S&P Global Ratings

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UPM-Kymmene Corp.

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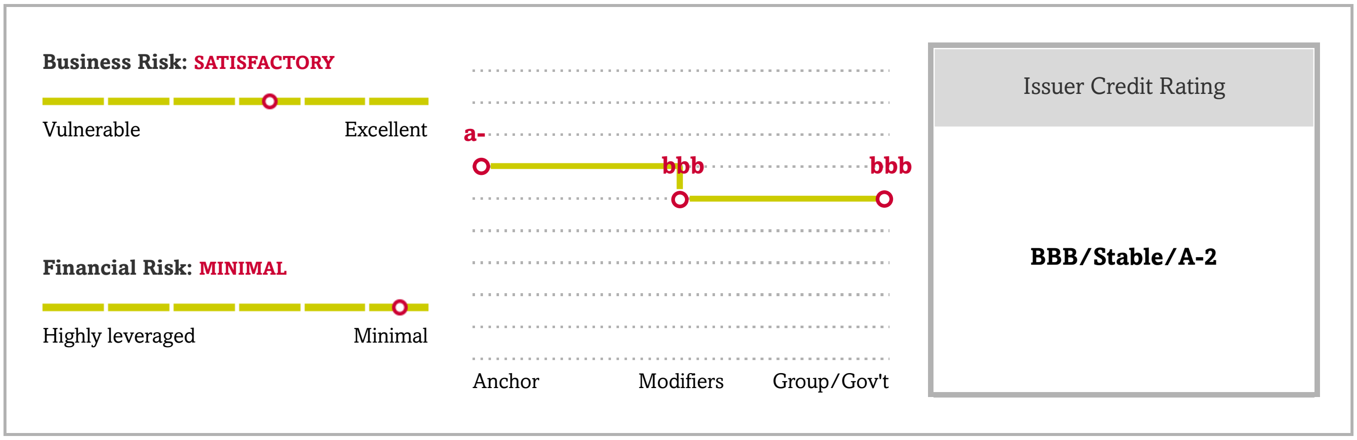

Credit Highlights

Overview	
Key strengths	**Key risks**
Large and diversified operations.	Cyclical nature of the paper and forest products industry.
Leading market positions across a variety of segments.	Still-large exposure to structurally declining graphic paper.
Cost efficiency underpinned by large scale and vertical integration.	Stated financial policy allows for potentially higher leverage.
High cash generation and low leverage.	

S&P Global Ratings expects UPM-Kymmene Corp.'s revenue and EBITDA margins will be negatively affected by the pulp and graphic paper divisions in 2020. The closure of offices and educational institutions, combined with cuts in advertising spending resulted in a sharp decline in demand for graphic paper in the first half of 2020. Lower volumes and prices are likely to undermine graphic paper sales by over 25% in 2020. We also forecast weaker EBITDA margins. In the Biorefining segment, we expect lower pulp prices and volumes will cut revenue by over 20% and lower EBITDA margins. Pulp production was also negatively impacted by a strike in Finland earlier this year.

On the other hand, we forecast stronger EBITDA margins in the label and specialty paper divisions versus 2019. We expect positive momentum in terms of EBITDA margins in the Raflatac and Specialty Papers segments. Both of these divisions benefit from strong underlying demand for label and packaging products (partly as a result of the pandemic) and cost reductions (fixed and raw material costs).

We expect credit metrics will weaken but remain commensurate with the current rating. We forecast an about 18% drop in revenue for 2020 driven by declines in the graphic paper and pulp businesses. The revenue decline will reflect lower selling prices and reduced volumes. We expect S&P Global Ratings-adjusted EBITDA margins of about 14.3% (down from 17.9% in 2019) due to lower average selling prices, lower fixed cost absorption and restructuring costs. As a result of weaker operating performance and higher capital expenditure (capex), we forecast S&P Global Ratings-adjusted debt to EBITDA of about 0.8x by year-end 2020 (compared with 0.1x at year-end 2019).

Outlook: Stable

The stable outlook reflects our expectations that UPM's strong and cost efficient market positions will continue to support solid operating cash flow generation. We expect the group's large expansion investments will lead to negative free operating cash flow (FOCF) in the next 24 months. We expect adjusted leverage to remain below 2.5x over the next 24 months.

Downside scenario

We could lower the rating if:

- UPM's credit metrics deteriorated markedly from current levels such that our weighted-average ratio of adjusted funds from operations (FFO) to adjusted debt fell below 40%.
- Adjusted debt to adjusted EBITDA exceeded 2.5x.

Although significant headroom currently exists, a deterioration in credit metrics could follow a very large debt-funded acquisition, capex, or higher shareholder returns, combined with a sharp decline in the performance of the business.

Upside scenario

We could raise the rating if UPM tightened its financial policy and amended its stated maximum leverage ceiling to reflect a commitment to maintain credit metrics commensurate with a modest financial risk profile:

- Our adjusted weighted-average FFO-to-debt ratio sustainably above 45%.
- Adjusted debt-to-EBITDA of less than 2x.

We believe this would be in line with a company-reported debt-to-EBITDA ratio of about 1.5x.

We could also raise the rating if we saw a material improvement in the company's business risk profile, possibly via a further expansion into products with higher margins and stronger growth prospects.

Our Base-Case Scenario

Assumptions

- S&P Global Ratings estimates that eurozone GDP will contract by 7.4% in 2020 and recover by 6.1% in 2021.
- Revenue is expected to decline by about 18% in 2020, largely driven by lower demand and prices in UPM Communication Papers and lower pulp prices. We expect a 1%-4% decline in revenue in 2021, given lower graphic paper volumes and prices are only partly offset by higher pulp prices and revenue growth in specialty papers.
- S&P Global Ratings' adjusted EBITDA margin of about 14.3% in 2020, largely driven by lower selling prices and mill closure costs. EBITDA margin of 16.53%-17.3% in 2021, supported by a recovery in pulp prices.
- Capex, including forest renewal costs, of €1 billion in 2020 and about €1.7 billion in 2021. To derive these figures, we assumed annual maintenance capex of about €200 million.
- Flat working capital in 2020 and outflow of about €100 million in 2021.
- We assume flat annual dividend distributions of €693 million.
- No acquisitions or share repurchases.

Key Metrics

UPM-Kymmene Corp.--Key Metrics*

	--Fiscal year ended Dec. 31--			
	2018a	**2019a**	**2020e**	**2021f**
Revenue growth (%)	4.7	(2.3)	(~18)	(1-4)
EBITDA margin (%)	18.8	17.9	~14.3	16.3-17.3
Debt to EBITDA (x)	0.4	0.1	~0.8	1.6-1.8
FFO to debt (%)	232.5	705.6	>100	48-54
FOCF to debt (%)	143.7	627.8	~0	(24-27)

a--Actual. e--Estimate. f--Forecast. FFO--Funds from operations. FOCF--Free operating cash flow. *All figures adjusted by S&P Global Ratings.

We anticipate weaker EBITDA margins for 2020. In 2020 we expect the Finnish labor strike (which had a negative impact of around €30 million on EBITDA), the volume decline in graphic papers (which leads to lower fixed cost absorption) as well as weaker pulp and graphic paper prices, to weigh on the EBITDA margin. We also forecast significant restructuring costs in 2020, related to mill closures and operational improvements. These negative factors will be only partly offset by improved EBITDA margins in UPM Raflatac and UPM Specialty Papers.

High capex owes to the construction of the Uruguay pulp mill and the German biorefinery projects. UPM is building a large eucalyptus pulp mill in Paso de los Toros, Uruguay. The investment is estimated at over $3 billion. UPM is also spending €550 million on a new biorefinery in Leuna, Germany. High expansion capex (about €1.4 billion per year) will lead to negative FOCF in 2021-2022. We anticipate UPM will partly fund these investments with incremental debt. Coupled with our expectation of stable dividend payouts during this time, we forecast UPM's leverage will increase to about 0.8x by year-end 2020 and about 1.6x-1.8x by year-end 2021.

Company Description

UPM is one of the largest and most diversified forest and paper products companies in the world, with over €10.2 billion in sales and €1.8 billion EBITDA in 2019. The group is listed on the NASDAQ Helsinki Stock Exchange.

It has leading positions in European publications paper, fine paper, and self-adhesive label materials. It also has large pulp and energy operations, as well as sizable manufacturing operations for plywood and sawn timber. UPM's 54 production plants are spread over 12 countries, primarily in Europe. UPM also has pulp production operations in Uruguay as well as paper and label material plants in China and in the U.S.

In 2019, external sales were split between communication papers (44%), biorefining including pulp, timber, and biofuels (20%), Raflatac self-adhesive labels for consumer goods (15%), specialty papers (12%), plywood (4%), energy (2%), and other operations (3%).

The group's revenue base is well diversified. Its most important geographies in terms of sales include Germany (15% of sales in 2019), the U.S. (12%), China (10%), Finland (9%), and the U.K. (6%).

Peer Comparison

Table 1

UPM-Kymmene Corp.--Peer Comparison

Industry sector: Paper/forest products				
	UPM-Kymmene Corp.	**Mondi Plc**	**Holmen AB**	**Svenska Cellulosa Aktiebolaget SCA**
Ratings as of Nov. 5, 2020	BBB/Stable/A-2	BBB+/Stable/--	BBB+/Stable/A-2	BBB-/Stable/A-3
	--Fiscal year ended Dec. 31, 2019--			
(Mil. €)				
Revenue	10,238.0	7,268.0	1,747.0	1,868.8
EBITDA	1,832.0	1,666.0	265.6	416.8
Funds from operations (FFO)	1,623.0	1,319.0	248.3	344.7
Interest expense	45.0	112.0	4.6	10.8
Cash interest paid	33.0	99.0	3.2	9.8
Cash flow from operations	1,843.0	1,296.0	274.8	314.4
Capital expenditure	399.0	814.0	99.6	218.3
Free operating cash flow (FOCF)	1,444.0	482.0	175.2	96.2
Discretionary cash flow (DCF)	751.0	71.0	(69.3)	(21.1)
Cash and short-term investments	1,536.0	74.0	46.1	43.3
Debt	230.0	2,370.5	407.4	874.0
Equity	10,174.0	4,385.0	3,826.1	6,535.1
Adjusted ratios				
EBITDA margin (%)	17.9	22.9	15.2	22.3
Return on capital (%)	12.7	18.9	4.6	4.3
EBITDA interest coverage (x)	40.7	14.9	58.0	38.7

Table 1

UPM-Kymmene Corp.--Peer Comparison (cont.)

Industry sector: Paper/forest products

	UPM-Kymmene Corp.	Mondi Plc	Holmen AB	Svenska Cellulosa Aktiebolaget SCA
FFO cash interest coverage (x)	50.2	14.3	77.6	36.1
Debt/EBITDA (x)	0.1	1.4	1.5	2.1
FFO/debt (%)	705.6	55.6	60.9	39.4
Cash flow from operations/debt (%)	801.3	54.7	67.5	36.0
FOCF/debt (%)	627.8	20.3	43.0	11.0
DCF/debt (%)	326.5	3.0	(17.0)	(2.4)

Business Risk: Satisfactory

Our assessment of UPM's business risk profile is supported by its leading market positions, large scale, well-invested asset base, diversified operations and customer base, vertical integration, and focus on being a cost leader in capital-intensive segments such as pulp, graphic paper, and energy generation.

UPM has a track record of shifting exposure to higher-margin wood and paper products from publication papers and continuous investments into its asset base to increase competitiveness. The group has a high degree of vertical integration and a broad product portfolio, with exposure to multiple grades of paper, pulp, wood products, biochemical products, energy and label materials.

On the other hand, our assessment is constrained by UPM's large exposure to graphic paper, which accounted for about 44% of revenue and 26% of EBITDA in 2019. Demand in this segment (which is in structural decline) has been hit by COVID-19 fallout. The segment's EBITDA margins are declining with volumes and prices. The division is exposed to further restructuring charges (linked to site closures and capacity reductions).

UPM's pricing power is limited due to the commoditized nature of its products. It is exposed to the cyclicality of the pulp business, with prices currently at low levels.

Financial Risk: Minimal

UPM's financial risk profile is supported by its strong operating cash flow generation and low leverage. However, UPM is making substantial investments into a large eucalyptus pulp mill in Uruguay and a biorefinery in Germany. The two projects involve more than €3.2 billion of capex over 2020-2022. We thereby forecast that credit metrics will deteriorate from the current level, albeit remain in line with the current rating.

UPM has significant financial headroom under the current rating. However, its cash flow generation is prone to volatility as a result of its exposure to pulp and graphic paper, where periods of overcapacity can depress prices. This is also reflected by our expectation of weaker margins in the current pricing environment.

Financial summary

Table 2

UPM-Kymmene Corp.--Financial Summary

Industry sector: Paper/forest products	--Fiscal year ended Dec. 31--				
	2019	**2018**	**2017**	**2016**	**2015**
(Mil. €)					
Revenue	10,238.0	10,483.0	10,010.0	9,812.0	10,138.0
EBITDA	1,832.0	1,970.5	1,690.5	1,614.5	1,366.5
Funds from operations (FFO)	1,623.0	1,675.1	1,418.6	1,400.2	1,168.8
Interest expense	45.0	61.4	78.9	95.3	90.7
Cash interest paid	33.0	43.4	55.9	69.3	57.7
Cash flow from operations	1,843.0	1,385.1	1,609.6	1,726.2	1,218.8
Capital expenditure	399.0	350.0	304.0	343.0	424.0
Free operating cash flow (FOCF)	1,444.0	1,035.1	1,305.6	1,383.2	794.8
Discretionary cash flow (DCF)	751.0	422.1	798.6	983.2	421.8
Cash and short-term investments	1,536.0	888.0	716.0	992.0	626.0
Gross available cash	1,536.0	888.0	716.0	992.0	626.0
Debt	230.0	720.4	1,221.4	2,223.4	3,097.4
Equity	10,174.0	9,797.0	8,664.0	8,238.0	7,944.0
Adjusted ratios					
EBITDA margin (%)	17.9	18.8	16.9	16.5	13.5
Return on capital (%)	12.7	14.1	11.6	9.7	7.2
EBITDA interest coverage (x)	40.7	32.1	21.4	16.9	15.1
FFO cash interest coverage (x)	50.2	39.6	26.4	21.2	21.3
Debt/EBITDA (x)	0.1	0.4	0.7	1.4	2.3
FFO/debt (%)	705.6	232.5	116.1	63.0	37.7
Cash flow from operations/debt (%)	801.3	192.3	131.8	77.6	39.3
FOCF/debt (%)	627.8	143.7	106.9	62.2	25.7
DCF/debt (%)	326.5	58.6	65.4	44.2	13.6

Reconciliation

Table 3

UPM-Kymmene Corp.--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. €)

	--Fiscal year ended Dec. 31, 2019--							
UPM-Kymmene Corp. reported amounts								
	Debt	**Shareholders' equity**	**EBITDA**	**Operating income**	**Interest expense**	**S&P Global Ratings' adjusted EBITDA**	**Cash flow from operations**	**Capital expenditure**
	710.0	10,061.0	1,808.0	1,344.0	45.0	1,832.0	1,847.0	403.0
S&P Global Ratings' adjustments								
Cash taxes paid	--	--	--	--	--	(176)	--	--

Table 3

UPM-Kymmene Corp.--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. €) (cont.)								
Cash interest paid	--	--	--	--	--	(29)	--	--
Reported lease liabilities	587.0	--	--	--	--	--	--	--
Postretirement benefit obligations/deferred compensation	581.0	--	12.0	12.0	12.0	--	--	--
Accessible cash and liquid investments	(1,496.0)	--	--	--	--	--	--	--
Capitalized interest	--	--	--	--	4.0	(4)	(4)	(4)
Share-based compensation expense	--	--	14.0	--	--	--	--	--
Dividends received from equity investments	--	--	2.0	--	--	--	--	--
Income (expense) of unconsolidated companies	--	--	(3)	--	--	--	--	--
Nonoperating income (expense)	--	--	--	2.0	--	--	--	--
Noncontrolling interest/minority interest	--	113.0	--	--	--	--	--	--
Debt: Fair value adjustments	(152)	--	--	--	--	--	--	--
EBITDA: Gain/(loss) on disposals of PP&E	--	--	(1)	(1)	--	--	--	--
Depreciation and amortization: Asset valuation gains/(losses)	--	--	--	(26)	--	--	--	--
Interest expense: Derivatives	--	--	--	--	(16)	--	--	--
Total adjustments	(480.0)	113.0	24.0	(13.0)	--	(209.0)	(4.0)	(4.0)
S&P Global Ratings' adjusted amounts								
	Debt	**Equity**	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**	**Capital expenditure**
	230.0	10,174.0	1,832.0	1,331.0	45.0	1,623.0	1,843.0	399.0

UPM has an indirect share in nuclear power plants operated by TVO through its shareholding in PVO, from which it buys electricity at cost. UPM's indirect share is 33% in Olkiluoto 1 and 2 and 31% in Olkiluoto 3.

Although UPM does not provide a guarantee for any of TVO's debt, all shareholders in TVO are obliged to cover their proportionate share of TVO's fixed and variable costs related to energy generation (incl. interest expenses). UPM has also indirectly provided funding to TVO in the form of shareholder loans through PVO to help fund a new, third reactor.

UPM has confirmed to us that, despite certain ambiguities in TVO's and PVO's articles of association, it considers that its liabilities do not extend beyond the generation costs of the electricity it purchases from PVO.

Although we acknowledge that UPM benefits from stable electricity, sourced at production cost, we also recognize that market prices have significantly decreased over the past few years, and that TVO's production costs will increase when the new reactor comes into operation. Although we do not currently adjust UPM's debt for any of TVO's liabilities, we continue to monitor the benefit for UPM of its indirect shareholding in TVO versus its obligations and factor the cost of its electricity (corresponding to its proportional share of fixed and variable costs) into our base-case forecasts.

Liquidity: Strong

The short-term rating on UPM is 'A-2', reflecting the long-term issuer credit rating and our assessment of UPM's liquidity as strong. Our liquidity assessment is based on our view that the group's liquidity sources will cover its uses by more than 1.5x over the next 12 months and by over 1.0x in the subsequent 12 months, starting Sept. 30, 2020. UPM's liquidity is supported by low debt maturities and our view of that it has a high standing in credit markets.

Principal Liquidity Sources	Principal Liquidity Uses
• Available cash balance of about €868 million at the end of September 2020; • Availabilities of about €1.46 billion under committed credit facilities; and • Our forecast cash FFO of about €1.0-1.1 billion.	• Capex of about €1.7 billion; • Working capital outflows of about €50 million-€100 million; and • Minimal debt maturities of less than €5 million.

Other Credit Considerations

UPM's current credit metrics remain in line with a minimal financial risk profile. However, the group's financial policy in terms of leverage specifies a maximum net debt-to-EBITDA ratio of 2.0x (corresponding to about 2.5x on an S&P Global Ratings-adjusted basis), which allows UPM to make further shareholder returns via dividend payments or share buybacks, or make large debt-funded investments.

We therefore apply a negative financial policy modifier that adjusts our 'a-' anchor for UPM downward by two notches to 'bbb', reflecting that leverage could increase materially from what we assume in our base case.

Environmental, Social, And Governance (ESG)

We believe that UPM's exposure to ESG factors is similar to that of other companies in the sector.

The group focuses on sustainable forest management and plants about 50 million seedlings every year. All of UPM's forests are certified and 82% of the wood it used in 2019 came from certified forests (i.e., it meets the requirements set by an independent third party for sustainable forest management). Wood harvesting levels are exposed to changes in weather conditions.

The company increasingly focuses on developing renewable and recyclable alternatives to traditional, non-renewable materials, also including fuels and chemicals. UPM emphasizes energy efficiency and low-emission energy generation via the production of hydro power, nuclear power, and biomass-based energy at its mills. Currently, about 70% of the fuels UPM uses are renewable.

We view governance as a supportive factor for the rating, reflecting management's experience and expertise, governance in line with best practices, and the balance of different stakeholders' interests.

In 2020, UPM signed a €750 million revolving credit facility with a margin tied to two sustainability indicators, involving biodiversity in UPM's Finnish forests and the reduction of CO2 emissions from fuels and purchased electricity.

Issue Ratings - Subordination Risk Analysis

Capital structure

As of Dec. 31, 2019, UPM's capital structure comprised $375 million 7.45% unsecured notes due November 2027 issued by UPM-Kymmene Oyj, €587 million of lease obligations, and €277 million of loan liabilities.

Analytical conclusions

The $375 million 7.45% unsecured notes due 2027 issued by UPM-Kymmene Oyj are rated 'BBB', the same as the issuer credit rating, because we have not identified any sources of significant subordination.

Ratings Score Snapshot

Issuer Credit Rating

BBB/Stable/A-2

Business risk: Satisfactory

- **Country risk:** Low
- **Industry risk:** Moderately high
- **Competitive position:** Satisfactory

Financial risk: Minimal

- **Cash flow/leverage:** Minimal

Anchor: a-

Modifiers

- **Diversification/portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Negative (-2 notches)
- **Liquidity:** Strong (no impact)

- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Neutral (no impact)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Forest And Paper Products Industry, Feb. 12, 2014
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	**Minimal**	Modest	Intermediate	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	**a/a-**	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Ratings Detail (As Of November 5, 2020)*

UPM-Kymmene Corp.	
Issuer Credit Rating	BBB/Stable/A-2
Senior Unsecured	BBB
Issuer Credit Ratings History	
24-Jul-2018	BBB/Stable/A-2
14-Feb-2017	BBB-/Positive/A-3
25-Aug-2016	BB+/Positive/B

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and

Ratings Detail (As Of November 5, 2020)*(cont.)

debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.