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Research Update:

Lupatech Outlook Revised To Negative From Stable, On High Refinancing Risk; 'B-' Global Scale Corporate Rating Affirmed

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Overview

- Lupatech has managed to improve profitability and is taking actions to improve liquidity, but its refinancing risk remains high and its overall financial profile is highly leveraged.
- We are revising our outlooks on the company to negative, from stable, while affirming our ratings, including the 'B-' global scale and 'brBB' national scale corporate credit ratings.
- We might lower the rating if Lupatech doesn't keep improving its profitability in the next few quarters or increase its liquidity by reducing refinancing risks.

Rating Action

On Oct. 11, 2011, Standard & Poor's Ratings Services revised its outlooks on Brazil-based industrial and oil and gas valve manufacturer Lupatech S.A. At the same time, we affirmed our ratings, including the 'B-' global scale and 'brBB' Brazilian national scale corporate credit ratings, on the company.

Rationale

The ratings on Lupatech reflect the company's weak business profile and highly leveraged financial profile. Relevant risks include weak liquidity; very high debt stemming from its historically aggressive, acquisition-based growth strategy; and a high, dollar-denominated interest burden that exposes the company to currency mismatches. Partially mitigating these risks are the company's leading position in valves in Brazil, the long-term profile of the majority of its debt, and the strong growth prospects that supply contracts to Brazilian national oil company Petróleo Brasileiro S.A. – Petrobras support.

Lupatech's business profile is weak, reflecting operating challenges to integrate, streamline, and improve the efficiency of its acquired businesses and to expand production. Industry fundamentals are favorable for Lupatech because investments in the oil and gas sector in Brazil will likely be sizable in the next several years, in particular in the exploratory and production (E&P) segment, in which Lupatech operates. Petrobras' E&P investments are ramping up, and Lupatech's backlog is robust, with orders totaling $2.5 billion for the next several years. However, the company has to cope with its high-fixed-cost structure, based on still low capacity utilization, and large working capital requirements to increase production in the coming months, which is somewhat challenging given its already leveraged financial profile. Several initiatives to improve operations are under way, and we expect these will result in stronger margins over the next few quarters. Indeed, Lupatech's EBITDA margin improved to 14% in second-quarter 2011, compared with 10% as of year-end 2010.

Lupatch's financial profile is highly leveraged. Debt is sizable and comes from several acquisitions it undertook in previous years. The bulk of its Brazilian reais (R$) 1.1 billion debt is long term, with about R$440 million consisting of perpetual notes and R$340 million of debentures, with amortization from 2014 through 2018. However, refinancing risk is high because of Lupatech's significant debt maturities in the next 12 months compared with weak liquidity and low cash generation. Under our base-case projections, we expect credit metrics to recover modestly in the next few quarters but leverage to remain high. We assume stronger sales and an EBITDA margin of 17% in 2012, for a total debt to EBITDA of about 8.0x and FFO to total debt of less than 10% by year-end 2012.

Currency mismatch risk is also significant for Lupatech, considering that the company doesn't hedge exchange risk for the interest payments on its perpetual notes and that exchange rates have become more volatile recently. The company pays about $25 million annually to bondholders, which is partially mitigated by some dollar-linked or dollar-pegged revenues.

Liquidity

The company's liquidity is weak. Cash reserves amounted to R$60.7 million as of June 2011, compared with short-term debt maturities of R$180 million for the next 12 months. Free operating cash flow (FOCF) in the 12 months ended June 2011 amounted to R$50 million, but the current trend is negative as working capital needs to ramp up production are increasing. So far, Lupatech has used its credit lines under the Progredir program, collateralized by nonperforming receivables to Petrobras, to fund working capital requirements. As of June 2011, it had about R$170 million in bank loans under this program, but these are short-term bank loans that will come due in 2012 and Lupatech will need to roll them over as well. Because of the company's low cash reserves and projected negative FOCF, we believe that Lupatech faces significant refinancing risks in the next 12 months. We project the company's refinancing needs through June 2012 at about R$200 million, including R$170 million of bank loans under the Progredir program.

Lupatech has recently amended the most restrictive covenants under its domestic debentures. As our base case, ability to comply with the amended covenants by December 2011, when they will be measured, is tight. However, we assume the company will obtain waivers or postpone the date its compliance is measured again. Lupatech's access to the Progredir program in our view allows it to roll over existing lines as it performs its contracts with Petrobras. However, bank financing of its increasing working capital requirements will probably be challenging.

Lupatech is currently working on ways to improve its working capital funding and liquidity. The company announced it intends to divest some of its noncore assets and implement working capital optimization to reduce short-term debt. We don't factor in our analysis any upside potential from these initiatives right now because they remain rather uncertain. Nonetheless, we acknowledge that these could significantly improve liquidity in the next few quarters should the company be successful in its current negotiations.

Outlook

The negative outlooks reflect Lupatech's weak liquidity and high refinancing risk. Despite initiatives announced to improve its capital structure, the company faces significant challenges to improve its profitability and strengthen its weak liquidity. We will lower the rating if Lupatech doesn't keep sequentially improving its operating margins in the next few quarters or finds it more difficult to roll over its short-term debt. Given its significant challenges and weak liquidity, we view a positive rating action as unlikely in the intermediate term.

Related Criteria And Research

- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008

Ratings List

Ratings Affirmed; Outlooks Revised

	To	From
Lupatech S.A.		
Corporate Credit Rating		
Global Scale	B-/Negative/--	B-/Stable/--
National Scale	brBB/Negative/--	brBB/Stable/--
Lupatech Finance Ltd.		
Senior Unsecured	CCC	

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