S&P Global
Ratings

Research

Summary:

The Navigator Company S.A.

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Summary:

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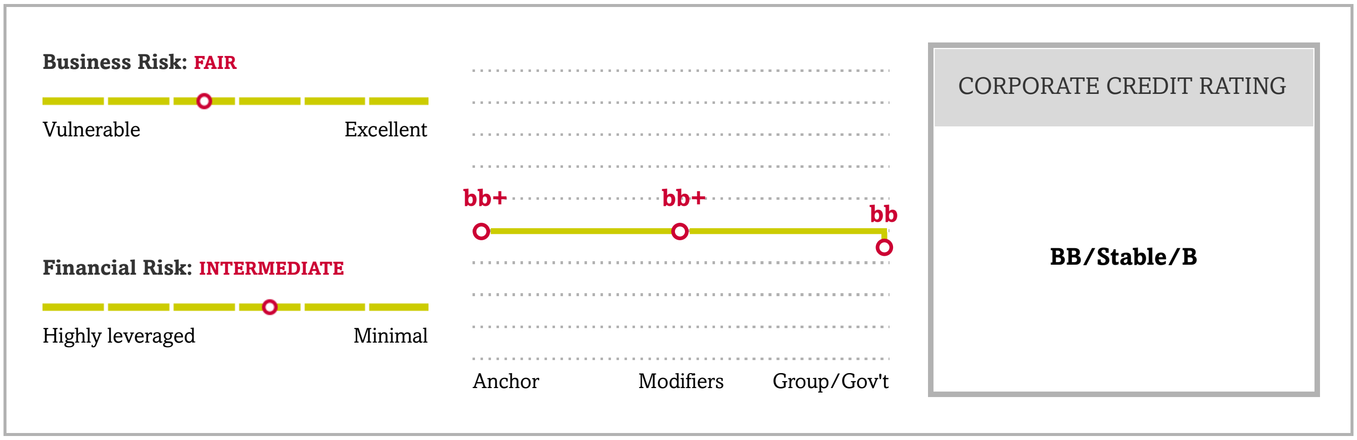

Rationale

Business Risk: Fair	Financial Risk: Intermediate
• Exposure to highly competitive European forest products markets. • Significant portion of sales from the challenging uncoated woodfree (UWF) paper market. • Relatively limited size, scope, and product diversity. • Asset concentration, with a large part of earnings derived from three mills. • Strong market position as the largest UWF paper producer in Europe. • Strong margins as a result of a well-invested asset base, high capacity utilization, focus on premium paper grades, good access to raw materials, and relatively low labor costs.	• Strong cash flow generation and low maintenance investments due to a well-invested asset base. • Cyclical cash flow generation as a result of fluctuating paper and pulp prices. • An expectation of ongoing high dividend payments to support deleveraging at parent company Semapa S.A. • Likely increasing investment due to focus on expansion projects.

Outlook : Stable

The stable outlook on Portugal-based pulp and paper group The Navigator Company S.A. reflects our expectation that the company will continue to benefit from strong operating performances at its mills in Portugal, and that, despite declining demand at its core UWF paper segment, the company will continue to maintain its profitability thanks to its highly efficient paper operations. We expect the tissue and pellets business to continue to grow as investments ramp up and subsequently boost earnings and enhance product diversification. We also expect the company to generate incremental cash flow from the expansion of its existing pulp business.

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 company's mills in Portugal. We could also lower the ratings if we saw deterioration in liquidity at Semapa. This could happen as a result of increasing dividends and greater 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 debt to EBITDA to rise sustainably above 4x and funds from operations (FFO) to debt to drop below 20% on a sustained basis.

Upside scenario

We could raise the ratings if we thought that the financial risk profile of the consolidated Semapa group was going to improve significantly, such that debt to EBITDA was below 3.0x and FFO to debt more than 30%, 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.

Our Base-Case Scenario

Assumptions

- Eurozone GDP growth of 1.4% in 2017 and 1.3% in 2018.
- A marginal increase in paper volumes. Pulp volumes are likely to remain flat in 2017, but rise markedly thereafter, due to the Figueira da Foz mill expansion from 2018. We assume an almost twofold increase in tissue volumes with the expansion of the Cacia mill from 2018.
- Some downward pressure on pulp prices due to demand-supply imbalances, with a bleached eucalyptus kraft pulp list price (for delivery in Europe) of about $670 per ton for 2017, translating into a realized price of about €475 per ton.
- As a result of the aforesaid drivers, low-single-digit topline growth for 2017, and mid-single-digit growth for 2018.
- Margins of 25%, supported by the efficient paper operations and cost-containment efforts. We assume an incremental increase in EBITDA as the new pellets capacity became fully operational in 2017, and the new pulp and tissue capacity comes online in 2018, adding 70,000 tons of incremental pulp capacity and 70,000 tons of incremental tissue capacity.
- Annual capital expenditure (capex) of €160 million-€170 million over the next two years, in line with management guidance. This capex mainly relates to tissue capacity expansion at the Cacia mill and pulp capacity expansion at the Figueira da Foz mill. The company continues its ongoing investments in forestland in Mozambique.
- Dividend payments in the range of €200 million-€250 million.

Key Metrics

	2016A	2017E	2018E
EBITDA margin (%)	25.7	24.5-25.0	24.5-25.0
Debt/EBITDA (x)	1.6	2.0-2.2	2.0-2.2
FFO/debt (%)	55	37-40	35-37

A--Actual. E--Estimate. FFO--Funds from operations. 2016 numbers are based on unaudited preliminary results.

Business Risk: Fair

Our assessment of The Navigator Company's business risk profile is constrained by the company's 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 paper. The rest of its sales are of pulp, tissue, and energy. Similarly, we currently view The Navigator Company's asset concentration as a constraint as it has a limited number of production sites and all are in Portugal (excluding the pellets plant in the U.S. that recently became operational, and the small-scale forestland operations in Mozambique).

These negatives are offset by The Navigator Company's market position as the largest UWF paper producer in Europe and the high profitability it has sustained over the past few years. The company derives its strong margins from 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.

Despite high-single-digit volume growth in the pulp and tissue business, as a result of the capacity expansion at Cacia and Velha de Ródão mills, respectively, The Navigator Company's top-line declined by 3% in 2016. This was largely due to challenges in the energy business as the natural cogeneration plant at the Figueira da Foz plant switched production to own-consumption basis only, thereby reducing the volume of sales to the national grid as compared to the previous year, and also due to repairs in the Setúbal and Cacia pulp mills. Lower pulp and paper prices also led to turnover decline.

However, the company continues to maintain its margins around 25% thanks to its position as the most cost-competitive UWF producer in Europe. We also think that the recent pellets capacity addition and the upcoming pulp and tissue capacity expansion will add to sales in 2017 and 2018. This expansion is positive for the company's business risk profile as it increases diversification and enables long-term growth outside the UWF paper segment. However, the contribution from the expansion in the tissue and pellets business is relatively limited at this point in time, reflecting a structural business transformation.

Financial Risk: Intermediate

Our assessment of the financial risk profile reflects The Navigator Company's strong and relatively stable stand-alone credit metrics. The company had S&P Global Ratings-adjusted FFO to debt of about 55% and debt to EBITDA of about 1.6x in 2016 (based on preliminary numbers). Despite our expectation of continuous strong free cash flow generation, we expect these measures to weaken further in 2017 and 2018 due to higher investments and continued high dividend payments as The Navigator Company supports the lowering of leverage at Semapa. We expect adjusted FFO to debt to progressively fall below 40%, and debt to EBITDA to reach around 2x in 2017.

The company is continuing its ambitious investment program to diversify away from UWF paper. The pellets plant in the U.S is now fully operational and is likely to be incremental to EBITDA in 2017. We understand that management will maintain high capex in 2017 and 2018 as it invests in products other than UWF paper. A large part of the growth capex will go toward new tissue capacity at the Cacia mill and pulp capacity at the existing Figueira da Foz mill. The company also continues to invest into forestlands in Mozambique, although we understand that an industrial pulp mill project is highly unlikely to start in the coming ten years.

Liquidity: Adequate

We assess The Navigator Company's liquidity profile as adequate, reflecting our forecast that its sources of liquidity will exceed uses by more than 1.2x over the next 12 months. The Navigator Company benefits from strong free cash flow generation, limited medium-term debt maturities, and ample headroom under its covenants.

Principal Liquidity Sources	Principal Liquidity Uses
• Estimated cash and equivalents of about €68 million as of Dec. 31, 2016; • FFO of around €300 million in 2017; and • Unused committed bank and commercial paper facilities totaling €225 million, maturing in 2020.	• Short-term debt maturities of around €70 million in 2017. • Capex in the range of €160 million-€170 million annually for 2017 and 2018; and • Dividend payments of €200 million-€250 million in 2017 and 2018, although we understand that payments could be significantly lower in a stress scenario.

Group Influence

We continue to view The Navigator Company as strategically important for the Semapa group, which owns 69.4% of the voting rights. The Navigator Company contributes to a substantial proportion of consolidated group revenues and profits and the Semapa group is dependent on dividend payments from The Navigator Company to service its own debt.

In our view, on a consolidated basis, Semapa has weaker credit metrics than The Navigator Company, 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 of around 4x and FFO to debt of about 20% in the coming years. These ratios could improve slightly, depending on the amount of dividends that Semapa pays out and Secil's operating performance.

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 on the consolidated group due to Semapa's heavy influence on The Navigator Company's financial policy.

Ratings Score Snapshot

Corporate Credit Rating

BB/Stable/B

Business risk: Fair

- **Country risk:** Intermediate
- **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)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Adequate (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 from SACP)

Related Criteria And Research

Related Criteria

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Forest And Paper Products Industry, Feb. 12, 2014
- Corporate Methodology, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related research

- What's Behind Recent Positive Rating Actions On European Forest And Paper Companies, Aug. 26, 2016

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	Minimal	Modest	**Intermediate**	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	**bb+**	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

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