

EUROPEAN PULP & PAPER SECTOR

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Analysts:

João Lampreia
joao.lampreia@big.pt

EUROPEAN PULP & PAPER SECTOR HIGHLIGHTS

Boring products, entertaining cash flows...

Developing countries and e-commerce push demand, digitalization weights on it. Global demand for Pulp should grow at an average annual pace of 1% until 2030, driven by growth of Tissue consumption of close to 3% and growth for Containerboards consumption of around 2%. Together these two product segments represent 40-50% of total fiber consumption worldwide.

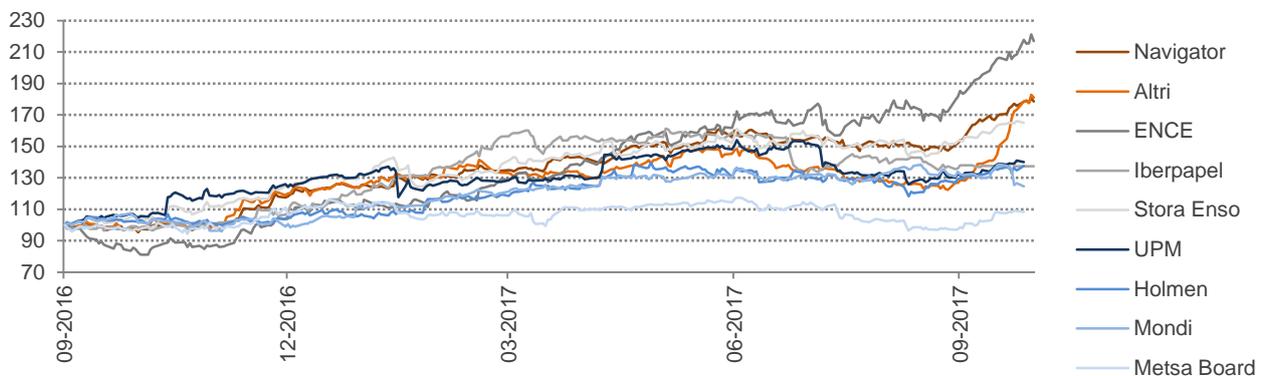
We feel pulp prices expectations are speculative. Pulp prices have been raising significantly over the past months mostly on the back of better China's renovated environmental conscience and its better economic conditions. Even though there are no major capacity increases planned for 2019 and 2020, we are

conservative about future pulp prices as we believe 1) China's environmental conscience was being anticipated by the main global players and 2) Chinese players will probably also adapt to this renewed demand for pulp by increasing capacity.

The Portuguese are kings in operating margins. The sector is mainly characterized by its flattish revenue growth and capacity to generate cash flows. The Portuguese stand out as the most efficient players operating wise.

Cheapness has been driven out of the market, but the Portuguese stand out. What we considered to be previous sector undervaluation has been driven out of the market especially since the end of 2014, which coincided with the start of the ECB's QE. Some of the Portuguese still stand out as undervalued in our opinion.

Pulp & Paper sector main players stock performance (Oct 2016=100)



Source: Bloomberg

Analysts:
João Lampreia
joao.lampreia@big.pt

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Cheapness has been driven out...

... only the Portuguese stand out

¹ (α) signals topics we believe are being under looked by the market

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PULP & PAPER MARKET OVERVIEW

- ▲ Sector growth drivers
 - ▲ Pulp prices
-

Overall we see the Pulp & Paper market standing on a rather smooth balance between steady demand growth, balanced net capacity changes over the long run. This smooth balance translates in low price volatility levels for the commodities and products, with price changes over the long run that have tended to be below global inflation rates.

Sector growth drivers

Steady and stable demand growth for paper products has the following factors behind it:

- Digitalization
- *E-commerce*
- Improving standards of living in developing countries

Starting with digitalization, it has severely impacted the demand for office, newsprint and magazine papers, in a trend that is gaining pace in recent years. Press publications are increasingly being delivered by digital means and office paper downward trend is also still gaining pace. We assume the digitalization trend is still in its middle stages and that there is still margin for demand of newsprint, office and magazine papers to fall.

E-commerce has been an important driver in the demand for packaging paper in recent years. As more and more goods are delivered individually to the consumer door, more packaging is necessary in comparison to when these goods were packaged in bunches. We see the *e-commerce* trend as being in its early stages and therefore, that there is still a considerable margin for the demand for packaging papers to increase.

Improving standards of living in developing countries is the main factor driving demand for tissue papers, more specifically in Asia. As the GDP per capita of developing countries grows from a low basis, the demand for tissue paper tends to grow more rapidly. Hygiene is one of the main priorities as populations grow richer and therefore demand growth for tissue paper tends to outpace GDP growth per capita in an early stage. Countries like China and India are still in this stage in many of their regions. Due to its openness and size, China has been the main driver of global demand for paper pulp in general.

Given the short description we've given of the main factors driving global demand for paper pulp, we summarize our views in the following table:

Paper demand framework

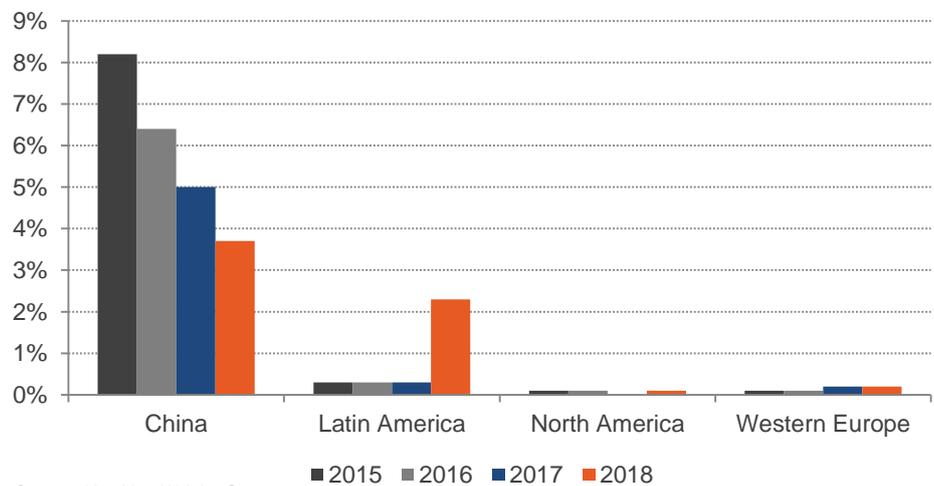
	Newspapers, office and magazines paper	Tissue and packaging paper
Developing economies	Low single digits growth	Low teens growth
Developed economies	Middle single digits decline	Low single digits growth

Source: BiG Research

According to Suzano, demand for pulp will be mostly driven by growth in consumption of tissue and containerboards. Tissue paper represents between 5-10% of total pulp consumption worldwide, and its consumption should grow at an annual pace of close to 3% until 2030. Containerboards represent around 35-40% of total pulp consumption and their consumption should grow at an annual pace of around 2% until 2030.

According to Hawkins Wright and Suzano, in 2018 demand for paper pulp will grow the most in China, by 3.7% and the least in North America, by 0.1%:

Pulp global demand yearly growth



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João Lampreia
joao.lampreia@big.pt

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Pulp prices

Given the mature stage the Pulp & Paper sector lives in, the balance between capacity additions and closures is an important feature of the market. In the Pulp market, capacity changes tend to follow a regional pattern, flowing from high cash cost production regions like the US to lower cash cost ones, like Brazil or Indonesia. In terms of product segment, the main sector trends are converting P&W capacity to packaging capacity and integrating pulp production to final product production lines (vertical integration).

Starting with net capacity expected to come into the market in the next years, for the first time in many years there are no major capacity additions planned in a time span of three years, something that hasn't happened since 2009. The year of 2017 has been particularly strong in terms of capacity increases, with Fibria's Horizonte 2 and APP's OKI adding 1.95 million tons and 2.2 million tons of pulp to the market (OKI's capacity increase will be partially integrated though), but for 2019 and 2020, there are only minor capacity increases entering the global market (from Metsa). Capacity increases have outpaced demand growth (between 1 and 1.5 million tons a year) for the past years - which might have been a reason BHKP price was subdued throughout 2016 - but from 2018 onwards this dynamic will most likely be reversed.

Not only is supply growth expected to outpace the average demand growth of the last few years, as there are some reasons to believe demand will grow more than the average in the period. A quick rise in China's environmental conscience is an important factor fueling the demand for pulp that we believe is being under looked by the market. China has been becoming increasingly strict about its environmental standards, and this conscience has already hit the Pulp & Paper sector. In the third quarter of 2017 China banned the imports of several recycled materials, among them mixed waste paper. China is the world's largest paper recycler, having produced around 63.3 million tons of waste paper pulp in 2016, 24% of which was produced from imported waste paper. So, all of a sudden China stopped importing around 15 million tons (annualized) of mixed waste paper.

Reports are already emerging of "mountains" of waste paper piling up in Hong Kong's docks, and the most direct substitute for the waste paper pulp that is not being consumed by Chinese paper producers is simply paper pulp (though more expensive). A final decision on the details of the ban is not expected until the end of November, but looking at the behavior of the market's main players, it seems that it will stick with its current restrictions.

This means that the sudden demand growth from China is not only explained by the improvement of economic conditions, but also by a rise in environmental conscience

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joao.lampreia@big.pt

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that results in sustained demand for market pulp in the years ahead. Chinese players will most probably adjust to this new reality in the future, but it should take time.

(α) Alpha Box

Having said this, our opinion is that this shift of environmental conscience in China was already being anticipated a couple of years in advance by the major global players (Fibria, APP), which justifies their decision to advance with such major capacity increases at a time when supply growth was outpacing demand growth, and when China's economic slowdown was being anticipated. In addition to that, it is likely that China's renovated environmental conscience will motivate local players to increase their capacity. Even if Chinese players are not that competitive, high BHKP prices that are expected to remain relatively supported will bring some players out of the water. The currently highest cash cost producers for delivery in Shanghai do it at a cost between \$500 and \$600 per ton. Consistent prices above \$850 will most likely be enough to incentivize these players to renew their expansion strategies.

We therefore see all the positives already being partially discounted by the sector's players, and are therefore conservative in forecasting BHKP's price in dollars. We assume a terminal price of \$796 per ton, which is in line with the median price of the previous five years plus inflation rate of 1%.

Bleached Hardwood Kraft Pulp \$ PIX



Source: Bloomberg; BiG Research

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OPERATING INDICATORS

- ▲ Some call them cash cows
- ▲ Portuguese players are the margin kings

Some call them cash cows

The European Pulp & Paper sector is mostly composed by Northern European and Iberian players, since these are the regions with the highest competitive advantages in the production of pulp.

The Northern European players tend to be more advanced in the value chain of paper products whilst Iberian players have simpler corporate structures and product segments. UPM-Kymmene is the biggest and more complex European player, having 10 business units, from the value chain base (Forest) to highly advanced products technology wise in its Biochemicals business unit. Its business model and vertical integration strategy is a role model for the sector. That being said, its results are not the most attractive from an operating perspective.

The European Pulp & Paper sector has been characterized in the last years by flattish revenue growth, EBITDA margins around 9% and profit margins of around 5%. Cash flows are probably its strongest feature as FCF compared to Revenues as stood at an average of 12,7%. Still there is a wide range of cash flow performers in the sector.

European Pulp & Paper sector operating indicators

Name	Country	Revenues			Profitability			
		5y CAGR	1y growth	Product segments	EBITDA margin 5y median	Profit margin 5y median	EBITDA margin (2016)	Profit margin (2016)
The Navigator Company	Portugal	1,2%	-3,1%	4	15%	14%	15%	14%
Altri	Portugal	4,7%	-8,2%	1	18%	10%	19%	13%
ENCE	Spain	-6,1%	-8,4%	1	10%	5%	20%	8%
Iberpapel Gestion	Spain	-1,1%	-7,5%	2	9%	7%	10%	7%
Holmen	Sweden	-3,6%	-3,1%	4	8%	6%	5%	3%
Metsa Board	Finland	-7,1%	-14,3%	1	4%	3%	7%	7%
Mondi	Austria	3,0%	-2,3%	4	10%	1%	13%	1%
Stora Enso	Finland	-2,2%	-2,4%	4	5%	3%	5%	8%
UPM-Kymmene	Finland	-0,5%	-3,2%	10	5%	5%	11%	9%
European median		-1,1%	-3,2%		9%	5%	11%	8%

Source: Bloomberg; BiG Research

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joao.lampreia@big.pt

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Sector debt levels are currently in a healthy situation, with the median 2016 Net Debt at 1.5x of 3y median EBITDA and median Debt to Assets of close to 30%. Iberpapel Gestion is the only company presenting a negative Net debt.

European Pulp & Paper sector debt and cash flows indicators

Name	Country	Debt factors		Cash flows	
		Net debt (2016)/3y Median EBITDA	Debt to Assets (%)	FCF to Revenues (5y average)	Capex to Revenues (5y average)
The Navigator Company	Portugal	1,8	29,4	14,1%	3,9%
Altri	Portugal	2,7	59,0	12,7%	4,7%
ENCE	Spain	1,5	35,5	4,0%	10,4%
Iberpapel Gestion	Spain	-0,7	3,1	6,9%	4,0%
Holmen	Sweden	1,5	11,3	15,7%	6,1%
Metsa Board	Finland	1,5	32,1	1,3%	4,9%
Mondi	Austria	1,1	24,2	16,3%	7,2%
Stora Enso	Finland	2,1	30,2	16,6%	6,9%
UPM-Kymmene	Finland	0,7	16,5	8,0%	3,7%
European median		1,5	29,4	12,7%	4,9%

Source: Bloomberg; BiG Research

Portuguese players are margin kings

Overall, Portuguese players compare very well to its European peers, especially on profitability indicators. Altri has the highest 5y median EBITDA margin at 18%, and The Navigator Company follows second with 15%. In terms of profit margin, Portuguese players also lead the table, but in this case, The Navigator Company comes first with a 5y median profit margin of 14% and Altri comes second with 10%. Portuguese players also present very healthy cash flow indicators but are on average more leverage than their European peers. Altri is actually the most indebted player, with a Net debt of 2.7x of 3y median EBITDA. In terms of revenue, Navigator and Altri are two of the three companies that were able to grow their revenues from five years ago. This revenue growth above peers is consistent with the capacity increases that both companies have been investing on over the period. We discuss the sustainability of Portuguese players growth, profitability and debt levels in more detail in their specific notes.

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joao.lampreia@big.pt

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VALUATION INDICATORS

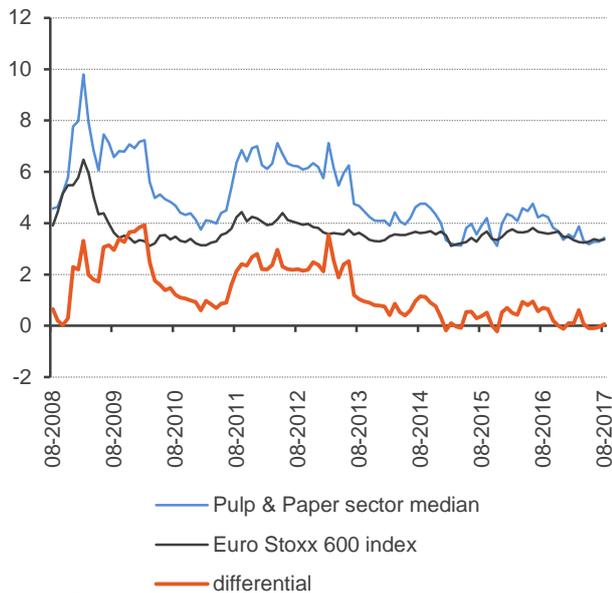
- ▲ Cheapness has been driven out of the sector...
- ▲ ... only the Portuguese stand out

Cheapness has been driven out of the sector...

Given its low growth characteristics, we prefer to look at the Pulp & Paper sector's valuation from a dividend perspective, especially in the current market conditions in which yield is a scarce commodity.

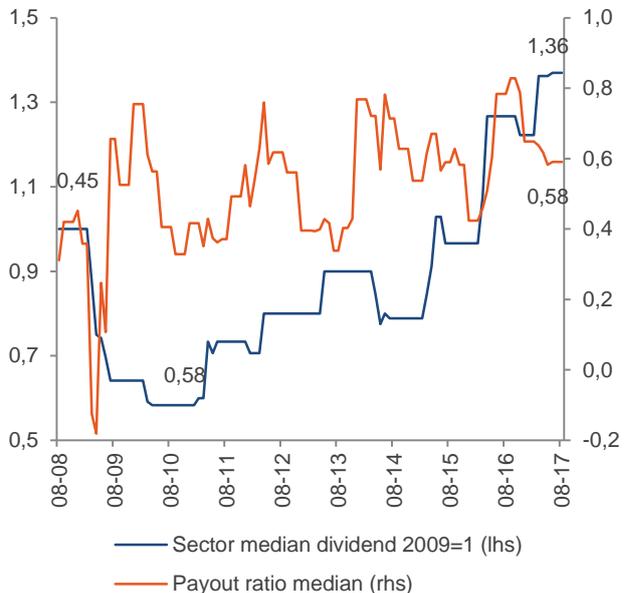
Looking at the European sector as a whole, we think it is important to point out that there was a clear impact in terms of valuation from the beginning of 2015, when ECB's QE was first announced. Until then, the sector's dividend yield and price multiples used to carry a discount comparing to the broad Euro Stoxx 600 index, but from then onwards, that discount was promptly consumed and the sector has been trading more or less in line with the Euro Stoxx 600 index in terms of dividend yield and Price to Sales multiple.

Dividend yield (%)



Source: Bloomberg

Dividend evolution and payout ratio



Source: Bloomberg

Looking at the dividend dynamic in a long term historical view, we see that the median sector dividend is 36% above its 2009 level and that the payout ratio has navigated between 40% and 80% in the period, being now at around 60%. In spite of this, the case of the Portuguese stocks is slightly inflated by two years (2015 and 2016) of dividend distributions inflated by years of cash accumulation and therefore it is likely that the sector's dividend yield will fall during 2018.

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... only the Portuguese stand out

On an individual basis, the Portuguese stocks are the only ones to stand out in terms of valuation, in our opinion because of: 1) spike in dividends in the last years, 2) country risk premium, but still 3) undervaluation in some cases. We further analyze the Portuguese valuation in the specific equity notes. Regarding the sector as a whole, we see little margin for valuations to get dearer comparing to the board European equities index.

European Pulp & Paper sector valuation indicators

	Current				1y median				3y median			
	Ind 12M DY	EV/ EBITDA	P/S	PER	DY	EV/ EBITDA	P/S	PER	DY	EV/ EBITDA	P/S	PER
Iberia												
The Navigator Company	5,5	9,8	1,9	13,6	7,9	9,1	1,5	10,8	15,6	8,4	1,2	10,2
Altri	4,7	7,5	1,8	14,2	6,5	7,6	1,3	10,2	6,2	6,8	1,0	9,7
ENCE	4,0	6,4	1,7	19,5	5,4	6,0	1,1	15,2	4,3	5,9	1,0	14,9
Iberpapel Gestión	2,5	6,4	1,4	13,9	2,4	6,8	1,5	14,1	2,9	5,2	0,8	14,1
median	4,3	6,9	1,8	14,1	5,9	7,2	1,4	12,4	5,2	6,4	1,0	12,1
Northern Europe												
Holmen	3,0	9,5	2,1	19,5	3,4	7,6	1,8	18,6	3,8	7,1	1,4	21,5
Metsa Board	3,1	7,4	1,2	19,3	3,0	9,6	1,2	22,2	2,7	8,0	1,0	18,9
Stora Enso	3,0	8,4	1,0	20,4	3,4	13,1	0,8	17,2	3,9	11,8	0,6	18,5
UPM	4,0	8,3	1,3	14,3	3,8	10,9	1,2	13,0	4,5	11,3	0,8	12,2
Mondi	2,6	8,3	1,5	16,7	2,5	9,3	1,6	16,3	2,6	8,6	1,3	15,0
median	3,0	8,3	1,3	19,3	3,4	9,6	1,2	17,2	3,8	8,6	1,0	18,5
Sector median		8,3	1,5	16,7	3,4	9,1	1,3	15,2	3,9	8,0	1,0	14,9

Source: Bloomberg

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 - Accumulate, expected absolute return between +5% and +15%;
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 - Reduce, expected absolute return between -5% and -15%;
 - Sell, expected absolute return below -15%;

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PSI20 Notes in the last 12 months as of 30th of September of 2017:

	Number of Recommendations	%
Accumulate/Buy	2	66,7%
Keep/Neutral	0	0,0%
Reduce/Sell	1	33,3%
Total	3	100,0%

Trading Ideas in the last 12 months as of 30th of September of 2017

	Number of Recommendations	%
Profit Taking	7	63,6%
Stop Loss	3	27,3%
In Place	1	9,1%
Total	11	100,0%

Pair Trades in the last 12 months as of 30th of September of 2017:

	Number of Recommendations	%
Profit Taking	3	75,0%
Stop Loss	1	25,0%
In Place	0	0,0%
Total	4	100,0%

Source: Research

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João Lampreia
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