capacity utilization, a focus on premium paper grades, good access to raw materials, and relatively low labor costs.

Our assessment of the financial risk profile reflects strong, albeit recently weakened, stand-alone credit metrics. It had adjusted funds from operations (FFO) to debt of above 45% and debt to EBITDA of about 1.7x in 2015 (compared with 89% and 1.0x in 2014). We expect these measures to weaken further in 2016 and 2017 due to high capex and continued high dividend payments as The Navigator Company supports the lowering of leverage at Semapa. We view positively The Navigator Company's recent refinancing exercises, including the redemption of its €350 million 5.375% senior notes, which have reduced its cost of debt materially.

The company is continuing its ambitious investment program. Pulp expansion in Cacia was recently concluded and tissue and pellets investments are ramping up in 2016. The company also continues to invest into forestlands in Mozambique, although we understand an industrial pulp mill project is likely not to begin

before 2020.

In our base case for The Navigator Company, we assume:

- A slight increase in paper prices in 2016 and our expectation of bleached hardwood kraft pulp at \$700 per ton for 2016. We also assume slightly increasing paper volumes (1%) and markedly higher pulp volumes due to the ramp-up of new capacity at Cacia mill.
- This will result in slightly increased revenues and a reported EBITDA margin of 23.0%-23.5% compared with 24.7% in 2015. We expect sales to increase further in 2017-2018 as new pulp, pellets, and tissue capacity come online.
- Capex to increase from the €154 million spent in 2015 due to ongoing strategic investments in pulp, tissue, pellets and forestland in Mozambique.
- Dividend payments to remain high at around the same level as the €170 million to be paid in 2016.

Based on these assumptions, we arrive at the following credit measures for The Navigator Company:

- FFO to debt of around 38% in 2016 and 35% in 2017.
- Debt to EBITDA of around 2.0x-2.5x in 2016 and beyond.
- Negative discretionary cash flows in the coming three years due to high capex and dividend payments.
- EBITDA interest coverage to improve markedly following recent refinancing at lower rates.

We continue to view The Navigator Company as strategically important for the Semapa group, which owns 69.4% of voting rights. We understand that Semapa does not intend to divest further shares following its disposal of an 11.6% stake in 2015. The Navigator Company contributes to a substantial proportion of consolidated group revenues and profits. In our view, on a consolidated basis Semapa has weaker credit metrics than The Navigator Company. This is primarily because of additional indebtedness at the holding company level and the lower profitability and creditworthiness of Semapa's other consolidated businesses (notably cement company Secil). We forecast that Semapa will maintain an adjusted leverage ratio around 4.0x in the coming years and that this could slightly improve depending on the amount of dividends paid out from Semapa. Overall, we assess the group credit profile (GCP) of the consolidated Semapa group as 'bb'. Although we view The Navigator Company's stand-alone credit profile at 'bb+', the ratings are capped by the GCP due to Semapa's heavy influence on the financial policy of The Navigator Company.

## **Liquidity**

We assess The Navigator Company's liquidity profile as adequate, compared with less than adequate previously. This is due to its reduced amount of short-term debt following recent refinancing transactions and limited debt maturities up until 2020.

Principal liquidity sources for the 12 months from March 31, 2016, include:

- Estimated cash and equivalents of about €57 million;
- FFO of around €300 million in 2016;
- Unused committed bank and commercial paper facilities totaling €140 million maturing in 2020; and
- Our understanding of new additional funding from Portuguese banks and the European Investment Bank of €195 million, which was signed in April and May.

Principal liquidity uses for the same period include:

- Short-term debt maturities of around €172 million, including the €150 million Eurobond that was redeemed in May;
- Capex, which we forecast at close to €200 million in 2016; and
- Dividend payments of €170 million, which was paid in May 2016 and around the same level to be paid in 2017, although could be significantly lower in a stress scenario.

## **Outlook**

The stable outlook reflects our expectation that The Navigator Company will continue to benefit from strong operating performances at its mills in Portugal. We expect the tissue and the pellets business to continue to grow as investments ramp-up and subsequently boost earnings and enhance diversification. We expect that the company will maintain a cautious expansion strategy for its long-term pulp project in Mozambique but that shareholder distributions will remain high in the coming years.

### **Downside scenario**

We could lower the ratings if The Navigator Company's operating performance deteriorated such that we expected its EBITDA margin to fall significantly below 20%, thereby impairing the performance of the whole Semapa group. This could result from an economic decline, coupled with input cost inflation or an operational issue at one of the group's mills in Portugal. We could also lower the ratings if we saw a deterioration in liquidity at Semapa. This could happen as a result of increasing dividends and a higher reliance on short-term debt. We could also take a negative rating action on The Navigator Company if we observed an increase in financial risk at Semapa with additional debt-funded investments, extraordinary dividends, or share buybacks that caused the debt-to-EBITDA ratio to rise sustainably above 4x.

### **Upside scenario**

We could raise the rating if we thought the financial risk profile of the consolidated Semapa group was going to improve significantly, such that debt to EBITDA was below 3.0x on a sustained basis. We view such a scenario as unlikely in the coming years as lower leverage at the Semapa holding company level is likely to be met with higher leverage at The Navigator Company.

## Ratings Score Snapshot

Corporate Credit Rating: BB/Stable/B

Business risk: Fair

- Country risk: Moderately High
- Industry risk: Moderately High
- Competitive position: Fair

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: bb+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (No impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bb+

- Group credit profile: bb
- Entity status within group: Strategically important (-1 notch)

## Related Criteria And Research

### Related Criteria

- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Group Rating Methodology - November 19, 2013
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Forest And Paper Products Industry - February 12, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012

- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013

## Ratings List

### Ratings Affirmed

The Navigator Company S.A. Corporate Credit Rating	BB/Stable/B
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### Ratings Withdrawn

	To	From
The Navigator Company S.A. Senior Unsecured Recovery Rating	NR NR	BB 3H

NR--Not rated.

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](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.globalcreditportal.com](http://www.globalcreditportal.com) and at [spcapitaliq.com](http://spcapitaliq.com). All ratings affected by this rating action can be found on the S&P Global Ratings public website at [www.standardandpoors.com](http://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.

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