Equity Research

SUZANO

Company Note: Alleged purchase of IP, Bermuda triangle

LatAm Pulp & Paper

(i) If the deal is closed as reported in the press, leverage would rise to **4.6x 24E Net Debt/EBITDA 24E** vs. 3.1x in 4Q23. For comparison purposes, we have a projection of 3.2x Net Debt/EBITDA 24E ex acquisition. **(ii)** The proposal seems to infer an **expensive transactional multiple**, with an **EV/EBITDA** of **9x** (well above what Suzano trades at today, at ~7x); **(iii)** An inopportune moment, with Suzano almost concluding its main venture in history. Investors were looking to monetize the appreciation of the shares or even dividends with the cash flow generated by the ramp-up of the Cerrado Project, situations that would certainly fall apart with an acquisition of this size, which would suck up the FCF generated by the project to be redirected to pay off debt; **(iv)** We believe that the participation of a potential "intruder" in the deal (DS Smith), could curb Suzano's impetus to make a more aggressive offer than the US$15bn; **(v)** The shares should lack bullish catalysts in the short term, given these uncertainties. Even so, as Suzano argued through the material fact that **there was no official binding proposal**, we remain **focused on** the **fundamentals**, which are positive; **(vi)** We see Suzano trading at an **EV/EBITDA 24E** of **6.3x** (vs. 7.5x historical average). We therefore reinforce our **BUY rating**, with a **12M Target Price of R$72.00**, reflecting an **upside** of **+37.98%**.

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Company

SUZB3 BZ Equity
Buy

Price: R$ 52.18 (08-May-2024)
Target Price 12M: R$ 72.00

SUZ US Equity
Target Price 12M: US$ 14.30

According to press reports yesterday morning (May 7th), **Suzano proposed to acquire International Paper (IP) for US$15bn (~R$76bn),** with an offer of US$42/share, payable entirely in cash. Suzano had a Market Cap of ~R$76bn before the start of the negotiation section, which is equivalent to 100% of the value of the supposedly binding proposal. **The offer was initially "leaked" by Reuters**, replicated in various press outlets throughout the day and commented on via a material fact by **Suzano** after the market closed, which **denied that there is any official proposal.**

What was Suzano's official response? Suzano clarified, officially and only at the end of the day, that it was not involved in any kind of formal agreement (binding or not) and there was no decision or deliberation by its management regarding the potential operation mentioned in media reports. However, it did include the statement that it is permanently analyzing market opportunities and investments in line with its strategy. This passage from the material fact is important, since it gives us room to believe that the company has been studying the supposed offer, which has just not been made official.

What was the market's reaction? Very negative. Following the news of the offer, International Paper's shares on the NYSE rose +5.2%, while Suzano's shares fell -12.3% on B3, reducing its market value by -R$8.5bn, to R$68bn (vs. ~R$76bn before the trading session). A priori, Suzano's investors reacted quite negatively to the news, and we'll explore why.

International Paper (IP) key data. IP is focused on the packaging and softwood pulp (BSKP) and is one of the world's most important players in this area. It is listed on the NYSE and is headquartered in the USA, where most of its assets are located. The company closed yesterday's trading session with a Market Cap of US$12.8bn (~R$65bn), making up an EV of US$17.6bn (~R$89bn) calculated through a net debt of US$4.8bn (~R$24bn). It has achieved a ROIC between 10-11% in recent years. It is also important to note that IP is also moving ahead with a merger with the European leader in packaging, the British company DS Smith, which in turn has an EV of US$7.2bn (~R$36bn). The transaction is expected to be finalized in 4Q24.

In terms of operational figures, IP has delivered EBITDA in the range of US$3.8-2.5bn over the last 5 years, including declines in net revenue, EBITDA and net margin over the last 2 years. It is trading at an **EV/EBITDA 24E of 7.9x** (vs. 8.1x historical average), with no relevant level of discount, considering that the DS Smith deal has already been priced. By way of example, as the businesses are more similar, we believe that Klabin serves more as a comparable for IP than Suzano. We see Klabin today trading at EV/EBITDA 24E of ~7x, with a short and similar level of gap vs. its own historical average.

The alleged deal is complex and involves three parties: Suzano, IP and DS Smith. Suzano's offer comes in the wake of International Paper's (IP) recent agreement to buy DS Smith for ~US$10bn, a transaction that Suzano wants to reverse as a condition of the deal. This acquisition would expand Suzano's verticals, which would enter the packaging segment where it currently has no presence amid a slowdown in the pulp segment, where it is one of the market leaders.

We believe that the deal is complex given its size. Suzano would have offered a bid that is the equivalent of its own market cap. This type of acquisition involves a considerable increase in debt, something that the market did not interpret as positive, since the deleveraging movement with the delivery of the Cerrado project in June was widely expected by investors.

Our analysis suggests that Suzano would be conditioning its offer on the withdrawal of the IP agreement with DS Smith in order to amortize part of the size of the payment. In other words, if Suzano wanted to take IP after incorporating DS Smith, it would have to raise its offer well above the proposal of US$42/share or US$15bn (~R$76bn). For us, **this situation is key to understanding what will happen from now on**, since, according to the original news published by Reuters, IP would deny Suzano's proposal. We believe that one of the main reasons for this would be the unraveling of the deal already agreed for the acquisition of DS Smith. Everything indicates that IP would have the understanding that the agreement with DS Smith makes more sense for its operations than a proposed merger with Suzano, where the synergies are not obvious.

What would have motivated Suzano to make this offer? Although we are witnessing a bullish cycle of pulp prices, the price of BHKP fell very sharply in 2Q23 and 3Q23. Therefore, the successive rounds of price transfers that Suzano has implemented in recent months are in line with a movement to recover margins and not a real gain, given that the price hit the marginal cost of smaller producers not so long ago.

For this reason, we have always been critical of Suzano's low diversification due to its high exposure to market pulp, which is much more cyclical and volatile than the paper and packaging segment. Our thesis for Suzano is classified as Value investing, unlike Klabin, which we label as Growth.

This means that we try to raise Suzano to a Buy rating whenever we identify an asymmetry in the way the market would be penalizing the company's valuation, due to uncertainties linked to the pulp cycle, vs. the price we believe to be fair. So, we always work to determine triggers that lead to an increase in the share prices and that are necessarily within a shorter period (i.e. 12M).

The idea of looking for a short timeframe for investment is linked to the cyclical component we see in Suzano's figures, which are extremely reactive to the pulp prices. On the other hand, we defend the idea that it would be healthy for the company to be more exposed to the paper and packaging segment, which has a higher correlation with GDP and inflation, and is therefore less volatile.

That said, although we are supporters of the idea of Suzano embracing the paper market a little more, we believe that a possible acquisition of Internacional Paper (IP) would not be the best way to broaden these horizons. This would be different from what we saw in the purchase of Kimberly Clark's (K-C) assets in Brazil, a deal announced for US$175mn (~R$870mn) in 2022 and closed in 2023. The acquisition of K-C's assets seemed to us to be much less complex, less financially daring and more coherent in terms of absorbing gradual synergies.

IP acquisition seems to lack synergies. Apart from the obvious difference in the size of the transaction (US$15bn for IP and US$175mn for K-C), the synergies from Suzano's history of M&As have been clearer in recent decades, compared to the first impression of the constraints of this possible takeover bid. In the case of Kimberly Clark (K-C), the product line is correlated with tissue, such as brands of toilet paper, napkins, towels and tissues, among others. In addition to being a business in which Suzano had already been operating since 2017, the manufacturing process for these tissue-related products uses BHKP, Suzano's production specialty.

On the other hand, International Paper's (IP) notable niche is corrugated paper, cardboard boxes and packaging, which necessarily have softwood pulp (BSKP) as an input. In other words**, we see no causal link between the purchase of IP and Suzano's credentials** since the main input for the manufacture of IP's product portfolio is not currently produced by Suzano.

Klabin has already been involved in a deal with IP, but it made much more sense than Suzano. This situation is different in the case of Klabin, which bought IP's assets in Brazil in 2020 for R$330mn. It is worth clarifying that Klabin is an integrated producer of softwood pulp (BSKP), so it has the know-how in extracting and producing the input for the manufacture of corrugated boxes and packaging. Therefore, the acquisition of IP's assets in Brazil by Klabin made sense, but we see little (or no) sense in the acquisition of IP's assets outside Brazil by Suzano. This brings us to another point, internationalization...

The strong desire for internationalization and less dependence on China. Suzano has been indicating to investors for some time that it wants to expand its business units and geographies, with the aim of diversifying its dependence on pulp sales and the Chinese market, with a view to territorial coverage focused on countries with more mature economies, mainly Europe and the USA, as well as greater dominance in the Brazilian market.

Attractive acquisition costs and operating leverage in synergy products have always guided Suzano's capital allocation principles in brownfield assets. The acquisitions of Fibria in 2018 and Kimberly Clark Brasil (K-C) in 2022 demonstrated this. However, despite being important in terms of their size and specific purposes, these acquisitions were not transformational in the sense of geography. Both were assets located in Brazil.

Our suspicion is that this offer to acquire IP was in fact studied by Suzano, and we base this assumption on the company's intention to significantly expand operations outside Brazil, reducing the export character and seeking to penetrate through domestic assets in these countries.

For US$15bn, what would Suzano be getting in return? With the acquisition, Suzano would take over a package of 28 BSKP mills, with partial integration for paper and packaging production, as well as 200 cardboard box converting units and 18 recycling units. The assets are distributed in 11 countries, including several plants in the USA (86% of operations), as well as Canada and Europe. IP has a capacity of 13.8Mtpa of packaging board, occupying a market share of 30% in North America, and a capacity of 3.3Mtpa of BSKP. As an order of magnitude example, Suzano's current capacity (pre Cerrado) is 10.9Mtpa in BHKP.

Acquisition of Fibria: 5 reasons why Suzano got it right. The principles that Suzano has and that we commented on in relation to the conscious capital allocation decision became crystal clear to investors in the deal involving Fibria. The purchase was announced in 2018, with 80% of the operation having been paid for in cash, made possible through a US$9.2bn bridge loan, plus the remaining part via an exchange of shares. This transaction, besides being opportunistic, was made up of very obvious synergies. Both produced BHPK, and at the time, by adding Fibria's capacity (7.2Mtpa) to Suzano's (3.7Mtpa), the new Suzano, the result of the business combination, ended up with 16% of the world's production capacity.

(i) As a significant part of the purchase was made with payment via a share swap, leverage was less penalized. In the years that followed, the company became **(ii)** the world market leader in BHKP, with **(iii)** the lowest cash cost among the main global players. In addition, **(iv)** it began to have a strong influence on the international supply system and, to a certain extent, on pulp pricing. Evidence of this was the price rebound we have seen in recent months, driven by Suzano since the middle of last year, bringing the level to US$720/t, saving the market from squeezed conditions and below the marginal cost of smaller producers, when BHKP China reached US$480/t in May 2023. Another synergy pointed out at the time was the **(v)** end of the discount “war” between Fibria and Suzano. Both companies had similar client portfolios. In order to bill some key customers, they granted discounts ranging from 20% to 30%.

However, with the combination of the businesses in the merger, there would no longer be this tug-of-war to see which company would close the batch of orders. As a result, some mills that used pulp as an input lost bargaining power, and Suzano gained a value generation of ~US$80mn in NPV for every US$1 less that was no longer offered via a discount. Another clear sign that the operation made sense for Suzano.

IP acquisition: 5 reasons that could potentially lead Suzano astray. As for this supposed transaction with IP, we believe there are several complexities. It is **(i)** substantially larger than the consensus might expect in a diversification move; **(ii)** offers limited synergy potential, since Suzano is not a BSKP pulp producer; **(iii)** is relatively expensive, considering that the market consensus for IP's numbers points towards a drop in 24E EBITDA to US$2.2bn (vs. US$2.9bn 2023), which would bring the transaction multiple to an **EV/EBITDA of 9x** (above what Suzano trades at today). Nevertheless, it also **(iv)** interrupts the prospects for deleveraging (which would fall without the acquisition to 2.7x Net Debt/EBITDA 25E vs. 3.1x in 4Q23). We know that the market has been very impatient with this topic, see Minerva's transaction with Marfrig, which are from different sectors, but work as a good example because they participate in commodity cycles as well.

In addition, we believe it is **(v)** an inopportune moment, with Suzano almost concluding its main project in history, the Cerrado, with an addition of ~22% of capacity, which leads investors to be more concerned with monetizing dividends or share price appreciation with the cash flow generated by the ramp-up of the plant in Ribas do Rio Pardo (MS), which would certainly fall apart with an acquisition of this size, as it probably suck up the FCF generated by Cerrado.

Our take on Suzano

Given everything we've reported, **our bias for the news is negative and potentially harmful for the investment thesis**. The main point, among the 5 we pointed out above, would be leverage. We'll explore this a little further.

Our analysis suggests that Suzano is valuing IP's shares at **~9x EV/EBITDA 24E**, which seems much higher than how we see Suzano trading, at **7x EV/EBITDA 24E**, which is an indication that the transaction would be expensive. With regard to the control premium, we don't rule out that it could occur, since the proposal is supposedly for US$15bn and the EV is US$17.6bn. The premium would have to be high to make IP give up on the DS Smith deal, perhaps something that exceeds 10% of the market cap.

Therefore, these conditions lead us to believe that the acquisition, should it actually go ahead, would inevitably compromise Suzano's leverage. The news circulating in the media reiterates that the proposal would be in cash, which would weigh on the contracting of debt, without the option of exchanging shares, something that was done in the deal with Fibria.

Leverage is the biggest negative reflection. Suzano closed 4Q23 with a cash and equivalents balance of ~R$21bn (~US$4bn), which corresponds to only 27% of the proposal value. During the process of acquiring Fibria in 2018, the company operated with a cash position of ~R$5bn (~US$1bn), therefore, assuming the consumption of US$3bn of cash resources, the company would have to **acquire a debt of ~US$12bn**, which would increase leverage to **4.6x Net Debt/EBITDA 24E**. vs. 3.1x in 4Q23. For comparison purposes, we have a projection of 3.2x 24E Net Debt/EBITDA ex acquisition.

Bermuda triangle. As we commented throughout the report, we see **3 names** being involved in the possible transaction: **(i)** Suzano, **(ii)** International Paper and **(iii)** DS Smith. We believe that the participation of a potential "intruder" in the deal, which would be DS Smith, could curb Suzano's impetus to make a more aggressive proposal than the US$15bn, given that the situation was leaked by the media and that the reception from investors was terrible in view of the performance of Suzano's shares in the trading session yesterday, amounting to a free fall of -12%.

This triangle (Suzano, IP and DS Smith) has the potential to make the company's profitability disappear over the next few years, like an airplane flying over the Bermuda triangle, since the negative pressure of the debts could usurp net operating profit and cash flow generation with the Cerrado project standing up as early as 2H24. **If Suzano goes ahead with the proposal, we believe that the shares could fall even further, considering that it would have to offer a higher premium**, either to captivate IP, which a priori would rule out the US$15bn offer, or to take the IP + DS Smith combination together. If the latter were the case, the offer could reach the US$20-25bn range.

With a number of synergy issues being questioned, and a size similar to its own market cap if the offer is US$15bn, which could reach ~1.5x if it raises the premium to keep DS Smith in the deal, we see the acquisition as devastating for our investment thesis in Suzano, which is based on gaining cost competitiveness, significantly lowering COGS/t and high cash generation, both factors coming from the 2025+ cerrado project, which did not seem to be in the share price (not even before yesterday's drop). For more details, we recommend reading our latest report, published just yesterday, before the news that impacted the stock was released. (Suzano 1Q24 Preview: Opposite Directions)

For now, we'll wait for further market movements and official actions from the company regarding the case. **The shares are likely to lack bullish catalysts in the short term**, given these uncertainties. Even so, as Suzano has argued through the material fact that there **has been no official binding proposal**, we continue to **focus on the fundamentals**, which are positive. We see Suzano trading at an **EV/EBITDA 24E** of **6.3x** (vs. 7.5x historical average), with a reasonable degree of discount. It is important to note that we are already using assumptions with a subtle decline in the pulp curve vs. the spot, and that even so, the new level of BHKP already makes the company's valuation attractive.

We believe that **share prices do not seem to reflect the improvement in indicators after the start-up of the Cerrado Project** in 2H24, including the fall in COGS/t to R$500/t in 2025+ (vs. ~R$800/t today). We therefore reinforce our **BUY rating**, with a **12M Target Price** of **R$72.00**, reflecting an **upside** of **+37.98%**.

Appendix: Suzano

Figure 1. Suzano – Income Statement in R$ Millions (Genial Est. 2024-2028)

Income Statement	2024E	2025E	2026E	2027E	2028E
Net Revenue	**44.034**	**51.068**	**53.783**	**56.737**	**57.702**
(-) COGS	(27.659)	(31.324)	(31.487)	(30.557)	(30.374)
Gross Profit	**16.375**	**19.745**	**22.297**	**26.180**	**27.328**
(-) Expenses	(5.251)	(6.155)	(6.620)	(7.074)	(7.191)
Adjusted EBITDA	**18.953**	**21.703**	**23.749**	**27.164**	**28.172**
(-) D&A	(7.829)	(8.113)	(8.072)	(8.059)	(8.035)
EBIT	**11.124**	**13.590**	**15.677**	**19.105**	**20.137**
(+/-) Financial Result	(5.031)	(1.661)	(3.534)	(1.342)	143
(-) Taxes	(1.024)	(2.006)	(2.042)	(2.987)	(3.410)
Net income	**5.068**	**9.923**	**10.101**	**14.776**	**16.870**
Profitability					
Net margin (%)	11,51%	19,43%	18,78%	26,04%	29,24%

Figure 2. Suzano– Cash Flow in R$ Millions (Genial Est. 2024-2028)

Cash Flow (FCFF)	2024E	2025E	2026E	2027E	2028E
Net Revenue	**44.034**	**51.068**	**53.783**	**56.737**	**57.702**
(-) COGS	(27.659)	(31.324)	(31.487)	(30.557)	(30.374)
Adjusted EBITDA	**18.953**	**21.703**	**23.749**	**27.164**	**28.172**
EBIT	**11.124**	**13.590**	**15.677**	**19.105**	**20.137**
(-) Taxes	(1.024)	(2.006)	(2.042)	(2.987)	(3.410)
(+) D&A	7.829	8.113	8.072	8.059	8.035
(+/-) Δ WK	(867)	(634)	(474)	(114)	(116)
(-) Capex	(13.547)	(8.244)	(8.065)	(7.791)	(7.954)
FCFF	**3.514**	**10.818**	**13.169**	**16.273**	**16.692**

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under Review	Under review	**5%**

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