



## RATING ACTION COMMENTARY

# Fitch Revises Outlook on Dexco's IDRs to Negative; Affirms at 'BB+'

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Fitch Ratings - Rio de Janeiro - 03 Apr 2023: Fitch Ratings has affirmed Dexco S.A.'s Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) at 'BB+' and revised the Outlook to Negative from Stable. Fitch has also affirmed Dexco's National Scale long-term rating at 'AAA(bra)' with a Stable Outlook.

The Negative Outlook is a result of the confluence of a material increase in adjusted leverage, a deterioration in business conditions and an aggressive investment cycle. Dexco's adjusted leverage should remain temporarily above the downgrade trigger, which is not consistent with Fitch's prior forecasts. Conversely, a scenario in which Dexco has to honor off-balance debt is unlikely and, excluding it, leverage is more aligned with the rating.

The company needs to capture additional cash generation from its capex cycle in order to avoid a downgrade, while it recovers volume and profitability in Deca and ceramic tile segments, amid weak economic prospects. Dexco's ratings continue to reflect its strong business position in the Brazilian wood panel and building materials industries, and its commitment to preserve robust liquidity.

## KEY RATING DRIVERS

Economic Downturn Challenges Performance: Soft consumer demand, high interest rates, inflationary pressures on costs and freights, and slower global GDP growth rates challenge Dexco, interrupting the strong momentum for the wood panel and building

materials industries in 2020/2021. Wood volume decreased by 8% in 2022, accounting for 70% of EBITDA. In addition, the company lost market share and profitability in Deca and ceramic tile segments, whose volumes decreased by 20% to 22% in 2022, while gross margin shrank in the 2H22. Fitch projects flat sales volume for wood panels in 2023 and 3.5% increase in ceramic tiles. For Deca, Fitch assumed a 10% volume decrease.

**Capex Program Pressures FCF:** Base case projections considered elevated investments of BRL3 billion in 2023/2024 and dividends at 30% of net income, resulting in negative FCF in the next couple of years. Fitch projects Dexco to generate BRL1.7 billion of EBITDA and BRL1 billion of cash flow from operations (CFFO) in 2023, and BRL2.0 billion and BRL1.3 billion, respectively, in 2024. This compares with BRL1.7 billion of EBITDA and BRL690 million of CFFO in 2022. EBITDA margins are expected to remain between 19% to 22%. FCF is projected to be negative at BRL935 million in 2023 and BRL80 million in 2024.

**Higher than Expected Leverage:** Base case considers net adjusted debt to EBITDA ratio to peak at 4.5x in 2023 and fall to around 4.0x in 2024, which compare with 4.0x in 2022 and a track record of below 2.5x until 2021. Higher investments, softer operating cash flow growth perspectives, and a BRL1.7 billion disbursement with dividends and stock repurchase between 2021 and 2022 resulted in higher indebtedness. Net debt increased to BRL4 billion at YE 2022, from BRL2.5 billion as of December 2021, and the rating case considers a further increase to close BRL5 billion by YE 2023.

**Strong Business Position:** Dexco's large operating scale, strong product portfolio and wood self-sufficiency are key competitive advantages that are difficult to be replicated. Dexco is the largest Brazilian wood panel producer, with an estimated market share of 33%. Dexco's product portfolio is also comprised of the Deca division, which consists of sanitary products and the company is also one of the main players in the ceramic tiles segment.

**JV Off-Balance Sheet Debt:** Dexco's 49% stake in dissolving pulp producer LD Celulose will diversify its business model and contribute to a dividends flow in hard currency in the long term. LD Celulose has an annual production capacity of 500,000 tons of dissolving pulp and annual EBITDA generation of approximately BRL1.5 billion, considering full operation. Fitch's rating case does not incorporate dividends inflow in the next four years. Fitch includes BRL2.9 billion of off-balance sheet debt from LD Celulose guaranteed by Dexco on leverage metrics. Excluding off-balance sheet debt, net debt to EBITDA ratio should increase to 3.0x in 2023, from 2.4x in 2022.

Rating Above Country Ceiling: Dexco's 'BB+' FC IDR is one notch higher than Brazil's 'BB' Country Ceiling, based on Fitch's expectation that EBITDA from exports and the Colombian operations would cover hard currency debt service in the next 12 months by 1.5x, in case of foreign currency issuances.

## **DERIVATION SUMMARY**

Dexco has a weaker business risk profile than its Latin American pulp & paper peers Celulosa Arauco y Constitucion S.A. (FC IDR BBB/Stable), Eldorado Brasil Celulose S.A. (FC IDR BB/Stable), Empresas CMPC (FC IDR BBB/Stable), Klabin S.A. (FC IDR BB+/Stable) and Suzano S.A. (FC IDR BBB-/Stable). These peers all have greater operating scale, strong revenue flow from the pulp division and a more export-oriented business profile. Dexco, on the other hand, is more exposed to demand from the local market than its peers, which makes it more vulnerable to the domestic macroeconomic conditions.

Dexco's rating equals Klabin's given a track record of more conservative capital structure and Negative Outlook on the IDRs reflects the expectation of higher leverage in the next two years. Dexco is rated one notch above Eldorado, as the latter has only one pulp mill and ongoing litigation issues at its controlling shareholders.

## **KEY ASSUMPTIONS**

Fitch's Key Assumptions Within the Rating Case for the Issuer:

- Wood sales volume of 2.9 million cubic meters in 2023 and in 2024;
- Deca division sales volume of 21.1 million items in 2023 and 24 million items in 2024;
- Ceramic tiles sales volume of 19 million sqm in 2023 and 22 million sqm in 2024;
- Investments of BRL4.2 billion during 2023-2025;
- Dividends limited to 30% of net income.

## **RATING SENSITIVITIES**

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- A positive rating action is not expected in the medium term. The Outlook Negative could be revised to Stable if Dexco's CFFO generation is stronger, allowing a quicker net debt reduction.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Perception that net adjusted debt/EBITDA ratio will remain above 3.0x;

--EBITDA margin recurrently below 18%;

--Additional and material capital injections at the JV LD Celulose;

--A downgrade on Brazil's Country Ceiling or a worsening in offshore structural enhancements would result in a similar rating action on Dexco's FC IDR.

## **BEST/WORST CASE RATING SCENARIO**

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit

<https://www.fitchratings.com/site/re/10111579>.

## **LIQUIDITY AND DEBT STRUCTURE**

**Strong Liquidity:** Dexco has historically maintained strong cash reserves, and Fitch expects the company to preserve an extended debt amortization profile. At YE 2022, Dexco had BRL1.8 billion of cash and marketable securities and BRL5.8 billion of total debt. The company faces BRL910 million of debt maturities in 2023, and BRL994 million in 2024. Dexco's financial flexibility is enhanced by its multiple access to financing, potential sale of forestry assets, if necessary, and a BRL500 million unused revolving credit facility. The accounting value of Dexco's biological assets was about BRL1.9 billion as of Dec. 31, 2022. Debt is denominated in local currency with a competitive cost.

## **ISSUER PROFILE**

Dexco is the leading wood panel producer in Brazil, with 3.5 million cubic meters of annual domestic production and 0.3 million cubic meters in Colombia. Dexco is also one of the largest producers of sanitary ware and metals in Brazil, the second largest shower producer, and one of the main ceramic tile producers.

## **SUMMARY OF FINANCIAL ADJUSTMENTS**

--Fitch excludes from EBITDA: asset impairment, results from asset sale, biological asset's fair value variation and impact from business restructuring.

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

## ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit [www.fitchratings.com/esg](http://www.fitchratings.com/esg).

## RATING ACTIONS

ENTITY / DEBT ⚡	RATING ⚡		PRIOR ⚡
Dexco S.A.	LT IDR	BB+ Rating Outlook Negative	BB+ Rating Outlook Stable
	Affirmed		
	LC LT IDR	BB+ Rating Outlook Negative	BB+ Rating Outlook Stable
		Affirmed	
	Natl LT		AAA(bra) Rating Outlook Stable
	AAA(bra) Rating Outlook Stable		
	Affirmed		

[VIEW ADDITIONAL RATING DETAILS](#)

## FITCH RATINGS ANALYSTS

Natalia Brandao  
Associate Director

**Primary Rating Analyst**

+55 21 4503 2631

natalia.brandao@fitchratings.com

Fitch Ratings Brasil Ltda.

Av. Barão de Tefé, 27 – Sala 601 Saúde Rio de Janeiro, RJ 20220-460

**Rodolfo Schmauk**

Director

Secondary Rating Analyst

+56 2 3321 2923

rodolfo.schmauk@fitchratings.com

**Ricardo De Carvalho**

Managing Director

Committee Chairperson

+55 21 4503 2627

ricardo.carvalho@fitchratings.com

**MEDIA CONTACTS****Elizabeth Fogerty**

New York

+1 212 908 0526

elizabeth.fogerty@thefitchgroup.com

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**APPLICABLE CRITERIA**[National Scale Rating Criteria \(pub. 22 Dec 2020\)](#)[Corporate Rating Criteria \(pub. 28 Oct 2022\) \(including rating assumption sensitivity\)](#)[Corporates Exceeding the Country Ceiling Criteria \(pub. 08 Dec 2022\) \(including rating assumption sensitivity\)](#)**APPLICABLE MODELS**

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 ([1](#))

## **ADDITIONAL DISCLOSURES**

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Dexco S.A.

EU Endorsed, UK Endorsed

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