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Russian Pipe Producer TMK Rated 'B+'; On Watch Neg Due To Uncertain Financial Structure

Rationale

On Sept. 4, 2006, Standard & Poor's Ratings Services assigned its 'B+' long-term corporate credit rating to RussiA-based pipe production company OAO TMK. Standard & Poor's also assigned its 'B+' preliminary senior unsecured debt rating to TMK's proposed Eurobond (the final rating is subject to receipt and review of final documentation and legal opinions), which will be issued by special-purpose vehicle TMK Capital S.A.

At the same time, 'ruA+' Russia national scale ratings were assigned to the company and its outstanding bonds. All ratings were immediately placed on CreditWatch with negative implications, pending clarification of the company's eventual balance sheet structure.

The ratings on TMK reflect the company's ambitious capital expenditure plans, improving but volatile margins, limited liquidity, and short track record as a combined group. These factors are offset by TMK's robust market positions and the currently favorable market fundamentals for seamless and large-diameter welded pipes. At year-end 2005, TMK had Russian ruble (RUR) 17.9 billion ($622 million) debt (adjusted for postretirement benefits and guarantees), of which RUR12.5 billion was short-term debt.

The 67% shareholder of the company, Dmitry Pumpyanskiy, is planning to increase his stake in TMK but details are undisclosed at this stage. Standard & Poor's believes this transaction will be largely financed by TMK, directly or indirectly. In addition to the Eurobond, TMK is planning an IPO in September or October 2006.

The CreditWatch status reflects our opinion that the rating could be lowered, likely by one notch, if the shareholder deal happens but refinancing with an IPO and longer-term debt does not occur in the second half of 2006. If the company's refinancing is successful or if the shareholder deal does not proceed, the ratings are likely to be affirmed.

TMK has embarked on a large $1.2 billion capital expenditure program aimed at facility modernization. This will limit free operating cash flow generation in coming years. TMK's margins are improving, but remain volatile and fundamentally depend on the steel cycle and capital-expenditure fluctuations in the oil and gas industries, and could also be affected by increasing competition in coming years. The oil and gas industries are responsible for about 61% of TMK's sales. Steel is TMK's main raw material and the company's partial vertical integration in steel production only partly offsets the risk, because scrap and iron ore prices are driven by steel prices.

TMK was only legally consolidated in 2004, when it purchased majority control in key operating subsidiaries from its core shareholders for RUR17.3 billion, which increased its debt.

TMK enjoys a strong market position, with more than 42% of Russia's pipe production and a diversified asset base of four plants in Russia and two smaller ones in Romania. TMK is particularly strong in seamless pipes for oil and gas. This is the most profitable segment, and demand is high due to growing capital expenditure in the oil and gas sector. In 2005, on the back of a material improvement in pipe prices, TMK's EBITDA doubled to RUR16 billion (with a 20% margin).

Liquidity

TMK's liquidity is weak. TMK has high liquidity requirements to finance the increase in the stake of its majority shareholder and to support its ongoing capital expenditure program. The company also has high short-term debt, although part of this was refinanced through a RUR5 billion bond placed in February 2006. This is only partly offset by $122 million of committed undrawn lines with several banks, some uncommitted lines, and RUR1.1 billion in cash.

Under the company's current plans, both the IPO and the Eurobond will be essential for refinancing. TMK has adequate access to external financing because investor demand currently remains for Russian securities on both the domestic and external markets, and because the company's consolidation has been completed. Like any emerging-market issuer, however, the company is subject to fluctuating demand for emerging market debt.

Recovery analysis

TMK's planned Eurobond is expected to be issued by a special-purpose vehicle, TMK Capital, which will on-lend the proceeds to TMK. The amount and maturity will be determined at placement, but we expect it to be about $300 million and five-to-seven years, respectively. A three-year maturity or a noteholders' put option in three years is also being considered. The rating on the proposed issue is preliminary, and the final rating is subject to receipt and review of final documentation and legal opinions. The 'B+' issue rating reflects our corporate credit rating on TMK and is based on our expectation that noteholders, through the trustee, will get access to the company and that the issue will bear guarantees from the key operating subsidiaries.

TMK has three Russian ruble bond issues outstanding, which are rated 'ruA+':

- RUR2 billion, due in October 2006;
- RUR3 billion, due in March 2009, with put options in March 2007; and
- RUR5 billion, due in November 2011, with put options in February 2008.

A significant part of the group's debt (46% at June 30, 2006) is located at the level of operating subsidiaries, and the guarantees issued by operating subsidiaries on the Russian ruble bonds are partial. This raises potential structural subordination issues. Given the company's centralized liquidity management and uncertainties due to the weaknesses of Russia's legal and judicial systems, however, at this stage we do not differentiate between the ratings on such bonds and the corporate credit rating.

Ratings List

OAO TMK

Corporate credit rating	B+/Watch Neg/—
Russia national scale rating	ruA+/Watch Neg
Senior unsecured debt	ruA+/Watch Neg
TMK Capital S.A.	
Proposed senior unsecured notes*	B+/Watch Neg

*Guaranteed by OAO TMK

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