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Research Update:

Norske Skogindustrier Rating Lowered To 'B-' From 'B' On Refinancing Risk And Tight Covenant Headroom; Outlook Negative

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Overview

- Norway-based forest product group Norske Skogindustrier ASA is faced with tough market conditions, a challenging debt maturity profile over the next 18 months, and tight financial covenant headroom.
- In our opinion, this increases the near-term liquidity risk to levels that are incommensurate with a 'B' long-term rating.
- We are lowering the long-term rating on the group to 'B-' from 'B'.
- The negative outlook primarily reflects the difficulties Norske Skogindustrier faces to improve its debt maturity profile.

Rating Action

On Aug. 12, 2010, Standard & Poor's Ratings Services lowered its long-term corporate credit rating on Norway-based forest product group Norske Skogindustrier ASA (Norske Skog) to 'B-' from 'B'. At the same time, we affirmed the 'B' short-term corporate credit rating. The outlook is negative.

Rationale

The rating action primarily reflects our view that Norske Skog's debt maturity profile until 2012 appears increasingly difficult to manage given its currently available and potential liquidity resources. It also reflects the tighter headroom under the group's financial covenants since the start of 2010. Furthermore, tough market conditions in the European newsprint markets in 2010 are limiting the group's operating cash flow generation. These factors are deteriorating the group's liquidity position, in our view. Consequently, we are reassessing our view on Norske Skog's liquidity profile to "less than adequate" from "adequate".

As we expected, a sharp decline in European newsprint selling prices, combined with rising input costs, have depressed Norske Skog's margins and cash flow generation so far in 2010. We note, however, that a recovery in demand across the group's product segments and a decent performance by its non-European divisions are countering this somewhat. Although we currently believe that market conditions in Europe are likely to improve in 2011, we see a risk that Norske Skog's operating cash flow will not recover sufficiently to eliminate refinancing risk over the next 18 months.

We continue to forecast a decline in Norske Skog's ratio of adjusted funds

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from operations (FFO) to debt to less than 5% in 2010. In the 12 months ended June 30, 2010, FFO to debt was 8.7%, continuing a downward trend that began at the end of 2009. We are forecasting neutral free operating cash flow (FOCF) generation in 2010, despite a material working capital outflow in the first half of the year. In 2011, FOCF could turn moderately positive, but prospects depend on the magnitude of price increases in annual newsprint contracts.

The ratings continue to reflect our view of Norske Skog's highly leveraged financial risk profile, including a high probability of weakening credit measures and a concentration of debt maturities in 2012. They also reflect its exposure to the oversupplied, cyclical, and structurally impaired publication paper industry. This is partly counterbalanced by good positions in the global newsprint markets, material debt reduction efforts, and an ability to meet debt maturities in 2011 with existing resources. As of June 30, 2010, Norske Skog's adjusted debt amounted to an estimated Norwegian krone (NOK) 11.9 billion (about €1.5 billion).

Liquidity

We currently perceive Norske Skog's liquidity profile to be less than adequate, based on tightening covenant headroom and material debt maturities in 2011 and in 2012 that total about NOK5.9 billion. Although substantial asset disposals in recent years have provided a cash reserve to meet maturities in 2011, we think the group has a refinancing need relating primarily to maturities in early 2012.

As of June 30, 2010, Norske Skog's liquidity position was supported by the following resources:

- Cash and equivalents of about NOK3.7 billion, of which we deem NOK3.1 billion to be surplus cash. We consider a cash position corresponding to 3% of annual revenue as necessary for the sustainable operations of the group.
- Planned asset sales during the remainder of 2010. According to Norske Skog, these could result in NOK1 billion-NOK1.5 billion in cash proceeds. The group has achieved NOK767 million so far (which is not included in the cash position as of June 30, 2010), following the sale of excess energy in Norway. Additionally, the group is considering divesting forest assets in Brazil and a property in Norway. We view this potential liquidity resource as uncertain, but recognize that the group has successfully divested assets in the past.
- Discretionary cash flow generation in 2010 and 2011. We expect this to be neutral in 2010 before turning moderately positive in 2011. Nevertheless, there is significant uncertainty primarily relating to operating conditions in 2011 and 2012, in our view.

This compares with debt maturities in the second half of 2010 of NOK345 million. Debt maturities in 2011 and 2012 amount to NOK2 billion and NOK3.9 billion, respectively. We currently assume that Norske Skog can cover debt maturities in 2010 and 2011 with available resources. However, we also assume that a €400 million (about NOK3.2 billion) loan maturing in February 2012 will need to be refinanced, unless the group can make further substantial asset divestments. Failure to address the near-term debt maturities by early 2011 could have a negative effect on our assessment of the liquidity profile and, potentially, the ratings.

The €400 million loan maturing in 2012 contains financial covenant requirements. If no waiver is obtained, a breach of the covenants could cause early redemption and cross-default on virtually all the group's debt. As of June 30, 2010, the covenant gearing ratio was 0.98x (0.91x pro forma for the sale of excess energy in third-quarter 2010) against a permitted maximum of 1.4x. This compares with 0.8x as of year-end 2009. The tangible net worth (defined as total book value of equity less intangible fixed assets) stood at about NOK10.1 billion against a minimum of NOK9 billion. This compares with about NOK11.7 billion as of year-end 2009. Given that Norske Skog's reported equity could be weakened by poor profitability, impairment charges, and volatility in the value of long-term power contracts, we view its current headroom as tight.

There are no rating triggers in Norske Skog's existing loan documentation.

Recovery analysis

The issue-level ratings on Norske Skog's €500 million unsecured notes due 2017, $200 million unsecured notes due 2015, $200 million senior unsecured notes due 2033, $295 million senior unsecured notes due 2011, and NOK750 million unsecured notes maturing in 2014 are 'B-', in line with the 'B-' corporate credit rating. The recovery rating of '4' assigned to this debt, indicating our expectation of average (30%-50%) recovery in an event of payment default, remains unchanged.

We have valued the group on a going-concern basis, given its leading market position, good asset base, and well-established distribution channels. Recovery expectations are underpinned by the group's substantial asset base and by significant "in the money" energy contracts. Nevertheless, our stressed enterprise value in a simulated default scenario remains unchanged at about NOK6.3 billion ($1.1 billion).

After deducting priority liabilities that include a mixture of secured/structurally senior debt obligations, recovery prospects on the unsecured issues are estimated in the 30%-50% range. Under our default scenario, we have assumed that the €400 million revolving credit facility ranks pari passu with the claims of all other unsecured creditors of the issuer. However, given its maturity in 2012, ahead of the majority of the notes, and the existence of a maintenance covenant in its documentation, a possibility exists that in an event of significant financial stress, the facility could be granted preferential ranking in return for ongoing lender support. This would increase the risk of a notching down of the issue ratings on the notes against the corporate credit rating.

For our full recovery report, see "Norske Skogindustrier ASA's Recovery Rating

Profile", published May 19, 2009, on RatingsDirect.

Outlook

The negative outlook reflects our view that there is a risk that Norske Skog will not be able to meet its debt maturities in 2012 and that headroom under financial covenants could tighten. We believe these factors could put further pressure on the ratings in the near term.

We could revise the outlook to stable if Norske Skog can reduce refinancing and covenant risk, for example through asset disposals or improved operating performance that results in meaningful positive FOCF.

Related Criteria And Research

- Principles Of Corporate And Government Ratings, June 26, 2007
- Rating Implications Of Exchange Offers And Similar Restructurings, Update, May 12, 2009
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Criteria Guidelines For Recovery Ratings On Global Industrials Issuers' Speculative-Grade Debt, Aug. 10, 2009

Ratings List

Downgraded; Ratings Affirmed

	To	From
Norske Skogindustrier ASA		
Corporate Credit Rating	B-/Negative/B	B/Negative/B
Senior Unsecured	B-	B
Recovery Rating	4	4

Additional Contact:
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