

Research Update:

France-Based Steel Tube Producer Vallourec Upgraded To 'B+'; Outlook Stable

November 23, 2022

Rating Action Overview

- In our view, continued strong demand for Vallourec's tubes and services in the U.S. and the ramp-up of its iron ore mining operation in Brazil will likely translate to peak performance in 2023.
- In addition, we believe the company is making progress on its business transformation to achieve lower fixed costs and less volatility.
- We raised our long-term issuer credit rating on Vallourec to 'B+' from 'B' and our issue rating on its senior unsecured notes to 'BB-' from 'B+'. We also affirmed our 'B' rating on its commercial paper program.
- The stable outlook balances the company's promising outcomes, once it completes its strategy, with the execution risk, as well as increasing concern of a global recession in 2023.

Rating Action Rationale

We expect further positive momentum for Vallourec's business over 2023, with EBITDA increasing about 25% from 2022 levels. The company's results for the first nine months of 2022 showed performance remained in line with our previous projection in May of about €700 million reported EBITDA for the full year (excluding restructuring costs). We also revised our projections to about €900 million in 2023 (excluding restructuring costs). Although the world economy is now heading to a recession next year, we believe that Vallourec would benefit from:

- Healthy natural gas prices of above \$5 per million British thermal units (/mBtu) in the U.S. and bans on Russian pipes. We now expect the company's U.S. profitability to decline about 10%-15%, after it increased tube prices in each quarter this year. That said, we may see upside if prices turn higher than expected.
- Mining operations going back to nameplate capacity. We now expect production of at least 7 million metric tons (mt) in 2023 compared to 4 million mt in 2022. However, iron ore prices are expected to soften to about \$90 per ton (/ton) from \$100/ton in the same period.
- The transformation of its production sites (between Europe and Brazil) being well on track. It

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should be completed within the original timeline (first-quarter 2024).

The new strategy is intended to be cycle proof and benefit from a reshaped cost base.

Vallourec has now finalized its social plan agreements in Europe and intends to implement initiatives in other regions including Brazil. It is also focusing on closing its German operations (including selling its real estate) and reducing global headcount in the near term, which could mean sustainable EBITDA improvements. The company targets a €230 million run-rate EBITDA improvement plus an about €20 million capital expenditure (capex) reduction with full effect from second-quarter 2024. The next milestone to monitor is the ramp up of production in Brazil. When the company's plan is completed, we estimate EBITDA could move as low as €400 million before free cash flow turns negative.

Working capital may slow the company's deleveraging. Vallourec continues to target a net-debt-free capital structure in the medium term. At Sept. 30, 2022, the company reported €1.5 billion of net debt versus €1.0 billion at the start of the year. This increase was mainly linked to massive working capital outflows of about €540 million. However, we don't view this negatively but see it as a demonstration of the healthy environment, with the recent outflow potentially turning to a material inflow if demand softens. In 2023 the company will see material restructuring costs. Under our current projections, assuming working capital returns to normal levels of about €1 billion (trade receivables plus inventory minus payables) compared to the current €1.6 billion, we expect Vallourec will be net debt free as early as year-end 2025. We note this process could be accelerated with the completed sale of German real estate.

Outlook

The stable outlook balances the company's promising outcomes, once it completes its strategy, with the execution risk, as well as increasing concern for a global recession in 2023. Our rating assumes expanding EBITDA and a continued favorable market environment in the next 12 months while the company focuses on transforming its portfolio and business operations.

Under our base-case scenario, in 2023, we expect reported EBITDA to expand to about €900 million (excluding restructuring costs) and material free operating cash flow. As a result, we expect adjusted debt to EBITDA of 2.0x-3.0x, or about 2.0x if we net all cash except for €150 million that we consider a sustainable minimum cash position.

For the current rating, we expect the company to maintain adjusted debt to EBITDA of 3x-4x (using sustainable cash levels) on average over the cycle, with the metric not exceeding 4x during downturns.

Downside scenario

We would see downside rating pressure if:

- Demand for the company's products, or operational issues, prevent EBITDA from increasing in 2023.
- Implementation of the transformation program is more complex than expected.

Upside scenario

Triggers for an upgrade could include:

- Tangible progress on the transformation program, for example, ramping up production in Brazil and shutting down operations in Europe.
- Receiving all necessary regulatory approvals to operate the iron ore mines in Brazil at close to nameplate.
- Adjusted EBITDA of about €700 million over the cycle with a minimum of about €500 million during the lower part. These levels should ensure positive free cash flow (excluding changes in working capital) at any stage during the cycle.
- Management's commitment to a further reduction in net debt. We view adjusted debt to EBITDA of about 3x (on average over the cycle under normal conditions and working capital) as supporting a higher rating.
- Vallourec demonstrating reduced earnings volatility through the cycle.
- Continued prudent liquidity management.

Company Description

Vallourec is a specialty seamless steel tube producer. It has rolling capacity of about 3 million mt, split across Europe, Brazil, the U.S., and China. The company also operates one iron ore mine in Brazil, with 8.1 million mt of dry annual production capacity (2021; about 8.7 million mt from 2022) primarily sold to third parties. Vallourec generated about €3.4 billion in revenue in 2021 and primarily caters to the oil and gas and petrochemicals sectors (60% of 2021 sales). The remainder of its sales are to diverse industrial and power generation clients.

The company was founded in 1899, and is headquartered in Meudon, France. Notable peers include Tenaris, TMK PAO, Interpipe, and U.S. Steel.

Our Base-Case Scenario

Assumptions

- Underlying reported EBITDA of about €700 million in 2022 and about €900 million in 2023 (excluding restructuring costs), compared with €485 million in 2021.
- Given the execution risks associated with the relocation of its manufacturing capabilities, and uncertainty regarding potentially significant one-off restructuring costs, we incorporate only part of the anticipated step-up in profitability in 2023.

Key metrics

Vallourec--Key Metrics*

Mil. €	2021a	2022e	2023f	Over the cycle
Brent price assumption (\$/bbl)	75	100	90	55
Henry Hub price assumption (\$/mil. BTU)	4.5	6.3	5.3	2.75
\$/€	0.84	0.91	0.88	N.R.
\$/BRL	5.39	5.20	5.25	N.R.
Iron ore (\$/ton)	120	100	90	80
Iron ore production capacity (mt/year)	8.1	8.7	8.7	8.7
Reported EBITDA (mil. €)(before restructuring costs)	500	About 700	About 900	700
Restructuring costs (mil. €)	6	150-200	300	N.R.
Change in working capital (mil. €)	(172)	(450)	(0-100)	N.R.
Capex (mil. €)	(138)	(200)	(200)-(250)	(200)
Dividends (1)	(1)	0	0	0
Free cash flow (mil. €) (2)	(283)	(150)-(50)	250-400	250-300
Proceeds from divestments	N.R.	0	0	N.R.
Adjusted debt to EBITDA (x) (3)	2.7	About 2.0	< 1.5	About 1.0
Reported net debt (bil. €) (4)	1.0	1.1	0.7-0.8	No debt

(1) The company can distribute some dividends only under certain conditions set by the documentation for its various debt instruments. We assume some dividends can be assumed once the company progresses toward its absolute debt position (2) Free cash flow does not include a €64 million Brazilian financial lease payment in 2021. (3) Netting all cash except €150 million (the minimum cash balance). (4) Excluding any proceeds from asset sales in Germany. All figures adjusted by S&P Global Ratings. a--Actual. e--Estimate. f--Forecast. BTU--British thermal unit. BRL--Brazilian real. N.R.--Not relevant.

Liquidity

We have revised up our liquidity assessment to adequate from less than adequate. This reflects the company's track record of prudent policy and improved relationships with market players including Tier 1 banks, as shown by the recent issuance of a five-year \$210 million asset-backed loan (ABL) facility. The company's liquidity sources cover uses more than 1.2x in the coming 12 months and it has no maturities until 2026.

We estimate that liquidity sources for the 12 months from Sept. 30, 2022, include:

- About €250 million in unrestricted cash on the balance sheet.
- Revolving credit lines of about €410 million, undrawn and maturing in June 2026, coupled with the new \$210 million undrawn ABL facility maturing in 2027.
- Cash funds from operations of €550 million-€600 million.

We estimate that liquidity uses for the same period include:

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- About €400 million of maturities, mainly related to Brazilian facilities for prefunding and hedging of exports, although we expect the company to roll those over.
- Some outflows to support the restructuring program.
- Capex of €200 million-€210 million.
- Working capital outflows of up to €100 million in the coming 12 months and intra-year working capital swings of up to €300 million.
- No dividends.

Covenants

Headroom under Vallourec's leverage covenant, defined as net debt to equity, should be significant. There are some adjustments, as agreed in the credit agreements. This will be tested for the first time after the restructuring at year-end 2023.

In September 2022, the company forecast net debt to equity of about 85% (before any above-mentioned adjustments), which is well below the 100% limit.

Issue Ratings - Recovery Analysis

Key analytical factors

- We rate the reinstated €1.02 billion senior unsecured notes 'BB-', one notch above the issuer credit rating.
- The recovery rating of '2' indicates our expectation of substantial recovery prospects (70%-90%; rounded estimate: 70%) in the event of default.
- The €1 billion senior unsecured notes, €462 million revolving credit facility, \$210 million ABL facility, and €262 million French state-guaranteed facility will rank pari passu.
- As part of our analysis, we assume that existing priority liabilities--that is, the debt in Brazil--will remain in the capital structure.
- Our analysis doesn't take into account the expected reduction in the company's gross debt in the coming years.
- Under our hypothetical default scenario, we assume a prolonged downturn in the oilfield services industry weighing on the company's earnings, ability to refinance its bank lines, and ability to meet its debt obligations.

Simulated default assumptions

- Year of default: 2026
- Jurisdiction: France

Simplified waterfall

- Emergence EBITDA: €342 million
- Multiple: 5x
- Gross recovery value: €1.7 billion
- Net recovery value for waterfall after 5% administrative expenses: €1.6 billion
- Priority debt: €273 million
- Estimated senior unsecured debt claims: Approximately €2.0 billion
- --Recovery range: 70%-90% (rounded estimate: 70%)
- --Recovery rating: 2

All debt amounts include six months of prepetition interest.

Ratings Score Snapshot

Issuer credit rating	B+/Stable/B
Business risk:	Weak
Country risk	Intermediate
Industry risk	Moderately high
Competitive position	Weak
Financial risk:	Aggressive
Cash flow/leverage	Aggressive
Anchor	B+
Modifiers:	
Diversification/portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Fair (no impact)
Comparable rating analysis	Neutral (no impact)

ESG credit indicators: E-3, S-2, G-3

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019

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- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- 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: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Upgraded; Ratings Affirmed

	To	From
Vallourec		
Issuer Credit Rating	B+/Stable/B	B/Positive/B
Senior Unsecured	BB-	B+
Recovery Rating	2(70%)	2(70%)

Ratings Affirmed

Vallourec		
Commercial Paper	B	B

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914

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