FitchRatings

Fitch Revises ChelPipe's Outlook to Stable; Affirms at 'BB-'

Fitch Ratings - Moscow - 29 November 2018: Fitch Ratings has revised PJSC Chelyabinsk Pipe Plant (ChelPipe) Outlook to Stable from Negative and affirmed its Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BB-'.

The Stable Outlook reflects our expectation that ChelPipe will be able to reduce its funds from operations (FFO) adjusted gross leverage towards around 3.5x by 2020 from a 4x peak at end-2017 as one-off factors such as low-margin export share hike and steel input volatility fade out from 2018. The Outlook change also reflects greater visibility on projects that will help the group recover its large diameter pipes (LDP) volumes post-2019.

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
PJSC Chelyabinsk Pipe-Rolling Plant	LT IDR BB- Affirmed		BB-

KEY RATING DRIVERS

LDP Volumes Recover post-2019: We conservatively expect ChelPipe's LDP shipments to dip below 550 thousand tonnes (kt) in 2019 as the completion of Nord Stream 2 in 1H19 is partly offset by Gazprom's other projects. Over the medium-term we forecast Russian LDP market to grow, driven by Gazprom's range of projects ranging from Power of Siberia-2 to Yamal megaproject, which provide medium-term support and visibility to LDP producers. This would allow ChelPipe to increase LDP shipments towards 700kt-750kt after 2019.

LDP Competition Intensifies: The market for LDP remains sensitive to Gazprom's megaprojects although replacement needs for the existing Russian pipeline system, one of the largest globally, partly mitigates the volatility. The entrance of Zagorsk into the market means competition for LDP replacement orders has intensified. The domestic market now consists of four major players, but their ability to pass cost onto LDP customers is limited by the structural overcapacity of the market. Fitch expects the 2019 dip in the LDP market to drive ChelPipe's FFO adjusted gross leverage higher to 3.7x in 2019 before reverting back to sustainably below 3.5x.

Non-LDP Volumes Less Volatile: Unlike LDP, demand for oil country tubular goods (OCTG) pipes is driven by oil drilling activity in Russia, which fluctuates less as drilling is required to maintain production. We do not expect Russia's ongoing participation in OPEC+ agreements to have a material impact on Russia's drilling activity as depleting oilfield replacement needs are strong and the share of horizontal drilling is continuously rising. Demand for seamless pipes for power generation, machinery, petrochemicals and other sectors is less cyclical while the customer base and end-markets are more diversified.

Margins Recover from 2017 Lows: ChelPipe's 2017 EBITDAR margin was down at 15% (2016: 21%) reflecting the combination of input inflation driven by a sudden surge in global steel prices in 2017 and an abnormally high 19% revenue share of lower-margin exports driven by the Nord Stream 2 project. Margins recovered to 17% in 1H18 as Chelpipe was able to pass on higher costs and managed to produce more billets. We expect ChelPipe's margins to remain near 17% over the next three years as the group's domestic sales share recovers. Over the next three years Fitch also projects steel prices to moderate, thus supporting ChelPipe's margins but this will likely be balanced by intensifying domestic competition in Russian LDP.

Dividend Payouts Continue: ChelPipe commenced dividend payouts with a RUB3.3 billion payment in 2017. Fitch expects dividends ranging from RUB3 billion to RUB5 billion over 2019-2021. We do not see dividend payouts as a substantial risk to free cash flow (FCF) generation due to the group's covenants and track record.

FCF Margin to Turn Neutral: Fitch expects ChelPipe to gradually increase capex towards 5% of revenues in 2019 and further to 6%-8% in 2020-2021, driven by investments in its Rimera unit, which is active in oilfield services. This would result in broadly neutral FCF and limit ChelPipe's deleveraging capacity. Should the increase in capex not be offset by corresponding growth in EBITDA in the non-pipe business segments, this may create pressure on the rating over the medium-term.

Established Regional Pipe Producer: ChelPipe's two Urals-based steel pipe plants retain the overall top-three market position with roughly a 20%-25% share each in LDP and OCTG, mainly used in the oil and gas industry. ChelPipe's market share in the non-oil and gas pipe sectors, eg machinery, energy and petrochemical seamless steel pipes, is stronger and is assessed by Fitch at over 50%. However, ChelPipe is lagging its competitors in the premium pipe connections segment.

The Russian steel pipe market can be characterised as oligopolistic, with four major players typically covering the vast majority of domestic pipe demand. ChelPipe's competitive advantage is the group's relative proximity to Siberian and Far Eastern oil and gas fields, an over 30% revenue share from non-oil and gas markets, and an over 75% integration into billets backed up by integrated scrap collection. ChelPipe remains committed to developing its oilfield services and boosting its market share, but significant investments are required and may not be immediately EBITDA-accretive.

Longer-Term Pipe Demand Risks: The Russian oil and gas pipeline system is the second-largest globally, but its high maintenance requirements will only partly mitigate a longer-term demand slowdown which may follow the end of Gazprom's expansionary projects. Longer-term risks stem from rising liquefied natural gas trade, increasing renewables contribution and decelerating energy consumption per capita but are deemed remote before they start to pressure Russian pipe producers with some exposure to Asia. Fundamental limitations also include Russian pipe players' significant exposure to the oil and gas industry in a single region.

DERIVATION SUMMARY

ChelPipe's IDR reflects its 'BB' operational profile with a high share of value-added products (steel pipes), established long-term customer base and top-3 positions domestically across major steel pipe types. while constrained by its exposure to Russia, particularly to its oil & gas sector.

ChelPipe is comparable to its Russian peers PAO Severstal (BBB-/Stable), PJSC Novolipetsk Steel (NLMK, BBB-/Stable) and OJSC Magnitogorsk Iron & Steel Works (BBB-/Stable) on global cost position and is stronger in terms of value-added products (pipes). ChelPipe, however, lacks Severstal's full self sufficiency or NLMK's geographical asset diversification. ChelPipe also has a higher exposure to the Russian oil and gas sector. ChelPipe's lower IDR than peers is also driven by higher leverage.

No operating environment aspect affect the rating.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer
- LDP shipments to dip below 550kt in 2019 before recovering towards 700kt
- Non-LDP shipments to settle at around 1,150kt-1,200kt following the 2018 peak of around 1,250kt
- EBITDA margin to rebase at 16%-18% after 2017 (15%) as lower-margin exports and cost volatility reduce
- Capex intensity to grow towards 5% in 2019 and 7%-8% thereafter (2018: 3.4%)
- Dividend payments of RUB3 billion - RUB5 billion commenced from 2017
- FCF margin roughly neutral after 2019 as higher working capital and capex needs mitigate FFO generation

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action
- FFO adjusted gross (net) leverage consistently at or below 2.5x (2.0x)

Developments That May, Individually or Collectively, Lead to Negative Rating Action
- EBITDAR margin sustained below 16%
- FFO adjusted gross (net) leverage sustained above 3.5x (3.0x)
- Tightening liquidity and/or FFO fixed charge coverage falling below 2x for a sustained period

LIQUIDITY AND DEBT STRUCTURE

At end-1H18 ChelpPipe's maturity profile of was well-spread with manageable near-term maturities as RUB12 billion short-term debt was fully covered by RUB13 billion cash. Liquidity position is adequate with ChelPipe's cash cushion, positive 2H18-1H19 FCF and undrawn credit lines covering short-term debt and RUB5 billion acquisition of a 49% stake in Eterno from Mountrise Limited.

Summary of Financial Statement Adjustments
-RUB154 million of operating leases capitalised using 6x multiple as ChelPipe operates in Russia
-RUB441 million of losses on asset disposal and impairment are excluded from EBITDA

DATE OF RELEVANT COMMITTEE

28-Nov-2018

Additional information is available on www.fitchratings.com

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Applicable Criteria

Corporate Rating Criteria (pub. 23 Mar 2018) (/site/re/10023785)
Sector Navigators (pub. 23 Mar 2018) (/site/re/10023790)

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