

## Suzano

Suzano is a Brazilian company focused on the production of pulp and different kinds of paper (uncoated paper, paperboard and coated paper). It ranks as the second largest producer of eucalyptus pulp in the world and the fourth largest producer of market pulp. In the paper segment, it accounts for about 40% of the Brazilian production of printing and writing paper and paperboard.

Despite being a company in a commodity-like sector, where typically the exchange rate and international macro scenario are crucial for the evolution of its results, we believe that Suzano's investment case has several interesting characteristics, related to both the moment that the company is going through and its outlook in the upcoming years.

From an operational point of view, the company is completing a heavy investment cycle in its pulp plant located in Maranhão (a northeastern state of Brazil); these investments led the company to high leverage levels (~5x EBITDA). Once the project is in production, there will be significant improvement of cash flow generation (we expect a growth of ~45% in the company's EBITDA), deleveraging will occur very quickly, and with it a substantial reduction in equity risk. We estimate that by the end of 2016 the company will present leverage close to 2.5x EBITDA, level required by credit rating agencies to obtain Investment Grade.

From management and strategy perspective, we have noticed a significant change with the arrival of the new CEO, Walter Schalka, in early 2013. His arrival was accompanied by a clearer definition of the company's strategic focus: deliver the Maranhão plant on time and on budget, promote deleveraging and review growth projects (with low returns). The transformation has not limited itself to the change of the CEO, but has also changed the board's attitude (and also the controlling shareholders'), reiterating our confidence in the likelihood that this new phase will be successful.

Associated with a clear definition of the company's focus, the new CEO has promoted a change in management and in the company's alignment of interests with shareholders, which we believe is a powerful approach to creating value in different areas of the company. Walter Schalka promoted important changes in senior management and has improved the evaluation system and incentives schemes for all areas. The company's compensation was focused on EBITDA generation and has shifted its focus to returns on investments, cash flow generation and Economic Value Added (EVA). We believe this to be one of the crucial changes necessary for a corporate culture to focus on value creation for shareholders, which generates positive impacts in the short and long term for the company.

### Cost Reduction

The changes brought on by the new CEO first impacted Suzano's cost structure. In reality, this first result was the consequence of an on-going cost cutting effort that had been in place prior to his arrival, but we believe Schalka played a fundamental role in the maintenance of these measures and the identification of future expense reductions. With the help of a consultancy firm, through a restructuring process and the implementation of matrix budget, the company managed to identify potential cost reductions and improve efficiency on several fronts, including the administrative, logistics and plants' operations.

The evolution of the administrative and general expenses clearly show these changes' first impacts: in 2013, expenses fell 7% in nominal terms, despite a scenario of wage increases and amidst the Maranhão plant implementation. The company simplified its operation in the logistics front, where beforehand it was segregated (into wood inbound, other raw materials inbound, paper outbound and pulp outbound). The logistics area was integrated under one single management, whose focus, besides unifying the hiring of logistic services, was to think of the system in a more cohesive and efficient manner. Another relevant measure deployed in logistics was the increase in hiring of self-employed truck drivers, mainly for wood supply, aiming to considerably reduce costs (although we understand the gains generated by this, we prefer, for conservative purposes, not to consider logistics' cost cuts in our calculations). As for the operating plants, many small high return (usually 1-2 years payback) investments for operational efficiency improvement have been identified. These investments were held back because of the company's focus on growth. Even with an investment

of R\$ 150 million made in 2013 and with an additional investment of R\$ 150 million planned for 2014, we believe there are significant investment opportunities in the years to come (we consider in our calculations these investments to only occur up until 2014; for every R\$ 150 million invested in the years after that we estimate an annual increase in EBITDA of R\$ 40-50 million).

Representing approximately 40% of the pulp's total cash cost, wood is the most important variable of the cost structure in pulp production. This variable has been responsible for creating pressure in the company's bottom line, mainly due to a drastic reduction of the expected average productivity of specific clones in the southern Bahia region because of low rainfall levels during 2008-2009. The consequences are twofold: greater dependence on third-party wood (from 25% to over 50% of all the wood used) and significant increase in the average harvest radius (distance between the wood harvest and factory) – with both consequences pressing the company's cost structure. This problem has been common to other companies also operating in the region (Fibria, for example), but as Suzano's pulp market is concentrated in Bahia, this phenomenon became more evident. This situation is likely to be normalized as the clones planted since are harvested, which is expected to happen as of 2016. Although this phenomenon has been well publicized by the company, we see few analysts normalizing these numbers, which will have significant effect on the results (we estimate an impact of R\$ 120 million on EBITDA).

#### Paper Market Potentials

Despite the growth in cash flow generation and deleveraging of the pulp industry in the upcoming years, the paper industry also has several other sources of growth and value generation, which is, in our opinion, understated by the market.

Of Suzano's total revenue in 2013, approximately 45% came from cellulose and 55% from paper. With the Maranhão plant in operation, we expect a shift in these contributions, where 60 % of revenue will come from cellulose and 40 % from paper.

In the paper segment, Suzano operates in the non-coated paper market (printing and writing), paperboard (packaging) and coated (commercial/marketing). In 2013, each type represented, respectively, 62 %, 22 % and 16 % of the company's paper revenue.

Suzano has an excellent competitive position in the Brazilian non-coated paper segment. It is the second largest player in a highly consolidated industry (Suzano + International Paper have approximately 70% of the market share) and in a market where sales channels management and capillarity can add significant value to the company's results (there are over 20,000 print shops in Brazil, not including stationery stores). In this sense, one of the new management's focus has been to add more margin to its paper sales by making direct sales using its own distribution channels. Prior to this initiative, the company sold about 80% of its paper through third party distributors, while owning the largest paper distributor in Latin America (SPP-KSR). In 2014, part of this effort was put in place and the outcome should begin to materialize this year. We believe this change can add a 2-3% gain to the average realized price of its paper in the domestic market (not included in our calculations).

Another relevant improvement in profit came from changing the company's regional sales mix. Naturally, Suzano's best margins are in Brazil sales, next are sales to the rest Latin America and, finally, to the rest of the world. Ultimately, with consumption in Brazil growing between 1-2% and the rest of Latin America between 3-4 %, it is likely that the company will decrease its export to Europe and North America in order to focus on neighboring markets, adding greater profitability to current assets.

Suzano's main competitor, International Paper (Latin America Operations), is more categorical in communicating this effect on their results. In 2012, for example, the EBITDA/ton sales in Brazil was US\$ 470, while in Latin America (excluding Brazil) was US\$ 270 and in Europe was US\$ 130. They expect that their Latin America sales expand in the next 4-5 years from 73% of total sales to 100%. We believe that it is possible to see a similar movement in Suzano (we partly consider this effect in our calculations).

From the market's perspective, there is another factor that may contribute to the improvement of industry's profitability: reduction in the importation of illegal exempt paper. In Brazil, the paper imported for editorial use (books and periodicals) is exempt from all taxes throughout the production chain – so-called exempt paper. In 2013, in Brazil, about 55% of coated paper and 5% of non-coated paper were imported. Although it is difficult to audit this number, the market estimates that 600,000 tons of paper, of a total market of 1.9 million tons of coated and uncoated paper, were illegally imported as exempt, as it was used for other purposes, this could generate a difference in price of up to 35% over the legally imported papers.

In order to improve this inefficiency, some initiatives have been implemented over the past years. RECOPI, is one of them – Recognition and Operations Control of Immune Paper – is a system that registers all companies in the chain that trade exempt paper. Established in late 2010 in São Paulo, it has expanded to nine other states since the second half of 2013 and, since then, has made it a requirement that a different label be used for the batches of paper imported as immune (thus preventing opportunistic, not planned, illegal exportation). These measures, coupled with the appreciation of the dollar, have brought significant reduction on the import of immune paper in the first half of 2014 (1S14, for example, imports fell about 15% in comparison with 1S13). In addition, the solution of this tax loophole can bring a healthier competitive environment, providing higher price levels or, at least, market share gains by Brazilian producers (to be on the conservative side, these possible benefits were disregarded in our calculations).

#### Additions to Pulp Capacity

A recurring discussion in reference to the pulp industry is the ability of producers to organize themselves for new capacity entering the market. Although numerous projects have been announced for the upcoming years, we believe that some of them will not be launched or will be postponed, especially those scheduled for 2017 onwards. With the current cost and CAPEX conditions, with pulp prices (CIF Europe) below US\$ 770/ton, considering the dollar at R\$ 2.30, we do not see attractiveness in these projects.

One factor that may help discipline the market is the new BNDES, Brazilian Development Bank (Banco Nacional de Desenvolvimento Econômico e Social), loan guidelines for projects in this sector. The new guidelines reduce their maximum exposure to the funding of investments from 60% to 50%, and the TJLP, long-term interest rate (taxa de juros de longo prazo), portion fell from 80% of the total funded to 70%. These changes reduce the availability of credit to the sector, in addition to being a source of financing with an extremely competitive cost (spread over TJLP). Sometimes this is the only source of funding available for highly leveraged companies and new players, who do not have the financial soundness to issue debt through the market. Take Eldorado, for example, a new player who opened its first factory in late 2012, and despite its leverage of more than 10x EBITDA, it plans to build a new plant with an entry scheduled for 2017.

#### Macroeconomic Aspects

Suzano's composition of revenues, with substantial participation of cellulose but with relevant exposure to the domestic market and Latin America paper market, provides an interesting balance to macro dynamics. As for cellulose, Suzano has a clear global competitive advantage in cost for a commodity that, despite its dependence on China – which accounts for 30% of world consumption, is linked to the change in people's consumption level and the change in habits it causes (growth in demand for industrial product packaging and tissue paper). As for paper, in a more local operating market, where competitive advantages are regional, Suzano has leading positions in well-established markets, in which consumption has not grown at such high rates but present more resilient characteristics than other products. Even though we anticipate 2014 to be a difficult year for the Brazilian economy, we expect a decent growth for domestic producers (especially for Suzano), aided partially by falling imports (considering the aforementioned factors), elections and growth of the PNLD, Textbook National Program (Programa Nacional do Livro Didático).

#### Valuation

From the point of view of equity return, an important variable to take in consideration is the exchange rate. Because we have no control over it, we evaluate the different scenarios in currency movement. One of the interesting aspects in the Suzano investment case is that, even considering an adverse scenarios for the company, with the dollar at R\$ 2.00, for

example, we do not believe we should have permanent loss of the investment. Considering our base scenario, with the dollar at least at R\$ 2.30, the investment returns appear to be quite attractive. The sensitivity of the investment returns to variations in exchange rates are shown in the table below, considering the price of R\$ 8.39 per share (closing 06/30/14).

R\$/US\$	2.00	2.15	2.30	2.45	2.60
real IRR	10.3%	11.5%	12.8%	14.1%	15.3%

Considering the expected growth in cash flow generation, with the Maranhão plant, the normalization of both the pulp price, to a level we consider sustainable, and the company's cost structure, due to its own wood supply stabilization, we see a very positive development of the FCF yield in the coming years and a significant deleveraging of the company. Following are our projections for the coming years.

Suzano	2014	2015	2016	2017
FCF yield	4.9%	9.4%	13.6%	16.3%
Net Debt/EBITDA	4.6x	3.4x	2.7x	2.4x

In the calculations above, we do not consider the value of land and forests related to projects that are currently suspended: Piauí and Energia Renováveis. We believe that the net investments in the company's balance sheet related to these projects are approximately R\$ 600 million.

Another important consideration is that the company's free cash flow during this period must be greater than that presented in this FCF yield. In this table, we tried to reflect only the recurring FCF yield. As the company has tax benefit for the Maranhão plant's accelerated depreciation, the income tax paid will probably be close to zero in the coming years, generating an even faster deleveraging than that presented above (we believe in a Net Debt/EBITDA closer to 2.5x 2016).

For comparison, below is the evolution of Fibria's FCF yield, a player whose balance sheet is already unleveraged ( $\approx$ 2.5x EBITDA), a scenario we believe to be true for Suzano by the end of 2016. In these projections, we focused on recurring cash flow generation (same premise used for Suzano, in the table above) and consider a price of R\$ 21.43 per share (closing 06/30/2014).

Fibria	2014	2015	2016	2017
FCF yield	4.2%	5.8%	8.9%	9.3%

### Conclusion

When we look at Suzano's competitive position and add to it the transformations through which it is undergoing, the process of de-risking that deleveraging will bring in the upcoming years, and consider the equity's returns in the expected base case scenario, we are very enthusiastic about the return that this thesis can bring to our portfolios.