Article Title: ARCHIVE | Criteria | Corporates | Industrials: Framework for Analyzing Emerging Nordic Forestland Companies Data: Background In May 2002, Finland-based forest products company Stora Enso Oyj (BBB+/Stable/A-2) announced that it plans to transfer its Finnish forestland holdings into a new company, in which Stora Enso will reduce its holdings to minority ownership. The announcement has intensified the discussion in the Nordic region about forest products companies' interest in spinning off forestland holdings. Recent developments could lead to a number of new forestland companies emerging in the Nordic region, with silviculture (forest cultivation and management), harvesting, and the supply of wood as the main businesses. These companies differ from the more traditional forest products companies, in which own wood supply is a supporting business and part of the vertical integration chain, and in which the profitability of the wood supply operations is of a secondary nature. A pure forestland company is exposed to a number of external and internal risk factors, which, to a large extent, differ from those affecting integrated forest products companies. Industry Characteristics for Forestland Companies When analyzing a forestland company's competitive position and business risk profile, Standard & Poor's takes the industry characteristics as a starting point. Positive attributes for Nordic forestland companies include: Favorable cash flow characteristics, with low operating costs and low capital expenditure requirements; and Renewable assets, and possibilities of land sales as an earnings cushion. Negative factors include: A declining trend in prices for roundwood in real terms; and Exposure to a cyclical sawmill industry with weak profitability and/or to large pulp and paper companies with strong bargaining powers. Supply and demand balance, and pricing. The demand for roundwood in Sweden and Finland has historically been increasing, and is expected to continue to grow, although at low rates. On the supply side, barriers to entry are high, as the trees in the Nordic countries normally are harvested at an age of between 50 and 120 years (depending on tree species and region). There are, however, plenty of wood resources available on the existing roundwood market, and the supplier market is very fragmented, with private individuals as the largest owner category. This structure can lead to fluctuations in supply, as many of these private individuals are not solely dependent on the income from the sale of wood, and therefore can stop harvesting if prices are unfavorable. In both Sweden and Finland, a large proportion (about 15%-20%) of demand is imported, primarily from Russia and the Baltic States. Many of the imports are of hardwood species (mainly birch) that are less available in the Nordic region. They also reflect attractive import prices. Relatively high transportation costs, however, limit large-scale imports. Roundwood can be divided into two major categories: sawlogs, which are used in the sawmill industry; and pulpwood, which is used in the pulp and paper industry. The value of sawlogs is about three times that of pulpwood and therefore represents a large share of the market in terms of value. Nevertheless, the Nordic sawmill industry has been hampered by overcapacity and poor profitability over an extended period. A gradual restructuring of the industry is expected, which could lead to mergers and mill closures, and potentially to lower demand for sawlogs. Larger sawmill entities might also push for lower sawlog prices. On the pulpwood side, the customer base is more concentrated, and includes the large forest product companies such as Stora Enso, UPM-Kymmene Corp. (BBB+/Stable/A-2), Svenska Cellulosa Aktiebolaget SCA (A-/Stable/A-2), M-real Corp. (BBB-/Stable/A-3), Norske Skogindustrier ASA (BBB/Stable/A-2), and Holmen AB (BBB+/Stable/A-2), which have significant bargaining powers. In addition, several of these companies have their own sawmills and therefore are combined sawlog and pulpwood buyers. As a result of the increased consolidation in the pulp and paper industry in recent years, major pulp and paper producers have become more disciplined on the supply side by restricting new capacity and better adjusting production volumes to end-user demand. Although this could lead to more fluctuations in the demand for pulpwood, it could at the same time smooth out major cyclical swings. Prices for industrial roundwood generally follow the end-product prices--that is, sawn timber, pulp, paper, and paperboard. The price trend in real terms is negative. This is a result of a number of factors, such as the large availability of wood resources, rationalizations in the harvesting operations, a declining trend in end-product prices, customers' bargaining powers, and cheaper imports. Costs and capital expenditure requirements. Most costs associated with forestland ownership and the supply of roundwood--such as harvesting, silviculture, and maintenance--are highly variable and not capital-intensive. Capital expenditure requirements are limited to roads, bridges, and equipment for silviculture and harvesting. The relatively high transportation costs mean that pulp and paper mills and sawmills are usually located

close to the forestland, and this cost is often borne by the buyer. Operating cash flows and forestland value. A forestland company's operating cash flows should be relatively good as a result of low operating costs and capital expenditures. In contrast to the forest product companies' largest capital base--the pulp and paper machines--forestland assets are renewable and normally appreciate in value over the years, as most companies' harvesting levels are below forest growth. The assets are also relatively liquid, which provides the forestland owner with good opportunities to gain from sales of noncore forestland. Environmental regulations and natural risks. The management and harvesting of forestland in the Nordic region are subject to environmental regulations that aim at the sustainable use of forestland. These regulations have, however, not had any major negative implications for the forest owners in the past, and are not expected to be a major risk going forward. Natural risks include wind damage, forest fires, and biological damage (for example, fungi), but appear limited in the region. Large forest fires are unusual due to the climate, and the improved management of forestlands over the years has decreased biological damage. Wind damage, however, could occasionally cause market disturbance as this results in a large amount of roundwood suddenly becoming available. Keys to Success Although forestland companies will be exposed to and benefit from the aforementioned factors, different companies will benefit or be affected to varying degrees, and there are a number of key factors that help determine a company's relative business risk. Forestland location, customer base, and contracts. Proximity to paper and sawmills is an advantage, as transportation costs are fairly high. Apart from the relative bargaining power of the customers (are they, for example, mainly large integrated pulp and paper producers or smaller sawmills?), the profitability of customers' mills is important. Although customer diversity should be an advantage, it could be better to sell to a few profitable mills than to a larger number of smaller, less profitable businesses; even if a customer were to go out of business, a profitable single mill would probably be acquired by a competitor and continue as a customer. Long-term customer contracts provide stability in the earnings base. Some volatility still remains, however, as the contracts are often connected to volumes but based on market prices, which are renegotiated over the duration of the contract. Size of forestland and geographical dispersion. Large diversified forestland holdings provide flexibility with regard to harvesting plans and the possibility of making land sales, and reduce exposure to any local changes in demand and pricing. Although there is some correlation between land values and roundwood prices, there could be price differences between regions that a larger forestland company could utilize, selling forestland to mitigate shortfalls in cash flow from roundwood operations. Diversity also reduces environmental risk (wind throws and biological damages). A large company should also have stronger bargaining power when it comes to pricing, as, from a logistical point of view, large integrated customers might prefer to buy from one supplier rather than from a large number of smaller forestland owners. Tree/product mix and age distribution of trees. Although sawlogs have a higher value than pulpwood, a wood supplier usually sells both. Different tree species (primarily pine, spruce, and birch in the Nordic region) are used for different purposes, however, and a mix of species could therefore be an advantage to mitigate fluctuations in demand and prices. Furthermore, an even age distribution of the trees would help mitigate any shortfalls in future planned harvesting levels. Flexibility in the cost base. Although operating costs are normally low, flexible costs for harvesting through prudent adjustment of harvesting volumes are an advantage. Outsourcing of harvesting, or even the sale of the standing timber, are also ways to increase flexibility in the cost base. Management, expertise, and advanced administrative systems. Besides the benefits of experienced management and expertise in silviculture, advanced administrative systems enabling detailed harvest planning represent an advantage; for example, advanced information systems that help the right tree to be harvested for the right purpose. Compliance with environmental regulations and norms. In view of the concern about the sustainable use of forestland, a forestland company should benefit from not only being in compliance with environmental regulations, but also from being recognized as an environmentally responsible wood supplier. For example, retail chains are increasingly only selling wood products from forests that are managed in an environmentally sensitive manner. Analytical E-mail Addresses alf_stenqvist@standardandpoors.com andreas_kindahl@standardandpoors.com CorporateFinanceEurope@standardandpoors.com