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TMK 'B+' Ratings Off Watch And Affirmed After IPO; Outlook Stable

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Rationale

On Nov. 7, 2006, Standard & Poor's Ratings Services removed from CreditWatch and affirmed all its ratings on RussiA-based steel pipe producer OAO TMK (TMK) and related entities, including its 'B+' long-term corporate credit and 'ruA+' Russia national scale ratings, following the company's successful IPO. The outlook is stable.

The ratings were originally placed on CreditWatch with negative implications on Sept. 4, 2006, pending clarification of the company's balance sheet structure related to shareholding changes.

The rating actions reflect our opinion that the $1.07 billion proceeds from TMK's recent successful IPO of 23% of the company's stock (including the over-allotment option) will be largely used to repay debt raised at the level of TMK and its parent, TMK Steel Ltd. (TMK Steel), in connection with the recent shareholding changes. As a result, the major risk to TMK's financial profile has been resolved.

In October 2006, Dmitriy Pumpyanskiy increased his effective ownership in the company to 100% from 67%. To finance this transaction, TMK Steel (which is owned by Mr. Pumpyanskiy) raised a $780 million loan from TMK and $470 million of bank debt, which we believe can be repaid primarily from TMK's dividends or a sale of TMK stock. To finance the loan to the parent, TMK issued a $300 million Eurobond in September 2006 and raised $454 million of bank debt. The IPO proceeds will be used to repay $150 million of debt at the TMK Steel level and $780 million of debt to TMK. At June 30, 2006, TMK had $710 million of debt (adjusted for finance leases, postretirement benefits, and guarantees). After the shareholding transaction and the IPO, we expect TMK's debt level to stay broadly at the same level.

The ratings on TMK continue to reflect the company's ambitious capital expenditure plans, improving but volatile margins, 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.

TMK has 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.

On the positive side, 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 the first half of 2006, EBITDA was $393 million, representing a 25% margin on sales.

Liquidity

TMK's liquidity is now adequate, because IPO proceeds largely cover the recent shareholder transaction. The key calls on liquidity are presented by the company's ongoing capital expenditure program and by still-high short-term debt. At June 30, 2006, short-term debt stood at a high $418 million, compared with $49 million in cash and financial assets and $110 million in unutilized bank lines. We believe the $300 million Eurobond issued in September 2006 should help to extend maturities, however.

TMK has adequate access to external financing because there is currently investor demand for Russian securities in both the domestic and external markets, and because the company is now consolidated. Like any emerging market issuer, however, TMK is subject to fluctuating demand for emerging market debt.

Recovery analysis

TMK's $300 million 8.5% Eurobond due in 2009 was issued by TMK Capital S.A., a special-purpose vehicle supported by TMK, which has on-lent the proceeds to TMK. The rating is preliminary, and the final rating remains subject to receipt and review of final documentation and legal opinions (notably regarding the guarantees of operating subsidiaries that have to be received by end-November 2006). The 'B+' issue rating reflects the 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 two Russian ruble (RUR) bond issues outstanding, which are both rated 'ruA+':

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

A significant part of TMK's debt is located at the operating subsidiary level, 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.

Outlook

The stable outlook reflects Standard & Poor's expectation that in 2006 and 2007, TMK's profitability will remain strong, because high demand for oil and gas pipes should enable the company to pass through its costs to customers. Free operating cash flow will be limited over this period, however, due to large capital expenditures. Dividends will also rise compared with previously low levels, according to the new 20%-25% payout target.

Medium-term rating upside exists and will be based in the first place on the accumulation of a track record of more predictable financial policy and governance. We believe that, after the IPO, the company's transparency standards will further improve, as already evidenced by publication of bi-annual IFRS financial figures. Successful implementation of the current capital expenditure program should also yield strong free cash flow generation after 2007. Rating downside is currently limited. Large debt-financed investments or a materially deteriorating situation in the pipe industry, such as a large mismatch between steel and oil and gas cycles or increased competition, could place pressure on the outlook or rating.

Ratings List

	To	From
OAO TMK		
Corporate credit rating		
	B+/Stable/—	B+/Watch Neg/—
Russia national scale rating		
	ruA+	ruA+/Watch Neg
TMK Capital S.A.		
Senior unsecured debt*		
	B+	B+/Watch Neg

*Credit support by OAO TMK.

NB: Not all ratings affected are mentioned in this list.

Complete ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com; under Credit Ratings in the left navigation area, select Find a Rating, then Credit Ratings Search.