

Research Update:

# Celulosa Arauco y Constitucion Outlook Revised To Stable From Negative On Expected Deleveraging Amid Higher Pulp Prices

April 20, 2021

## Rating Action Overview

- Recovery in pulp prices in 2021 should accelerate Arauco's deleveraging. We estimate the 2021 average effective pulp prices for Arauco to be about 35% higher than in 2020.
- As a result, we expect Chilean pulp and woods producer, Celulosa Arauco y Constitucion S.A. (Arauco), to reduce its leverage metric to below 3.0x in 2021 and 2022.
- On April 20, 2021, S&P Global Ratings revised its outlook on the company to stable from negative. We also affirmed our 'BBB-' ratings on the company.
- The stable outlook reflects our expected improvement in the company's cash flows and leverage metrics thanks to stronger prices and efforts to contain the leverage peak in 2020.

### PRIMARY CREDIT ANALYST

**Amalia E Bulacios**  
Buenos Aires  
+ 54 11 4891 2141  
amalia.bulacios  
@spglobal.com

### SECONDARY CONTACT

**Luisa Vilhena**  
Sao Paulo  
+ 55 11 3039 9727  
luisa.vilhena  
@spglobal.com

## Rating Action Rationale

**Higher pulp prices and strong performance in the woods segment would allow for deleveraging despite still very high capex.** The outlook revision follows the rapid pickup in pulp prices since late 2020, which we estimate will boost the company's EBITDA and operating cash flow in 2021 and allow Arauco to return to leverage levels in line with the rating, with debt to EBITDA comfortably below 3.5x by the end of 2021. After rapid downward price correction in 2019 and very low prices for most of 2020, producers started increasing some prices toward the end of 2020, particularly for softwood. In the first quarter of 2021, prices rallied well above our expectations for a combination of reasons (stronger demand, increases in downtimes, logistic issues, weaker dollar that favors paper producers' margins, and likely some speculative demand based on futures). Although we assume a correction in the second half of the year for seasonality reasons and effect of the MAPA mill start up, we expect average benchmark price in China and Europe to be 30%-45% higher for hardwood and 25%-30% for softwood versus 2020 prices.

Additionally, we expect good momentum in the woods business to persist throughout the year in most markets where the company operates. As a result, we expect EBITDA to climb to \$1.7

billion-\$1.8 billion in 2021 from \$1.0 billion in 2020. This would strengthen operating cash flow, which should be enough to cover capital expenditures (capex) of about \$1.35 billion, and result in rapid deleveraging with a debt-to-EBITDA ratio between 2.5x and 3.0x in 2021.

**Completion of MAPA's ramp up and no other large investment projects should ensure ample free cash flow starting in 2022.** In 2022, we expect relatively balanced pulp supply and demand during the first few months of the year, but as Arauco's eucalyptus pulp mill, MAPA, completes ramp-up and the new UPM mill start-up approaches, we expect to see relevant price corrections, resulting in average realized pulp prices lower than in 2021 but about 15%-20% stronger than in 2020. When MAPA ramp-up is complete, we expect Arauco to add about 1.0 million sold tons in 2022, which should offset lower pulp prices and result in EBITDA of \$1.6 billion-\$1.7 billion. Additionally, we do not envision any other large investment projects for at least the next two or three years, so capex should be significantly lower at about \$670 million in 2022, resulting in ample free operating cash flow (FOCF) and leverage consistently between 2.5x and 3.0x.

**Group support and countercyclical initiatives somewhat helped contain the peak in leverage last year.** While the company has not explicitly stated a financial policy, we believe the company and the group made efforts to somewhat contain leverage and demonstrated commitment to investment-grade ratings. In our view, the company took countercyclical measures that allowed it to contain to some extent the peak in leverage in 2020 and return more rapidly to leverage levels consistent with the rating. These measures included:

- Capital injection from parent company Empresas Copec S.A. (E-Copec; BBB-/Stable/--) of up to \$700 million: \$250 million completed in 2020 and an additional \$200 million already approved for 2021 to be completed most likely in the second quarter;
- Postponing capex for non-essential projects; and
- Selling some minor assets (stake in Puertos & Logística and Forestal Los Lagos) and the ability to sell further forest assets if needed.

## **Outlook**

The stable outlook on Arauco reflects our expectation that it will benefit from better market conditions in the next 12-24 months, posting strong EBITDA and operating cash flow recovery. Despite still significant capex planned for 2021, operational recovery should allow leverage metrics to sharply improve. The stable outlook is consistent with an adjusted debt-to-EBITDA ratio between 2.5x and 3.0x in 2021 and 2022.

## **Downside scenario**

A negative rating action in the next two years could occur if Arauco's credit metrics don't improve as we expect. This could likely come from a combination of weakening pulp prices and higher investments, which would reduce EBITDA and cash flow. If the company announces a new large investment in the next few quarters, or if pulp prices are consistently \$70-\$80 per ton lower than our base case, a downgrade is possible. In this scenario, we would see debt to EBITDA persistently above 3.5x and funds from operations (FFO) to debt below 20%.

## Upside scenario

The pulp market's volatile nature somewhat constrains Arauco's business. An upgrade would depend on the company's ability to maintain some cushion in its debt levels that would allow it to absorb significant pulp-price volatility without hurting its leverage. An upgrade would be consistent with adherence to an explicit financial policy and maintaining debt to EBITDA below 3.0x throughout the cycle and high investment periods. Finally, an upgrade would require a similar rating action on its parent E-Copec.

## Company Description

Chile-based Arauco, a wholly owned subsidiary of E-Copec, focuses on forest management and produces and sells market pulp and wood products. The company operates five pulp mills in Chile, one in Argentina, has a 50% stake in a pulp mill in Uruguay, and a new pulp mill under construction in Chile. It's among the world's largest pulp producers, with a capacity of 4 million tons of bleached and unbleached kraft pulp (on an attributable basis, that will increase to 5.2 million once new mill construction is completed). Arauco has 30 panel mills across the world (given its 50% stake in Sonae Arauco) with 10 million cubic meters (m<sup>3</sup>) in production capacity.

## Our Base-Case Scenario

- Significant recovery in pulp demand coupled with tighter producer inventories has rapidly pushed prices up during the first months of the year. We assume average realized pulp prices of \$720-\$730 per ton in 2021 and \$620-\$640 in 2022, up from \$536 in 2020.
- Pulp production of 3.7 million tons in 2021, including Arauco's share in Montes del Plata in Uruguay and assuming minor impact from MAPA's ramp-up in the last quarter of the year. With the ramp-up of MAPA, we expect total production to reach 4.8 million tons in 2022.
- Growth of 5%-7% in sold panels volume in 2021, recovering from 2020 when volumes dropped despite the strong performance in the second half of the year, and slowing to 1%-2% growth in 2022.
- 2%-3% higher panel prices of \$295-\$300 per m<sup>3</sup> in 2021 due to stronger demand and appreciation of some regional currencies, and flat in 2022.
- EBITDA margins to significantly improve to 29%-31% in 2021 from 21.7% in 2020, mostly because of higher pulp prices, and about 27%-28% in 2022 because of still higher pulp prices than the previous two years and MAPA's ramp-up that should improve average cash costs.
- Approximately \$1.35 billion in capex for 2021, consisting of about \$550 million in maintenance and forestation and \$800 million for MAPA. In 2022, about \$670 million, consisting of almost \$120 million for MAPA and \$550 million for maintenance, forestation, and other small projects.
- No dividend payments in 2021 and about \$350 million-\$370 million in 2022.
- Capital increase for \$200 million in 2021.

Key metrics

## Celulosa Arauco y Constitución S.A.--Key Metrics\*

(Mil. \$)	--Fiscal year ended Dec. 31--			
	2019a	2020a	2021f	2022f
Average Realized pulp price	633	536	710-730	620-640
Revenue	5,329	4,733	5,800-6,000	6,000-6,100
Revenue growth (%)	(10.5)	(11.2)	22-25	2-5
EBITDA	1,100	1,028	1,700-1,800	1,600-1,700
EBITDA margin (%)	20.7	21.7	29-31	27-28
Funds from operations (FFO)	480.2	740.9	1,500-1,700	1,250-1,450
Capital expenditure	1,223.40	1,668.10	1,300-1,400	600-700
Free operating cash flow (FOCF)	(798.7)	(562.5)	100-200	550-750
Dividends	182.1	1	0	350-370
Debt	4,676.90	5,225.90	4,800-4,900	4,500-4,600
Debt to EBITDA (x)	4.2	5.1	2.5-3.0	2.5-3.0
FFO to debt (%)	10.3	14.2	30-35	25-30
FOCF to debt (%)	(17.1)	(10.8)	0-5	12-16

\*All figures adjusted by S&P Global Ratings. a--Actual. e--Estimate. f--Forecast.

## Liquidity

We view Arauco's liquidity as strong. In the next 24 months, we expect sources of liquidity to exceed uses by more than 50% and to cover uses even if EBITDA were to fall 30% against our base-case scenario. The company ended 2020 with a strong cash position, has access to ample revolving credit facilities, has a smooth maturity profile, and once MAPA investments are concluded, cash needs will significantly fall. We believe Arauco has ability to absorb high-impact, low probability events with limited need for refinancing given its flexibility to postpone capex and some flexibility to sell forest assets. We assess Arauco's standing in domestic and international debt markets as positive and also consider the very comfortable cushion expected under its incurrence covenants for the next three years. Moreover, its parent, E-Copec, has shown strong commitment to support the company if needed.

### Principal liquidity sources:

- Cash and cash equivalents of \$1.06 billion as of December 2020;
- Undrawn committed credit facility totaling \$375 million maturing in 2025;
- Cash FFO generation of \$1.5 billion-\$1.7 billion in the next 12 months;
- Asset sales completed for \$27 million; and
- Committed capital increase for \$200 million to be completed in 2021.

### Principal liquidity uses:

- Short-term debt maturities of \$252 million as of December 2020;
- Club deal prepayment for \$200 million completed during March 2021;
- Working capital needs of \$120 million-\$140 million;
- Capex of about \$1.36 billion in the next 12 months; and
- No dividend payment during 2021.

### Covenants

Arauco's international bonds don't have covenants. On the other hand, other debts have limits on incurring additional debt and liabilities through the following covenants:

- Debt-to-equity ratio of a maximum of 1.2x; and
- Interest coverage ratio of a minimum of 2x.

We expect Arauco to maintain a very comfortable cushion under its incurrence covenants for the next two years--more than a 50% cushion under its debt to equity and more than a 160% cushion under minimum interest coverage.

### Environmental, Social, And Governance

We view Arauco's exposure to environmental factors as similar to that of its industry peers. Arauco benefits from favorable climate conditions that underpin its competitive position. The efficient and rapidly growing nature of its forest assets, sustainable forest management practices, and well-invested asset base support the rating. With planted forests of radiata, taeda, and elliottii pine and eucalyptus in Chile, Argentina, Brazil, and Uruguay, the company benefits from high harvesting yields and is among the lowest-cost (in terms of cash) producers in the world, behind only Brazilian producers. Its 100% energy self-sufficiency also supports its EBITDA margins.

On one hand, Arauco is one of the largest unconventional renewable energy producers in Chile and sells excess capacity to the national energy grid. In 2020, it became the first certified carbon-neutral forestry company in the world. On the other hand, its Chilean forests are exposed to wildfires that have caused considerable losses in the past. For instance, a massive fire in Chile in 2017 destroyed about 7% of Arauco's planted area, but didn't cause credit metrics to worsen. The company subsequently launched a forest renovation plan in Chile, and strengthened its insurance coverage, fire prevention, and suppression programs. These investments didn't have a material effect on its profitability.

### Issue Ratings - Subordination Risk Analysis

#### Capital structure

As of December 2020, Arauco's capital structure consisted of about \$4.7 billion in senior unsecured bonds issued at the level of holding company (Arauco), and slightly more than \$1.3

billion in bank loans and finance lease obligations, of which about half are at operating subsidiaries' level. Its secured obligations were minimal.

## **Analytical conclusions**

We rate Arauco's senior unsecured notes at the same level as the issuer credit rating because we don't believe there are material financial obligations that would rank ahead of the company's unsecured debt by way of structural or contractual subordination in a default scenario. Arauco's secured obligations represent less than 1% of consolidated debt, and unsecured debt at the level of operating subsidiaries is less than 10% of total debt.

## **Ratings Score Snapshot**

Issuer Credit Rating: BBB-/Stable/--

Business risk: Satisfactory

- Country risk: Intermediate
- Industry risk: Moderately high
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bbb-

Modifiers

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

Stand-alone credit profile: bbb-

## **Related Criteria**

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013

- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

## Ratings List

### Ratings Affirmed; CreditWatch/Outlook Action

	To	From
<b>Celulosa Arauco y Constitucion S.A.</b>		
Issuer Credit Rating	BBB-/Stable/--	BBB-/Negative/--
Senior Unsecured	BBB-	

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