STANDARD & POOR'S

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Primary Credit Analysts:
Elena Anankina
Moscow
(7) 495-783-4130
elena_anankina@
standardandpoors.com

Secondary Credit Analyst:
Andrey Nikolaev
CFA
Moscow
(7) 495-783-4131
andrey_nikolaev@
standardandpoors.com

Additional Contact: Industrial Ratings Europe
CorporateFinanceEurope@
standardandpoors.com

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OAO TMK Upgraded To 'BB-' On Strong Performance, Favorable Industry Dynamics; Outlook Stable

Rationale

On July 3, 2007, Standard & Poor's Ratings Services raised its ratings on RussiA-based steel pipe producer OAO TMK to 'BB-' from 'B+'. The outlook is stable. At the same time, the Russia national scale rating on TMK was raised to 'ruAA-' from 'ruA+'.

The upgrade reflects TMK's strong operating and financial performance in 2006 and currently favorable dynamics in the pipe industry. The company has achieved some progress with its capital expenditure program. In 2006, TMK commissioned continuous casters at its Tagmet and Seversky plants and completed a major overhaul of the pipe press at its Volzhsky plant. EBITDA increased to $786 million in 2006, from $558 million in 2005, as strong demand for steel pipes—mainly from the oil and gas sector—pushed prices up by 15%-20%, more than offsetting higher input costs. We believe that growing investments in the Russian and global hydrocarbon industry and a concentrated supply of seamless pipes should preserve the attractiveness of the company's market niche in the medium term.

The rating action also reflects TMK's favorable financial metrics after the company's loan to its shareholder was repaid from IPO proceeds in late 2006. At Dec. 31, 2006, total debt (adjusted for pensions and other debt-like liabilities) was $1.051 billion, compared with $286 million of cash. Funds from operations to total adjusted debt was comfortable in 2006, at 52%.

The ratings continue to be constrained by TMK's ambitious capital expenditure plans. The company plans to spend $1.4 billion in 2004-2010 on modernizing its asset base and expanding production of seamless and large-diameter pipes (of this, $0.3 billion was spent in 2004-2006). This will limit free cash flow generation in the next couple of years. In the long term, TMK's margins are fundamentally exposed to the steel cycle and to capital expenditure fluctuations in the hydrocarbon sector, and may be subject to growing competition.

The key positive rating factor is TMK's robust market position and the currently favorable market fundamentals for seamless and large-diameter welded pipes. The company is the largest pipe manufacturer in Russia, with 65% of Russia's seamless pipe production, and the third largest worldwide. TMK benefits from a diversified asset base, with five plants in Russia and two smaller ones in Romania.

Liquidity

TMK's liquidity is comfortable, after its $300 million eurobond and $1.1 billion IPO helped refinance most short-term debt in late 2006. At Dec. 31, 2006, TMK had $365 million of short-term debt versus $286 million of cash and bank deposits and about $300 million of availability under committed bank lines. The key calls on liquidity are presented by the company's ongoing capital expenditure program. Although, like other Russian companies, TMK currently enjoys adequate access to external financing, it may be subject to fluctuating investor demand for emerging-market debt in the longer term.

Outlook

The stable outlook reflects our expectation that TMK's profitability will remain strong in 2007-2008, as growing input costs will be more than offset by high pipe prices on the back of strong demand from the oil and gas industry. High capital expenditures will, however, pressure free operating cash flow. We expect TMK's dividend payout to increase in line with its 25% target, and its key credit metrics to stay in line with management's financial policy target of net debt to EBITDA of below 1.5x (0.9x in 2006).

Rating upside will be largely driven by the company's capital expenditure program. Downside is currently limited, but large debt-financed investments or a materially deteriorating situation in the pipe industry could put pressure on the outlook or ratings. A major merger or acquisition, such as the reported possible merger with Ukraine-based Interpipe Ltd. (unrated), would require re-evaluation of the ratings.

Ratings List

	To	From
Corporate credit rating	BB-/Stable/—	B+/Stable/—
Russia national scale rating	ruAA-	ruA+
Senior unsecured debt	ruAA-	ruA+

NB: This list does not include all ratings affected.

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