

Research Update:

Chilean Pulp and Panel Producer Arauco 'BBB-' Ratings Affirmed On Capitalization Announcement, Outlook Remains Negative

May 20, 2020

Rating Action Overview

- Chile-based Celulosa Arauco y Constitucion S.A. (Arauco) focuses on forest management and the production and sale of market pulp and wood products. The company posted EBITDA of \$1.1 billion in 2019.
- On May 19, 2020, Arauco's shareholders announced their commitment to increase the company's capital of up to \$700 million.
- We believe the capital increase will bring some leverage relief and financial flexibility amid the company's high investments and business downturn.
- We are therefore affirming our 'BBB-' issuer credit and issue-level ratings on the company.
- The outlook remains negative, reflecting downside risks that could keep Arauco's debt to EBITDA above 3.5x in 2021.

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Rating Action Rationale

Capitalization will shore up the capital structure and illustrates strong commitment from the group to maintain Arauco's investment-grade rating. At an extraordinary shareholders meeting held on May 19, Empresas Copec S.A. (E-Copec) committed to increase Arauco's capital by up to \$700 million until 2021 with a minimum of \$250 million during 2020. Capitalization is consistent with our assessment of Arauco as E-Copec's highly strategic subsidiary and Arauco's expressed commitment to maintain a 'BBB-' rating. The capital increase will support Arauco's investment plan and strengthen its financial position that's been considerably hurt by the sharp fall in pulp prices last year and will continue to struggle from the impact of COVID-19. However, even if the capitalization is completed in full, we believe Arauco's leverage could still peak this year at 5.0x-5.5x, and drop to about 3.5x only in 2021.

EBITDA will likely continue to diminish in 2020, leading to significant free cash flow deficit. The COVID-19 outbreak will take a toll on the company's performance in 2020 following an already weak performance in 2019. Although at the start of the year, pulp prices were below cash cost of less efficient producers in China and pulp demand for tissue and certain types of packaging production has remained strong so far, demand for graphic paper has collapsed. This, coupled with a global recession, generates huge uncertainty for paper producers. So far, buyers have remained somewhat reluctant to accept price hikes, while the latter have been so far minor and inconsistent across pulp grades and geographies. We believe pulp producers will struggle to pass significant price hikes until the fourth quarter. Under this scenario, we have lowered our average pulp benchmark prices for 2020 and 2021, while we expect Arauco's pulp revenue to fall further 12%-15% this year. Additionally, the extensive lockdowns across the world and recession will reduce demand for Arauco's wood and panel products and we expect revenues in this segment to fall 5%-7%. We expect these factors to reduce the company's EBITDA by 14%-16% to slightly below \$1 billion and result in a wide cash deficit given capex needs of about \$1.4 billion this year.

We expect sound recovery in 2021 but there are still some downside risks. Amid some recovery in pulp prices, the ramp-up of MAPA (the new pulp mill) that should add about 600,000 tons of pulp capacity already in 2021, and a strong recovery in the woods and panel business, the company's EBITDA should climb to close to \$1.5 billion in 2021. This, together with the remaining \$450 million capital increase, should slash the leverage metric to slightly below 3.5x. Yet there are some downside risks to our base-case scenario:

- Pulp price recovery could be sluggish;
- MAPA's start-up could be delayed, resulting in lower pulp volumes than our forecast;
- E-Copec could face challenges to complete the capital increase at Arauco as planned. We believe the capital increase will be tied to some asset sales from the group. If they're delayed or market conditions for it are unfavorable, full capitalization could be at risk.

Outlook

The negative outlook on Arauco reflects our expectation that it will post very high leverage in 2020 between 5.0x and 5.5x, and that downside risks in 2021 could cause the metric to remain above 3.5x.

Downside scenario

We would downgrade Arauco if we believe its debt to EBITDA would remain above 3.5x and funds from operations (FFO) to debt would be below 20% in 2021. This could materialize if:

- We were to expect average pulp prices below \$600 per ton in 2021;
- The start-up of MAPA is delayed, weakening EBITDA (to about \$1.3 billion in 2021);
- Arauco incurs higher capex than we expect; or
- The company doesn't receive full capitalization from its shareholders.

Upside scenario

We could revise our outlook on Arauco to stable in the next 12 months if we see stronger cash flows and debt to EBITDA drops below 3.5x in 2021. This could occur if:

- Arauco completes its investments on time;
- Pulp price increase 10%-15% next year; and/or
- The company receives full capitalization of \$700 million.

Company Description

Chile-based Arauco, a wholly owned subsidiary of E-Copeco, focuses on forest management, the production, and sale of market pulp and wood products. The company operates five pulp mills in Chile, one in Argentina, and has a 50% stake in a pulp mill in Uruguay. 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). Arauco has 30 panel mills across the world (given its 50% stake in Sonae Arauco) with 10 million cubic meters (m³) in production capacity.

Our Base-Case Scenario

- COVID-19 will prevent pulp prices from rising significantly. We assume average realized prices of \$580-\$550 per ton in 2020, and about \$625 in 2021.
- Pulp production of 3.7 million - 3.8 million tons in 2020, including Arauco's share in Montes del Plata in Uruguay. With the ramp-up of MAPA, we expect total production to reach 4.4 million tons in 2021. The mill should be fully operational by 2022, resulting in total pulp volumes of more than 5 million tons.
- A decline of around 5% in sold panels volume in 2020, and a 10% growth in 2021. This includes capacity additions from the gradual ramp-up at the Grayling plant in the U.S., and around 500,000 m³ at the recently acquired facilities in Mexico.
- Average panel price of \$305-\$307 per m³ in 2020 due to depreciation of regional domestic currencies and \$314-\$316 in 2021.
- As a result of these factors, Arauco's consolidated revenue should fall about 8% in 2020 and rise 18%-20% in 2021.
- A slight drop in EBITDA margins to about 20% in 2020 from 21.6% in 2019, and improving to 24%-26% in 2021.
- Approximately \$1.4 billion in capex for 2020, consisting of about \$550 million in maintenance and forestation, and \$850 million for MAPA. In 2021, almost \$1.2 billion, consisting of slightly above \$700 million for MAPA and \$450 million for maintenance and forestation.
- No dividend payments in 2020 and 2021.
- Capital increase of \$250 million in 2020 and \$450 million in 2021.

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

- Total consolidated EBITDA of \$0.9 billion - \$1.0 billion in 2020 and \$1.4 billion - \$1.5 billion in

2021;

- Debt to EBITDA of 5.0x-5.5x in 2020 and 3.3x-3.5x in 2021; and
- FFO to debt of 14%-16% in 2020 and 20%-25% in 2021.

Liquidity

We view Arauco's liquidity as adequate. In the next 12 months, we expect sources of liquidity to exceed uses by more than 30% and to cover uses even if EBITDA were to fall 15% below our base-case assumptions. We believe Arauco has ability to absorb high-impact, low-probability events with limited need for refinancing given the flexibility to postpone capex or flexibility to sell some forest assets. We believe Arauco has a good standing in domestic and international debt markets and it has a very comfortable cushion under its incurrence covenants for the next three years. Moreover, E-Copec has shown strong commitment to support the company if needed.

Principal Liquidity Sources:

- Cash and cash equivalents of \$1.15 billion as of March 2020;
- Committed credit facility totaling \$375 million maturing in 2025;
- Cash FFO of \$800 million - \$850 million in the next 12 months; and
- Capital increase for \$250 million in 2020.

Principal Liquidity Uses:

- Short-term debt maturities of \$610 million as of March 2020;
- Working capital needs of \$70 million; and
- Capex of about \$1.36 billion in the next 12 months.

Covenants

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

- Debt to equity ratio of maximum of 1.2x; and
- Interest coverage ratio of 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 130% cushion under minimum interest coverage one.

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 credit 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, only behind Brazilian ones. The company's EBITDA margins are also supported by its 100% energy self-sufficiency. On the one hand, Arauco is one of the largest unconventional renewable energy producers in Chile and sells excess capacity to the national energy grid and expects to be certified as the first carbon-neutral company in the sector in 2020. 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 deteriorate. 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 impact on its profitability.

Issue Ratings - Subordination Risk Analysis

Capital structure

As of March 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 \$1.4 billion in bank loans and finance lease obligations, mostly at the 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 25% of total debt.

Ratings Score Snapshot

Issuer Credit Rating: BBB-/Negative/--

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

Ratings List

Ratings Affirmed

Celulosa Arauco y Constitucion S.A.

Issuer Credit Rating BBB-/Negative/--

Celulosa Arauco y Constitucion S.A.

Senior Unsecured BBB-

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