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Research Update:

Ukraine-Based Interpipe Holdings PLC Assigned 'B' Rating; Outlook Stable

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Rating Action Overview

- The Ukrainian steel pipes and railway wheels manufacturer Interpipe Holdings PLC (Interpipe) met important milestones in 2020, despite the challenging market conditions, after emerging from default in October 2019.
- Our view of the company's creditworthiness is underpinned by its position as a small steel producer with a leading position in the niche steel market of railway wheels, its limited debt on balance sheet, and our expectation of positive free operating cash flow (FOCF).
- We are assigning our 'B' long-term issuer credit rating to Interpipe.
- The stable outlook reflects the company's ability to navigate the tough operating environment with limited pressure on its balance sheet, while building a supportive track record.

Rating Action Rationale

Interpipe's credit quality is determined by its small-scale operations, exposure to Ukraine, and supportive financials, but is constrained by a limited operating and financial track record. We view Interpipe as a small capital goods producer with an annual "normalized" EBITDA of about $150 million. Despite its scale, Interpipe has a leading position in a niche steel market (railway wheels), complemented by small-scale pipes operations. The rating takes into account a slightly more geared capital structure with a gross debt of about $350 million, compared with the current very low leverage (a reported net debt of $28 million at end-June 2020) and our expectation of positive FOCF in 2020 and beyond. At this stage, the rating is constrained by the company's lack of track record, after it completed its debt restructuring at end-2019.

Despite the recent improvement in Ukraine's macroenvironment, we still see the potentially negative connotations of doing business in Ukraine as presenting a challenge when compared with other, Western countries. However, this does not impose a cap on our rating on Interpipe.

After the global financial crisis in 2008 and the geopolitical conflict between Ukraine and Russia, Interpipe has made a fresh start. Interpipe entered the 2008 crisis with a high level of debt and large capital expenditure (capex) commitments, which in 2013 led to a breach of covenants and triggered cross-defaults on its borrowings. Between 2014-2017, it continually failed to make sizable scheduled principal repayments. Over this period, Interpipe experienced a range of difficulties in its markets: a volatile situation in Ukraine, the loss of the Russian market for pipes, and a decline in oil country tubular goods (OCTG) sales across all markets in a low-oil-price environment. In October 2019, the company reached an agreement with its lenders, reducing its gross debt to $0.4 billion from $1.4 billion.

In contrast, Interpipe entered the COVID-19 pandemic with a very low debt level and an improved cost structure. While the steel industry in Europe saw a production decline of about 40% in the second quarter of 2020 (the 'peak' of the pandemic), Interpipe's overall production declined by only about 16% year-on-year, and since then we have seen a very encouraging recovery.

Interpipe's small-scale operations and unique position in the railway wheels industry underpin our assessment of its business risk profile as weak. We consider Interpipe as a small player with overall steel capacity of about 1.3 million tons, operating through three divisions: steelmaking, pipes, and railway wheels. The company enjoys a strong position in the railway wheels segment, as reflected in its market share of about 54% in the European freight segment and average EBITDA margins of about 30% in 2016-2019. On the other hand, we consider its pipes business to be relatively small, with exposure to the volatile oil and gas industry, and commodity prices. At the same time, Interpipe has a strong presence and key supplier status in Ukraine, and a low cost of production (vertically integrated with all domestic manufacturing assets). The latter allows it to compete successfully outside its domestic market (about 70% of revenue in 2019). We view the company's business transformation into higher value-added products, and diversification away from the Commonwealth of Independent States (CIS), as supporting a better business model that would translate over time into more resilience across cycles.

Our assessment of Interpipe's aggressive financial risk profile does not fully reflect the company's very low debt level, as we also take into account its history and limited track record. Following the completion of its capital restructuring in October 2019, and after full repayment of the $91 million term facility and working capital facilities (last $22.5 million repaid in February 2020), and partial redemption of the bonds in the year-to-date ($228 million redeemed), Interpipe's capital structure consists of $81 million bonds due 2024. We understand that the current capital structure places major limitations on the company's growth and deployment of future FOCF. Consequently, it will aim to refinance the current structure, with a new structure that would better match its needs. We understand that Interpipe's financial objectives include a gross debt of about $300 million-$350 million, a minimum cash level of about $100 million, and reported net debt to EBITDA of up to 2.0x.

Under our base case, we project an S&P Global Ratings-adjusted debt to EBITDA of just below 1.0x (before any cash deduction) in 2020, compared with 1.9x as of end- 2019. When assuming a refinance of the capital structure with a "normalized" EBITDA level, we calculate adjusted debt to EBITDA of up to 2.5x.

Outlook

The stable outlook reflects the company's ability to complete its transformation in the coming 12-18 months--mainly operationally, but with the potential to complement it financially later on.

Under our base-case scenario, we assume that the company will complete its transformation, by putting in place a new capital structure with a gross debt of about $350 million (compared with the current $81 million) in the coming 12-18 months. Other key assumptions include an adjusted EBITDA of $200 million-$220 million in 2020 and $150 million-$200 million in 2021, compared with a level of $150 million, which we view as more representative through the cycle. In addition, we expect the company to generate FOCF of up to $100 million in 2020 and $40 million-$90 million in 2021.

We view an adjusted debt to EBITDA of 2.0x-3.0x (before any cash deduction) as commensurate with the 'B' rating. We may reassess the leverage range if the company's business performance became more resilient and it made progress in meeting its financial objectives, including the refinancing of the capital structure.

We do not see our sovereign rating on Ukraine ('B') as a cap for Interpipe's rating.

Upside scenario

We view a positive rating action as less likely in the short term. The higher 'B+ ' rating would require meeting the following:

- A robust operating performance in the coming six to nine months, ensuring Interpipe's ability to deliver an EBITDA of at least $150 million through the cycle;
- Successful completion of the refinancing of the current temporary capital structure, with a new structure that better matched the company's financial objectives;
- A supportive track record, with sound credit metrics and positive FOCF, and better visibility over the company's future financial policy--including allocation of excess cash between debt reduction, growth, and dividends; and
- Adequate liquidity.

Downside scenario

We believe that the headroom under the rating, namely the level of reported net debt and lack of maturities in the coming years, limits any rating downside in the coming 12 months.

In our view, a negative rating action could arise from:

- Refinancing the existing capital structure with a highly geared structure, deviating from the company's financial objectives; or
- A drop in EBITDA to $100 million or below, without a clear prospect of recovery in the following years.
- We note that a deterioration in the rating on Ukraine to 'B-' would not affect our rating on Interpipe, all else being equal.

Company Description

Interpipe is a Ukraine-based, vertically integrated, low-cost manufacturer of steel pipes and railway wheels.

The company operates three divisions (steelmaking, pipes, and railway products) that are run with separate management teams. There are no particular synergies between the pipes and railway product businesses and they could be sold separately. The company employs about 10,000 people.

Established in 1990, Interpipe is a private company, 100% owned by Mr. Viktor Pinchuk and his family via a number of discretionary trusts. The ownership structure has no effect on our rating.

Steel pipes (EBITDA $55 million in 2019, and $55 million-$75 million over the cycle)

With a capacity of around 1 million tons, the steel pipes division manufactures a variety of pipes, with end-markets exposure of 40% to oil and gas, 45% to construction, and 10% to machine-building. Of that total capacity, 75% represents seamless pipe products (including linepipe, OCTG, mechanical pipe), of which premium OCTG products represent about 20%, and 25% are attributable to welded pipes that are fairly commoditized products. Key markets are Ukraine (25% of revenue in 2019), America (24%), Europe (24%), and Middle East and North Africa (MENA; 15%). In the first half of 2020, Interpipe shifted volumes from the weak domestic and American markets into more stable regions such as Europe and MENA (about 56% of first-half revenue versus about 37% in 2019). In previous years, the division's performance was fairly volatile, with EBITDA ranging between $15 million-$108 million in 2016-2019. First-half EBITDA was $22 million.

Railway wheels (EBITDA $200 million in 2019, and $75 million-$95 million over the cycle)

With a capacity of about 200,000 tons, the division manufactures more than 250 types of wheel and axle that it sells to a variety of customers, namely in the commonwealth of independent states (46% of revenue), Europe (26%) and Ukraine (22%). In the first half of 2020, Interpipe shifted volumes from the weak domestic market into Europe, where demand remained particularly well-supported from the freight segment. In previous years, the division's performance was fairly volatile, with EBITDA ranging between $29 million-$203 million in 2016-2019. First-half EBITDA was $124 million.

Our Base-Case Scenario

Under our base-case scenario, we project Interpipe's adjusted EBITDA will be about $200 million-$220 million in 2020, decreasing to about $150 million-$200 million in 2021.

While the company started 2020 with a promising prospect and a good order book for both divisions, the situation has reversed with the outbreak of COVID-19. The pandemic led railway companies to delay the purchase of new wheels, and oil and gas customers to put on hold orders for new pipes. We understand that Interpipe's improved and very competitive cost structure allowed it to shift some of its products (mainly from Ukraine to Europe), mitigating the impact of lower demand in its core markets.

In our view, the shape of the recovery in 2021 will be an important indicator of the demand for the company's products, notably the return of the transportation sector to "normal" activity and the reinitiation of "on-hold" oil and gas projects, especially in Ukraine.

Our rating is underpinned by the company's ability to generate at least $150 million at the bottom of the cycle.

Key Metrics

Interpipe Holdings PLC --Key Metrics

	2019a	2020f	2021f
GDP growth--Ukraine (%)	3.2	(7)	4
GDP growth--eurozone (%)	1.3	(7.4)	6.1
UAH to $	25.9	26.4	29.5
Pipes--sales volumes (000s tonnes)	595	460-480	500-550
Wheels--sales volumes (000s tonnes)	203	175-190	150-170
Pipes--reported EBITDA (mil. $)	55 (1)	60-80 (2)	80-100 (2)
Wheels--reported EBITDA	200	160-180	100-120
Capex (mil. $)(5)	60	~45	65-75
Change in working capital (mil. $)	79	(40-50)	(25-35)
Reported net debt (mil. $)	82	N.M.	200-250
Adjusted EBITDA (mil. $)	242	200-220	150-200
Adjusted debt to EBITDA (x)(3)	1.9	<1.0x	<2.5x
Free operating cash flow (mil. $)	130	Up to 100	40-90

Notes: (1)After the deduction of reserves/provisions; (2)After the addition of reserves; (3)No cash is netted from the gross debt, which is adjusted for leases, pension liabilities and the performance sharing fees and securities. Base case assumes the issuance of $300 million-$350 million bonds in 2021. (4)Dividends and acquisitions are restricted by the restructuring documents. (5)Maintenance capex of $25 million-$28 million per year. a--Actual. Capex--Capital expenditure. f--Forecast. N.M.--Not meaningful. UAH--Ukrainian hryvnia.

A new capital structure will eliminate restrictions and residual obligations. As part of the debt restructuring, Interpipe agreed to compensate the lenders with additional payments, namely exit fees and performance sharing fees/performance securities. The mechanism of these payments was designed to incentivize an early refinancing. As such, we add the company's reported provision to our adjusted debt ($82 million as of December 2019, which the company reports on balance sheet). That said, if the company completed the refinance in 2021, we calculate payments of $70 million-$100 million, and the actual amount will depend on actual realized EBITDA.

Our rating assumes that over time, Interpipe will put in place a new capital structure with a gross debt of $300 million-$350 million and maintain about $100 million of cash on the balance sheet. As part of the refinance, it will repay all the outstanding legacy obligations. Lastly, we also assume that post such a refinance, the positive free cash flow will be needed reduce the debt but would be allocated toward growth projects and dividends.

Liquidity

We assess Interpipe's liquidity as less than adequate. Our assessment takes into account liquidity sources of about 1.7x in the 12 months from July 1, 2020. Other supportive factors for the company's liquidity are the long-term debt maturity profile with limited maturities before 2024, and the sizable cash on balance sheet.

At the same time, the company's default impaired Interpipe's standing in the capital markets, with no credit lines available. While we acknowledge that the company does not need such credit lines, given its sizable cash on balance sheet, building some track record of well-established relationships with banks as well as a good standing in debt capital markets is a key condition for our higher assessment of the company's liquidity.

For the 12 months starting July 1, 2020, we calculate the following liquidity sources:

- Cash available on balance sheet of $187 million, with more than 50% of the cash held outside Ukraine; and
- Our estimate of cash funds from operations of $140 million-$170 million.

We calculate principal liquidity uses over the same period:

- The completed redemption of $129 million of the outstanding bonds ($97 million in August and $32 million in October);
- Working capital outflow of about $10 million, with potential seasonal working capital swings of up to about $20 million;
- Capex of about $40 million-50 million; and
- No dividends.

Covenants

There are no maintenance covenants under the documentation of the outstanding $81 million bonds.

Ratings Score Snapshot

Issuer Credit Rating: B/Stable/--

Business risk: Weak

- Country risk: High
- Industry risk: Intermediate
- Competitive position: Weak

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: b+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Less than adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Weak (-1 notch)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

New Rating	
Interpipe Holdings Plc	
Issuer Credit Rating	B/Stable/--