20 APR 2022

# Fitch Assigns 'BB+' IDR to Dexco; Outlook Negative

Fitch Ratings - Rio de Janeiro - 20 Apr 2022: Fitch Ratings has assigned 'BB+' Foreign Currency (FC) and Local Currency (LC) Issuer Default Ratings (IDRs) to Dexco S.A. (Dexco). The Rating Outlook for the FC IDR is Negative and for the LC IDR is Stable. Fitch currently rates Dexco's National Scale Long-Term rating 'AAA(bra)'/Stable.

Dexco's ratings reflect its strong business position in the Brazilian wood panel and building materials industries, as well as its proven ability to generate robust operating cash flows throughout economic cycles. Dexco demonstrates strong financial discipline, underpinned by a long track record of operating with low financial leverage and a strong liquidity position. This has resulted in strong access to both banks and the local capital market.

The Negative Outlook for the FC IDR mirrors the Outlook of Brazil's sovereign rating. The Stable Outlook for the LC IDR reflects Fitch's expectation that Dexco's adjusted net leverage will remain below 3.0x over the rating horizon, despite a punctual and moderate peak of 3.3x in 2022, due to higher investments. Dexco should continue to present growing operating cash flow generation and healthy profitability.

## Key Rating Drivers

Strong Business Position: Dexco's large operating scale and strong product portfolio are key competitive advantages. These factors, in addition to the fragmented nature of its customers, allows the company to pass through most cost increases and maintain operating margins throughout cyclical downturns. Dexco is the largest Brazilian wood panel producer, with an estimated market share of 33%. This segment represented 68% of EBITDA in 2021. Dexco's product portfolio is also comprised of the Deca division, which accounts for about 20% of EBITDA and consists of sanitary products. Dexco is also one of the main players in the ceramic tiles segment.

Increasing Diversification: 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, which is a JV with Lenzing, is in the process of ramping up a mill that has an annual production capacity of 500,000 tons of dissolving pulp; the investment related to this pulp mill cost about USD1.4 billion. Dexco does not consolidate LD Celulose on its balance sheet, and Fitch's rating case incorporates dividends inflow starting only in 2025. The mill will have some of the lowest costs in the industry, and all production will be absorbed by Lenzing through an off-take agreement valid until 2035.

Challenging 2022 Scenario: Fitch expects Dexco to face some headwinds in 2022 due to an economic downturn in Brazil and slower global GDP growth rates. Fitch projects sales volume increasing by 1% in 2022 in wood panels and Deca and by 2.5% in ceramic tiles, supported by additional installed capacity.

The rating case assumes a 10% to 12.5% increase in revenue per unit in 2022.

While demand from homebuilders should remain solid, supported by high launches in the last years, the unstable business conditions could slowdown demand in the retail segment and momentum for more aggressive upward price adjustments. Dexco's sales volumes increased in 2021 by 10% in wood panel, 8% in Deca and 4% in ceramic tiles, while revenue per unit increased by 20% to 33%.

Robust Cash Flow Generation: Fitch expects Dexco to generate EBITDA of BRL2.0 billion and cash flow from operations (CFFO) of BRL1.1 billion in 2022, and BRL2.3 billion and BRL1.7 billion, respectively, in 2023. This compares with BRL2.1 billion of EBITDA and BRL1.6 billion of CFFO in 2021. Fitch's projections considered a modest EBITDA margin reduction to 21.5% in 2022 from a strong 26% in 2021, due to inflationary pressures. In the medium term, Fitch expects margins in the 23%-24% range, as a result of Dexco's strategy in recent years to improve operating efficiency and optimize cost structure.

New Investment Cycle: Dexco's FCF is projected to be negative in 2022 and 2023, at BRL1.1 billion and BRL375 million, respectively, and return to positive in 2024, following a period of higher investments. The company's new investment cycle includes factory modernization, forestry base increase, portfolio mix improvement and additional production capacity. Fitch's projections incorporate elevated investments of BRL3.7 billion in 2022 and 2023, while dividends should remain limited at 30% of net income.

Conservative Capital Structure: Dexco has strong credit metrics and remains committed to preserve a conservative balance sheet. Fitch projects a temporary increase in adjusted net leverage to 3.3x in 2022 due to higher investments before returning to below 3.0x in 2023. Dexco has historically maintained its adjusted net debt/EBITDA ratio below 2.5x. Dexco's BRL6.3 billion adjusted total debt at end-2021 included BRL2.4 billion of off-balance debt from LD Celulose guaranteed by the company. Fitch forecasts Dexco's net debt to increase by BRL1.4 billion by 2024 and the off-balance sheet debt should increase to BRL2.9 billion by this year, before starting to reduce in 2023. Once LD Celulose's dissolving pulp mill is fully operational, it should generate an average of BRL1.5 billion of EBITDA per year.

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 HC debt service in the next 12 months by 1.5x, in case of foreign currency issuances. The Negative Outlook for the FC IDR reflects the Outlook of Brazil's sovereign rating (BB-/Negative). Dexco's 'BB+' LC IDR with a Stable Outlook reflects its underlying credit quality.

## 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-/Positive), 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 due to a track record of maintaining a more conservative capital structure. Dexco is rated above Eldorado, which is constrained by a more concentrated debt amortization profile and by the ongoing litigation issues at its controlling shareholders and weak corporate governance standards.

## Key Assumptions

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

--Wood sales volume of 3.2 million $m^3$ in 2022 and in 2023;

--Deca division sales volume of 29.8 million items in 2022 and 31.6 million items in 2023;

--Ceramic tiles sales volume of 25.9 million sqm in 2022 and 29.1 million sqm in 2023;

--Investments of BRL5 billion during 2022-2024.

## RATING SENSITIVITIES

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

--Positive rating action for the company's FC IDR would be associated with the combination of an upgrade on Dexco's LC IDR and an upgrade on Brazil's Country Ceiling and/or improvement in offshore structural enhancements, allowing an uplift of two notches above the Country Ceiling;

--Positive rating action for the company's LC IDR would be associated to greater geographical or business diversification coupled with net adjusted debt/EBITDA ratio recurrently below 2.0x;

--An upgrade is not possible for the National Scale rating as it is at the highest level.

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

--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;

--Negative rating action for the LC IDR and National Scale rating would be associated with a deterioration of Dexco's financial profile, with EBITDA margin recurrently below 18%, additional and material capital injections at the JV LD Celulose, pressuring its capital structure and/or net adjusted debt/EBITDA ratio recurrently above 3.0x.

## 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 and conservative liquidity. At end-2021, Dexco had BRL1.4 billion of cash and marketable securities and BRL3.9 billion of total debt. The company's cash position comfortably covers debt maturities up to the end of 2023 of BRL1.4 billion. 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 BRL1.3 billion as of Dec. 31, 2021.

Dexco's total debt consists of debentures (31%), Certificates Agribusiness Receivables (18%), FINAME lines (14%), export credit notes (14%), export financing (10%) and others (13%). 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.

## Date of Relevant Committee

13 April 2022

## 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.

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## Rating Actions

| ENTITY/DEBT | RATING | | | RECOVERY | PRIOR |
|---|---|---|---|---|---|
| Dexco S.A. | LT IDR | BB+ | New Rating | | |
| | LC LT IDR | BB+ | New Rating | | |

| RATINGS KEY | OUTLOOK | WATCH |
|---|---|---|
| POSITIVE | | |
| NEGATIVE | | |
| EVOLVING | | |
| STABLE | | |

## Applicable Criteria

Corporate Rating Criteria (pub.15 Oct 2021) (including rating assumption sensitivity)

National Scale Rating Criteria (pub.22 Dec 2020)

## Applicable Models

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

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.0.2 (1)

## Additional Disclosures

Solicitation Status

Endorsement Status

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## Endorsement policy

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