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Research Update:
Klabin S.A. 'BB' Rating Affirmed; Outlook Stable

Primary Credit Analysts:
Reginaldo Takara, Sao Paulo (55) 11 3039-9740;reginaldo_takara@standardandpoors.com
Milena Zaniboni, Sao Paulo (55) 11 3039-9739;milena_zaniboni@standardandpoors.com

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Overview

- Klabin's performance, despite its high financial leverage, has been improving gradually.
- We have affirmed our 'BB' ratings on Klabin with a stable outlook.
- We expect improving free cash flow in 2010 based on a significant reduction in capital expenditures.

Rating Action

On Nov. 12, 2009, Standard & Poor's Ratings Services affirmed its 'BB' corporate credit rating on Brazil-based packaging paper producer Klabin S.A. (Klabin). The outlook is stable.

Rationale

The rating on Klabin reflects the company's aggressive financial risk profile arising from its heavy levels of investment, exposure to volatile input costs, and challenging market conditions. These risks are partially offset by Klabin's strong liquidity, competitive cost position, product mix, and adequate liquidity.

Klabin's third-quarter 2009 results improved from previous quarters, with higher volumes and net sales, as domestic economic activity improved and export markets recovered. Sales of kraft liner, carton board, and packaging paper improved in the quarter, with increases in both year-over-year and quarter-over-quarter volumes. We believe this recovery is sustainable and bodes well for improving credit metrics in 2010. Indeed, since Klabin's current credit metrics are still aggressive for the rating category, a key assumption on the ratings is that the company will be successful in reducing financial leverage over the next several years by using internal cash generation to pay down debt.

Klabin's profitability measured by EBITDA improved in the third quarter of 2009 to 27%--compared with 20% in third-quarter 2008--due to cost-cutting initiatives, lower idle capacity, and streamlined operations. Prices, which are still below previous quarters levels, contributed not nearly as much to EBITDA. Still, working capital requirements remained high, as the company continued holding large inventories of finished products. The recently concluded MA-1100 project will add 350,000 tons per year of carton board production at full capacity by year-end 2009.

Klabin's credit measures remain weak for the rating category. For the 12 months ended Sept. 30, 2009, total debt-to-EBITDA and funds from operations-to-total debt ratios were at 6.6x and 8.2%, respectively, mainly due to the long-term debt used to finance the MA-1100 project and weak cash generation. We expect these ratios to reach about 5.0x and 15% by year-end 2010 (with a net debt to EBITDA of around 3.0x)--a pivotal assumption in our base case scenario, as we expect improved cash generation and stable total debt levels.

Liquidity

Klabin's liquidity is strong and a key supporting factor for the current rating. Cash reserves totaled R$1.89 billion as of Sept. 30, 2009; its short-term debt maturities, including some working capital loans and the current portion of its long-term debt, came to R$784 million in the same period. We think Klabin will maintain ample liquidity over the next few years as it uses free cash flow--which we now expect to grow with lower capital expenditures--to significantly pay down debt starting in 2011; its debt maturities should more concentrated in 2012 and 2013. We expect Klabin to sustain its prudent approach to dividend distribution and do not anticipate any big capital expenditures (apart from maintenance and some forest investments) in the next several years.

Outlook

The stable outlook reflects our expectation that Klabin will strive to pay down debt with free cash flow and, thus, bring its credit metrics to projected levels by year-end 2010. Downside risks include operating challenges in increasing production at its new plant or deterioration in volumes and prices leading to declines in cash generation in 2010 due to market conditions. We would have a negative view of any changes in investment plans that would postpone the firm's deleveraging.

We could lower the rating if Klabin's credit measures do not improve consistently, if they diverge from our 2010 expectations, or if liquidity is squeezed due to market conditions or working capital pressures. We will closely monitor the company's refinancing needs in 2011 and 2012, and will track its short-term debt balances over the next several quarters. We currently believe that a positive rating action is not likely, since the company needs to reduce its financial leverage--something it will accomplish only gradually.

Related Research

- "2008 Corporate Criteria: Analytical Methodology," April 15, 2008.
- "Criteria Methodology: Business Risk/Financial Risk Matrix Expanded," May 27, 2009.

Ratings List

Ratings Affirmed

Klabin S.A.

Corporate Credit Rating	
Global Scale	BB/Stable/--
National Scale	brAA/Stable/--

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