FitchRatings

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Fitch Rates ChelPipe's LPNs 'BB-(EXP)'; Affirms IDR at 'BB-'

Fitch Ratings-Moscow-04 September 2019:

Fitch Ratings has assigned PJSC Chelyabinsk Pipe Plant's (ChelPipe) proposed debut issue of loan participation notes (LPNs) an expected senior unsecured rating of 'BB-(EXP)'. At the same time, Fitch has affirmed ChelPipe's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BB-' with Stable Outlook.

The rating of the notes, which are issued by Ireland-based Chelpipe Finance Designated Activity Company (FinCo) on a limited recourse basis for the sole purpose of funding a loan to ChelPipe, is on a par with ChelPipe's IDR. This is because the LPNs will constitute direct, unconditional senior unsecured obligations of ChelPipe and rank equally with all other present and future unsecured and unsubordinated obligations.

The affirmation reflects our view that ChelPipe's diversification into non-oil and gas pipe segments will mitigate medium-term margin pressure on large-diameter pipes (LDP) and support modestly positive free cash flow (FCF). ChelPipe's IDR continues to capture a 'BB' operational profile with a high share of value-added products (steel pipes), an established long-term customer base and a top-three position domestically across major seamless pipe types. Rating constraints include ChelPipe's exposure to the Russian economy and to the domestic oil and gas sector, in particular.

Key Rating Drivers

LPNs Guarantee: The notes will also benefit from an irrevocable and unconditional guarantee from Joint Stock Company Pervouralsk Pipe Plant (PNTZ), ChelPipe's largest EBITDA-generating subsidiary, thus ranking equally with the existing bank debt at ChelPipe and PNTZ levels, and structurally senior to ChelPipe's RUB25 billion rouble bonds. Prior-ranking debt, represented by RUB3 billion of borrowings at operating subsidiaries excluding PNTZ, is deemed immaterial and not affecting the LPNs' recovery prospects. ChelPipe plans to use the proceeds to partly refinance bank debt that accounted for RUB65 billion of its RUB90 billion total debt at end-1H19.

FX Exposure to Remain Manageable: Over 60% of ChelPipe's revenues are directly or indirectly exposed to hard currencies against 20%-25% of costs in hard currencies. The group intends to keep hard-currency debt, including the LPNs, within one-third of total borrowings. This should not compromise ChelPipe's overall exposure as part of its FX debt would be structurally hedged by its

FX revenue and cost structure.

Balanced Portfolio Supports Resilience: ChelPipe's steel pipes, representing 80%-85% of total revenues, reflect a balanced mix of LDP (typically 35%-40% of pipe shipments), oil country tubular goods (OCTG, 20%-25%) and other seamless pipes (35%-40%). In 2018, this portfolio mix helped mitigate a combination of rising production costs per ton and broadly flat LDP pricing as double-digit growth in non-LDP realised prices helped lift EBITDA to RUB28 billion in 2018 from RUB23 billion in 2017. Some RUB4 billion in cost savings realised in 2018 were another major factor supporting EBITDA.

Oil and Gas Exposure: ChelPipe's has a high exposure to the Russian oil and gas sector, mostly through LDP, OCTG and oilfield services, both in terms of pipe shipments (historically above 60%) and revenues (above 50%). However, the trends have diverged since 2017 as an oversupplied LDP market precluded ChelPipe from passing through rising production costs entirely onto customers while the contribution of non-LDP increased owing to rising prices and margins. The OCTG market outlook is supported by our expectations of broadly flat oil and gas production in Russia, the stability derived from the need for drilling to replace depleting oil and gas deposits, and a gradually increasing share of horizontal drilling in the industry.

LDP Structural Oversupply: The launch of a 500 thousand tonnes (kt) Zagorsky pipe plant intensified the structural LDP overcapacity in Russia, where 5.7mt capacity was set against domestic and export shipments of 2.6mt, suggesting capacity utilisation rates of less than 50% in 2018 (against ChelPipe's 65%-70%). Overcapacity has translated into shrinking margins to single-digit levels since 2017. The impact of further price and margin pressure in the LDP market on Chelpipe is limited by the group's flexibility not to enter LDP supply contracts if their pricing implies neutral or negative margins.

LDP Demand Likely Subdued: The LDP market's upside is limited as demand is unlikely to boost sector-wide capacity utilisations to above 50% in the medium-term. Demand is sensitive to Gazprom's megaprojects, and expected to dip in 2020 after peaking in 2019, as Nord Stream-2 and Power of Siberia are near completion and further megaprojects are unlikely to support the market before 2021. Demand volatility is only partly mitigated by LDP replacement needs for the existing Russian pipeline system, one of the largest globally. We conservatively expect ChelPipe's LDP shipments to peak at above 850kt in 2019 and rebase at around 700kt over the 2020-2022.

Industrial Seamless Pipes Peak: ChelPipe's exposure to non-oil and gas seamless pipes is strong with market shares of at least 40% in machinery, energy, chemicals and general use pipes. ChelPipe's supplies to these segments were healthy and exceeded 700kt throughout 2017-2019, supported by intensified expansionary capex by a number of chemical companies. We have a cautious view on post-2019 supplies and expect other seamless pipes shipments to moderate to 650kt-700kt.

FCF Margin Closer to Neutral: Fitch expects ChelPipe's EBITDA to peak at RUB30 billion on record-high 2.1mt pipe shipments in 2019 before drifting towards RUB27 billion-RUB28 billion thereafter. Simultaneously, we assume that ChelPipe will increase capex towards 6%-8% of revenues from 2020 in pursuit of a higher market share in premium pipe solutions. Coupled with RUB4 billion-RUB5 billion dividends assumed under our base case, this will lead to marginally positive free cash flow (FCF) generation with funds from operations (FFO) adjusted gross leverage declining to 3.4x in 2019 and to 3.2x over 2020-2022 (2018: 3.7x).

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 the company at over 40%. ChelPipe's competitive advantage is its relative proximity to Siberian and Far Eastern oil and gas fields and more than 75% integration into scrap-fed billet production. However, ChelPipe is lagging its competitors in the premium pipe connections segment.

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 volatility from Gazprom's expansionary projects. Longer-term risks stem from rising liquefied natural gas trade, increasing renewables contribution and decelerating global 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 a 'BB' operational profile with a high share of value-added products (steel pipes), a solid top-three domestic position across oil & gas and industrial seamless pipes, partial backward integration into scrap and billets, and an established long-term customer base. ChelPipe's constraints incorporate weak presence outside Russia, high exposure to the domestic oil and gas sector (typical for steel pipe players but not for steel players), and lack of exposure to margin-boosting premium pipe solutions.

ChelPipe lacks the scale, cost leadership and sales diversification of its Russian peers PAO Severstal (BBB/Stable), PJSC Novolipetsk Steel (NLMK, BBB/Stable) and OJSC Magnitogorsk Iron & Steel Works (BBB/Stable) but ranks above them in terms of value-added products (pipes).

ChelPipe's partial vertical integration into billets and scrap compares well with MMK's but not with more integrated NLMK's and Severstal's. ChelPipe's higher exposure to the Russian oil and gas sector and higher leverage are factors differentiating their ratings.

Operating environment does not impact ChelPipe's IDR.

Key Assumptions

Fitch's Key Assumptions within our Rating Case for the Issuer

- LDP shipments to peak at above 850kt in 2019, averaging at around 700kt in 2020-2022

- Non-LDP shipments to remain broadly flat, fluctuating around 1,150kt-1,200kt in 2019-2022

- EBITDA margin to remain around 16%-17% translating into RUB27 billion-RUB30 billion EBITDA until 2022

- Capex/sales conservatively assumed to exceed 7% in 2021-2022, up from 5%-6% in 2019-2020 (2018: 3.1%)

- Dividend payments at or below RUB5 billion over 2019-2022, reflecting a 50% net profit payout ratio

- FCF margin modestly positive, averaging at below 1% in 2019-2022

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action

- FFO adjusted leverage consistently at or below 3.0x on a gross basis (2018: 3.7x) or 2.5x on a net basis

Developments That May, Individually or Collectively, Lead to Negative Rating Action

- EBITDAR margin sustained materially below 16% (2018: 16%)

- FFO adjusted leverage sustained above 4.0x on a gross basis or 3.5x on a net basis

- Tightening liquidity and/or FFO fixed charge coverage falling below 2x (2018: 2.7x) for a sustained period

Liquidity and Debt Structure

Manageable Liquidity: The forthcoming notes placement are expected to further smooth and stretch out ChelpPipe's existing debt maturity profile. Its cash balances of RUB16 billion fell below short-term debt of RUB29 billion at end-1H19. It should be noted that RUB9 billion of short-term debt was obligations reclassified as short-term debt to reflect ChelPipe's irrevocable call option to prepay this debt. Moreover, liquidity is supported by RUB19 billion in undrawn committed credit lines and neutral-to-positive FCF generation forecast in the next 12 months.

Summary of Financial Adjustments

- A multiple of 6x applied to the 2018 operating lease expense of USD31 million as the company operates in Russia.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3. ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity.

For more information on our ESG Relevance Scores, visit www.fitchratings.com/esg.

Chelpipe Finance Designated Activity Company
----senior unsecured; Long Term Rating; Expected Rating; BB-(EXP)
PJSC Chelyabinsk Pipe Plant; Long Term Issuer Default Rating; Affirmed; BB-; RO:Sta

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Applicable Criteria

Corporate Rating Criteria (pub. 19 Feb 2019)

Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

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