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Research Update:

Russian Pipe Maker OAO TMK Upgraded To 'B+/ruA' On Notably Improved Liquidity And Financial Results; Outlook Stable

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Overview

- Russia-based pipe manufacturer OAO TMK demonstrated notably improved financial results and credit metrics in the first half of 2011.
- The company refinanced short-term maturities with long-term and mostly unsecured debt, improving its liquidity to "adequate", in our opinion.
- We are raising our long-term rating on TMK to 'B+' from 'B', and the national scale rating to 'ruA' from 'ruA-'.
- The stable outlook reflects our expectation of a stable operating and financial performance in 2011-2012 and perceived more manageable debt maturities over 2012-2013.
- We are raising the issue rating on TKM's $500 million loan participation notes issued in January 2011 (due 2018) and $413 million convertible bond (due 2015) to 'B+' and are revising our recovery assessment on these instruments to '3', indicating our expectation of "meaningful" (50%-70%) recovery in an event of default.

Rating Action

On Sept. 22, 2011, Standard & Poor's Ratings Services raised its long-term corporate credit rating on Russia-based pipe manufacturer OAO TMK to 'B+' from 'B'. The outlook is stable. At the same time, the Russia national scale rating was raised to 'ruA' from 'ruA-'.

At the same time, we have revised our recovery assessment on $500 million loan participation notes (LPNs) issued in January 2011 (due 2018) by special purpose vehicle TMK Capital S.A., and on a $413 million convertible bond (due 2015) issued by TMK Bonds S.A. and guaranteed by parent company OAO TMK. The recovery rating is now '3', indicating our expectation of "meaningful" (50%-70%) recovery in an event of default. We raised the issue rating on these instruments to 'B+' from 'B', in line with the corporate credit rating.

Rationale

The upgrade reflects the improvement in TMK's liquidity and its operating and financial performance.

In the first half of 2011, TMK reported $618 million of adjusted EBITDA (EBITDA margin of 17.4%) and gross adjusted debt of $4,084 million. Its fully adjusted ratio of debt to EBITDA therefore improved to 3.3x on an annualized basis.

Another reason for the upgrade relates to our perception that TMK's liquidity has improved. We have raised our assessment to "adequate" from "less than adequate", based on TMK's refinancing of substantial maturities due in 2011-2012. We further expect management to proactively address upcoming maturities by issuing long-term debt.

TMK's financial and operating performance in the first half of 2011 improved thanks to a 16% increase in pipe sales volumes compared with the same period of 2010 and better margins because of price appreciation and higher capacity utilization. We expect that the company's performance in the second half of 2011 will further benefit from currently favorable market conditions in Russia and in its key oil and gas end markets, as well as from some softening of steel and scrap prices, which are key raw material input costs for TMK.

The ratings reflect our view of TMK's business risk profile as "fair" and its financial risk profile as "aggressive".

TMK's business risk profile is constrained by the cyclical steel pipe industry, which was underlined by TMK's very weak performance during the 2009 downturn, and exposure to Russian country risks. In our view, these weaknesses are only partly offset by TMK's robust market positions and diverse operations.

We consider that TMK's financial risk profile is constrained by high leverage, following its 2008 acquisition of U.S. pipe maker IPSCO. A key risk factor remains sizable total debt and lumpy maturities in 2014-2015. On the positive side, we note the company's gradually strengthening credit metrics, improved liquidity position, reduced debt maturities over 2012-2013, and demonstrated access to financing from Russian state-owned banks.

Liquidity

We view TMK's liquidity as "adequate", based on the estimated ratio of potential sources of liquidity to potential uses of liquidity of more than 1.2x over the two years started July 1, 2011, as well as demonstrated access to financing from Russian banks.

The key sources of liquidity are:

- Low surplus cash of about $70 million as of June 30, 2011;
- Long-term committed credit lines of about $525 million, most of which mature after 2013; and
- Funds from operations, which we estimate in our base-case credit scenario will be about $770 million in the first year and $740 million in the second year.

The company has substantial uncommitted lines from banks, which we do not include in our analysis.

The key potential uses of liquidity include:

- Debt maturities of about $501 million in the first year and $304 million in the second year;
- Capital expenditures of about $350 million-$400 million in both the first and second years; and
- Working-capital outflows estimated at about $150 million in the first year.

TMK is subject to maintenance covenants under several of its bank loan agreements (versus only incurrence covenants under the bonds). The maintenance covenants limit the debt-to-EBITDA ratio to 4.9x and are tested semiannually. We consider that the headroom for the June 30, 2011, test is comfortable and will remain so in 2011-2012, with debt to EBITDA closer to 3.0x under our base-case scenario, with EBITDA of about $1.1 billion. That said, we believe a 30% downside to EBITDA is realistic, given the industry's cyclicality. However, even if the covenants are breached, we expect that TMK should be able to receive waivers from its key relationship banks (as was the case in 2009 and the first half of 2010).

Recovery analysis

The issue rating is now 'B+', in line with the corporate credit rating. We have revised our recovery assessment on the $500 million LPNs issued in January 2011 (due 2018) by special purpose vehicle TMK Capital S.A., and on the $413 million convertible bond (due 2015) issued by TMK Bonds S.A. and guaranteed by parent company OAO TMK. The recovery rating is now '3', indicating our expectation of "meaningful" (50%-70%) recovery in an event of payment default.

The recovery rating on the LPNs and convertible bond reflects recovery prospects consistently above 50% and the company's gradual simplification of its capital structure. While the company still maintains a number of facilities with complex security and guarantee arrangements, it has made good progress, and we expect it to continue to do so, in refinancing prior-ranking debt and strengthening its financial profile.

Our simulated default scenario contemplates a default in 2013, owing to TMK's inability to refinance following operating underperformance because of ongoing weakness in TMK's core markets and rising interest rates.

Recovery prospects are supported by a substantial asset base and our belief that the company would reorganize in the event of a default. However, recovery prospects are constrained at the current level by TMK's complex capital structure, which includes an extensive array of debt facilities.

Our estimated stressed enterprise value of the company at default is about $2.9 billion, leading to recovery prospects in the 50%-70% range for both the LPNs and convertible notes, resulting in a recovery rating of '3' and an issue rating of 'B+'.

Outlook

The stable outlook reflects our view that TMK will continue to benefit from sufficiently supportive market conditions in Russia and its key oil and gas end markets, as well as from current oil and gas prices, despite increased macroeconomic uncertainties. The stable outlook also assumes that TMK will continue to timely address refinancing needs, refrain from substantial acquisitions, and gradually decrease its debt leverage to achieve an adjusted debt-to-EBITDA ratio no higher than 3.0x (under our base-case EBITDA of about $1.1 billion).

Ratings upside could follow further improving financial results and credit metrics in 2011-2012, if accompanied by notable debt reduction. The current absolute debt amount and lumpy 2014-2015 maturities leave the company vulnerable in case of a renewed downturn.

Ratings downside could result from substantially weaker liquidity, or from depressed conditions in the company's key markets, likely linked to a severe drop in oil prices and related curbing of oil industry investment levels, or competitive margin pressures.

Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal.

- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- 2008 Corporate Criteria: Ratios And Adjustments, April 15, 2008
- Principles Of Credit Ratings, Feb. 16, 2011
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Methodology And Assumptions: Standard & Poor's Standardizes Liquidity Descriptors For Global Corporate Issuers, July 2, 2010
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Key Credit Factors: Methodology And Assumptions On Risks In The Metals Industry, June 22, 2009
- Standard & Poor's Revises Its Approach To Rating Speculative-Grade Credits , May 13, 2008

Ratings List

Upgraded

	To	From
OAO TMK		
Corporate Credit Rating	B+/Stable/--	B/Stable/--
Russian National Scale Rating	ruA/--/--	ruA-/--/--
Senior Unsecured	B+	B
Recovery Rating	3	4

TMK Capital S.A.		
Senior Unsecured*	B+	B
TMK Bonds S.A.		
Senior Unsecured*	B+	B
Recovery Rating*	3	4

*Guaranteed by OAO TMK

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