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## Research Update:

# Portugal-Based Pulp And Paper Manufacturer The Navigator Company S.A. Outlook Revised To Positive; 'BB' Rating Affirmed

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## Rating Action Overview

- Higher volumes and prices drove The Navigator Company's (Navigator's) strong revenues and EBITDA expansion in 2018.
- In line with our group rating methodology, we cap the issuer credit rating on Navigator at the 'bb' group credit profile (GCP) of its parent company, Semapa S.A.
- However, we think there is at least a one-in-three chance that Semapa will continue to show financial discipline, and further improvements in Navigator's cash generation could lead to an upward revision of Semapa's GCP.
- We are revising the outlook on Navigator to positive from stable.
- We are affirming our ratings on Navigator, including our 'BB/B' long- and short-term issuer credit ratings.
- We are also revising upward Navigator's stand-alone credit profile to 'bbb-' from 'bb+'.

## Rating Action Rationale

The positive outlook on The Navigator Company (Navigator) reflects our view that there is at least a one-in-three chance that the parent company, Semapa S.A., will continue to show financial discipline, and further improvements in Navigator's strong cash generation could improve our financial risk assessment of Semapa's group credit profile (GCP).

Semapa's S&P Global Ratings-adjusted funds from operations (FFO) to debt increased to 28% in 2018 from 24% in 2017. Semapa's adjusted debt to EBITDA improved to 2.9x in 2018 from 3.5x in 2017. We expect Semapa to further reduce debt in 2019, with FFO to debt of about 34% and adjusted leverage of about 2.4x.

Despite our upward revision of Navigator's stand-alone credit profile (SACP) to 'bbb-', we are affirming our 'BB' issuer credit rating on Navigator because it remains capped by the parent's GCP of 'bb'. The consolidated Semapa has higher leverage and lower profitability than Navigator on a stand-alone basis.

On Dec. 31, 2018, Navigator's adjusted debt to EBITDA was 1.7x and FFO to debt was 47%. Over the next two years, we expect these credit metrics to improve further; we expect adjusted debt to EBITDA to reduce to 1.5x and FFO to debt to exceed 50%. These ratios are consistent with a modest financial risk profile.

Navigator's credit metrics are comfortably entrenched in our modest financial risk profile assessment. They provide Navigator with some leeway to absorb the effect of potentially lower pulp and paper prices or higher investments. We believe that Navigator's leverage will remain below its publicly stated maximum leverage of 2.0x (similar on an S&P Global Ratings-adjusted basis).

Our assessment of Navigator's business risk profile reflects its market position as Europe's largest uncoated wood free (UWF) paper producer. Our assessment also considers Navigator's strong profit margins, which reflect its well-invested, modern asset base, high capacity utilization, focus on premium paper grades, vertical integration into hardwood pulp, full degree of energy self-sufficiency, and relatively low labor costs.

In 2018, pulp prices increased by 21% and paper prices rose by 8.5%. This supported revenues and offset the impact of adverse foreign exchange movements and slightly lower volumes caused by production stoppages. Damage caused by Hurricane Leslie stopped production at the Figueira da Foz site for a week, and prolonged maintenance and unplanned stoppage hindered paper production at the Setubal mill. In 2019, we expect average pulp and paper prices to be below those achieved in 2018.

Navigator continues to expand its tissue operations and is now the third-largest tissue producer in Iberia. However, tissue operations only account for 5% of total sales. This will further reduce Navigator's exposure to the structurally declining UWF paper segment.

Navigator's business risk profile is constrained by the cyclical and competitive nature of the paper and pulp industry, its small size, its reliance on two paper mills, and narrow product range. Office paper accounts for 73% of revenues; the rest relates to pulp, tissue, and energy.

The combination of a fair business risk profile and a modest financial risk profile results in a 'bbb-' anchor for Navigator. We continue to view Navigator as strategically important for Semapa, which owns 69% of Navigator's shares and 69.4% of the company's voting rights. We assess Semapa's GCP as 'bb'. Although we view Navigator's SACP at 'bbb-', our issuer credit rating on Navigator is capped by Semapa's credit assessment. Semapa is a conglomerate operating in the cement segment (Secil Co.), pulp and paper (Navigator), and waste management (ETSA). In our view, Semapa has weaker credit metrics than Navigator, primarily because of its higher leverage and the lower profitability and the creditworthiness of its other businesses--notably Secil, which contributes about 20% of Semapa's EBITDA. Navigator contributes a substantial proportion of Semapa's revenues and profits--75% of sales and 80% of EBITDA. Semapa relies on Navigator's dividends to service its own debt.

## Outlook

The positive outlook on Navigator reflects that there is at least a one-in-three likelihood that we could raise the rating on Navigator in the coming 12 months.

### Upside scenario

An upgrade of Navigator would be contingent on us revising upward Semapa's GCP to 'bb+'.

We could revise upward Semapa's GCP if Semapa continues to show financial discipline and Navigator's strong cash generation continues to improve our financial risk assessment of Semapa, such that Semapa's debt to EBITDA drops below 3.0x and FFO to debt rises above 30% on a sustained basis.

### Downside scenario

We could revise the outlook on Navigator to stable if we observe an increase in Semapa's financial risk, with additional debt-funded investments, extraordinary dividends, or share buybacks causing debt to EBITDA to rise above 3.0x and FFO to debt to drop below 30% on a sustained basis.

We could also revise the outlook to stable if Navigator's EBITDA margins and cash generation deteriorated materially. This would also harm Semapa's performance and GCP. This could stem from an economic decline, coupled with input cost inflation, or an operational issue at one of Navigator's mills in Portugal.

## Company Description

Navigator is a Portugal-based pulp and paper manufacturer. In 2018, it generated sales of about €1.7 billion and adjusted EBITDA of about €440 million. Sales are split between UWF paper (73%), pulp (11%), and tissue paper (5%), with the remaining being energy. Semapa is entirely self-sufficient in energy; Navigator sells excess energy to the grid and accounts for 10% of revenues.

Navigator relies on four production sites: Cacia (pulp), Figueira da Foz (integrated pulp and paper), Setúbal (integrated pulp and paper), and Vila Velha de Ródão (tissue). The company's production capacities are as follows: 1.6 million tons of UWF paper, 1.6 million tons of hardwood pulp, and 130,000 tons of tissues. Navigator uses about 80% of its pulp production in its paper operations.

The company was formerly known as Portucel, S.A.; it changed its name to The Navigator Company S.A. in February 2016.

## Our Base-Case Scenario

Our base-case assumptions for Navigator include:

- Eurozone GDP growth of 1.6% in 2019 and 2020. Portugal GDP growth of 1.7% in 2019 and 1.6% in 2020.
- Sales growth of 10% in 2019 due to capacity additions in pulp (70,000 tonnes in 2019) and the ramp-up of the new tissue facility (Cacia).
- Revenues to decline by 1.5% in 2020 due to a further softening of pulp and paper prices.
- Adjusted EBITDA margin to improve to 26.5% in 2019 and 27% in 2020, up from 26% in 2018. We expect higher volumes (following capacity additions), higher efficiencies, and cost containment to support the improvement in EBITDA margins.
- A reduction in capital expenditures (capex) in 2019 to €140 million, since Navigator has now completed most capacity expansions. We estimate capex at €115 million in 2020. These amounts include annual maintenance capex of about €70 million and regulatory capex of €30 million.
- Modest working capital outflow of about €20 million in 2019.
- Annual dividend payments of about €200 million.

Our base case for Semapa assumes:

- Revenue growth of 9% in 2019, including 3% revenue growth in the cement division and 10% revenue growth at Navigator. Construction markets in Portugal and Brazil are the main drivers of expansion in the cement division. This is partly offset by the challenging market environment in Lebanon. We assume flat revenues from 2020 onward.
- Working capital of about €25 million.
- Capex of about €200 million in 2019 and €180 million in 2020.
- Annual dividend payments of about €100 million.

Based on these assumptions, we arrive at the following credit metrics for Navigator:

- Adjusted debt to EBITDA of 1.5x in 2019 and 1.3x in 2020; and
- FFO to debt of about 53% in 2019 and 56% in 2020.

We arrive at the following credit metrics for Semapa:

- Adjusted debt to EBITDA of 2.4x in 2019 and 2.0x in 2020; and
- FFO to debt of about 34% in 2019 and 39% in 2020.

## Liquidity

We assess Navigator'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. Navigator benefits from strong free operating cash flow generation, limited medium-term debt maturities, and ample covenant headroom.

We expect Navigator's principal liquidity sources for the 12 months from Dec. 31, 2018 will include:

- Estimated cash and equivalents of €80 million;
- New debt issuances of €90 million, comprising a bond issuance of €50 million and term loan of €40 million;
- FFO of €375 million in 2019; and
- Unused committed bank and commercial paper facilities totaling €110 million to cover short-term usages.

We expect principal liquidity uses over the same period will include:

- Short-term debt maturities of about €112 million;
- Working capital outflow of €20 million;
- Capex of €140 million in 2019; and
- Dividend payments of €200 million, although we understand that payments could be significantly lower in a stress scenario.

## Environmental, Social, And Governance

Environmental and social factors are relevant to Navigator, but they are not currently material ratings drivers. We view governance as a supporting factor for the rating, reflecting management's experience and expertise, governance in line with best practices, and the balance of different stakeholders' interests.

Navigator focuses on sustainable forest management. Navigator's certified forests account for 42% of Portugal's certified woodlands. The company's forest holdings are certified under Forest Stewardship Council and Programme for the Endorsement of Forest Certification schemes.

Cost reductions are key to remaining competitive, since many of the products are rather standardized. As part of its ongoing efforts to streamline costs, Navigator seeks to cut down its energy consumption and reduce its carbon, greenhouse gas, and malodorous gas emissions. Navigator incurs regulatory capex of about €30 million to comply with environmental standards. Biomass-based renewable fuels now account for about 64% of its fuel consumption. Navigator also focuses on waste reduction and limits its air and water pollution. This, together with other, non-ESG-related measures, result in a low cost base, improved operating leverage, and strong EBITDA margins.

## Ratings Score Snapshot

Issuer credit rating: BB/Positive/B

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

Financial risk: Modest
- Cash flow/leverage: Modest

Anchor: bbb-

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: bbb-
- Group credit profile: bb
- Entity status within group: Strategically important (-2 notches)

## Related Criteria

- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Forest And Paper Products Industry, Feb. 12, 2014
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013

- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Ratings List

Ratings Affirmed; Outlook Action

| | To | From |
|---|---|---|
| The Navigator Company S.A. | | |
| Issuer Credit Rating | BB/Positive/B | BB/Stable/B |

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 for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at 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.