MOODY'S
INVESTORS SERVICE

Credit Opinion: OAO TMK

Global Credit Research - 16 Jan 2012

Russia

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	B1
NSR Corporate Family Rating - Dom Curr	A2.ru
TMK Capital S.A.	
Outlook	Stable
Bkd Senior Unsecured	B1/LGD3

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Key Indicators

OAO TMK[1]

	9/30/2011(L)	12/31/2010	12/31/2009	12/31/2008	12/31/2007
EBIT Margin	**11.2%**	**11.0%**	**0.3%**	**12.0%**	**19.1%**
Debt / Capital	**65.2%**	**67.5%**	**68.1%**	**58.9%**	**40.2%**
Debt / EBITDA	**3.5x**	**4.3x**	**10.3x**	**3.3x**	**1.7x**
(CFO-Div) / Debt	**10.1%**	**1.9%**	**11.3%**	**10.5%**	**5.6%**
FCF / Debt	**-0.5%**	**-6.2%**	**0.7%**	**-15.5%**	**-36.2%**
EBIT / Interest	**2.0x**	**1.4x**	**0.0x**	**2.4x**	**7.6x**

[1] All ratios are calculated using Moody's Standard Adjustments. Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Corporate Profile

OAO TMK is Russia's largest producer - and one of the world's largest producers - of steel pipe for the oil and gas industry, operating 24 production sites in the US, Russia, Romania and Kazakhstan. The largest share of TMK's shipments are of high margin oil country tubular goods, with line pipe, large diameter pipe and industrial pipe also in its sales mix. More than half its sales, by volume, are of seamless pipe. For the 12 months ended 30 September 2011, TMK shipped approximately 4.3 million tonnes of pipe. For the same period, revenues were US$6.8 billion and EBITDA was US$1.1 billion. TMK's largest shareholder is Mr. Dmitriy Pumpyanskiy, who owns an approximate 70% stake in the company.

Rating Rationale

TMK's B1 corporate finance rating reflects its market leading role in Russia for pipe products, especially for high-margin energy products such as seamless oil country tubular goods (OCTG) and large diameter pipe (LDP); its geographical diversification with meaningful production assets in North America and Europe; its favourable cost profile; the volume and margin benefits associated with its strategic investment programme; and the favourable long-term outlook for oil and gas E&P drilling and pipeline construction, especially in terms of intensity of use as drill hole lengths get longer and horizontal drilling more common. However, the rating also considers the competitiveness of the steel pipe market, which when coupled with the volatility of energy prices and the oil and gas industry can lead to wide swings in OCTG and pipe demand, inventory and TMK's profitability. Other factors that affect the rating are high customer concentration for its Russian business, the volatility of prices for steel, TMK's largest cost, the company's high leverage and its fairly constant need to refinance maturing short-term debt. Lastly, we note that the rating incorporates the fact that the economic, operating and legal framework in Russia is still in development.

DETAILED RATING CONSIDERATIONS

VOLATILITY OF ENERGY PRICES, THE O&G INDUSTRY AND STEEL INPUT PRICES

While the energy sector is generally a good market to serve, it is subject to wide and often unpredictable swings as market fundamentals and geopolitical developments influence oil and gas prices, the capital budgets of the E&P and pipeline companies, and drilling activity. Drill rig count, the complexity of oil and gas drilling, and the amount of line pipe and large diameter pipe needed to connect and transport oil and gas are the primary drivers of TMK's business, although it also produces industrial pipe for a wide range of applications. When energy prices are high or rising, drilling activity and pipe consumption expand and OCTG stocks may dwindle, pushing OCTG prices up and encouraging a greater amount of foreign trade. On the other hand, when energy prices fall, oilfield drilling and development budgets are trimmed, OCTG inventory builds, imports diminish and OCTG prices decline. Downcycles can be exacerbated by the inability of companies to access credit. While all steel companies are cyclical, most steel companies serve diverse industries and their performance correlates with the general economy. However, the energy sector can be disconnected from the general economy and its cycles can dampen or amplify the general business cycle. Therefore, TMK can experience higher highs and lower lows than a steel company serving a broader range of end markets. This volatility is somewhat mitigated for TMK because of its international presence, its strong market share in the more stable Russian oil and gas market, and its self-sufficiency for the making of steel billets required for its seamless pipe-making operations.

TMK's reliance on the oil and gas industry also gives it relatively high customer concentration. In 2010, approximately 32% of its pipe sales were to its top five customers, all Russian: Gazprom (excluding Gazprom Neft), Transneft, Rosneft, Surgutneftegas, and TNK-BP, with LUKOIL also an important customer. Gazprom is its largest customer for the highly volatile LDP business, accounting for approximately 55% of LDP sales in 2010. TMK has supply and cooperation agreements with many of these customers although there usually are no minimum purchase volumes associated with these agreements. Recently, TMK and other pipe producers reached an agreement with Gazprom for LDP that ties pipe prices to a formula that adjusts for changes in the costs of critical raw materials such as scrap, iron ore and metallurgical coal. LDP projects are large and the pipe can be delivered over many months, so it is important for both TMK and its customer to allow prices to reflect current market prices. However, the formula-based pricing in the new agreement with Gazprom only adjusts every six months, so the company still takes raw material price risk.

FUNDAMENTALS FOR O&G DRILLING AND TRANSMISSION: FAVOURABLE IN LONG-TERM, SOFT IN SHORT-TERM

Having highlighted the variability of the oil and gas industry, we note that it currently has a relatively favourable long-term outlook. Oil prices are high and rig count and exploration budgets are trending upward. In Russia, oil and gas output should be stable as the development of new fields and higher well recoveries offset depletion at older fields. New projects in Eastern Siberia and the Far East will require transmission pipe to get the hydrocarbons to market. In North America, despite continuing low natural gas prices the total number of drill rigs and wells being drilled has increased. OCTG use has also been boosted by the greater lengths and greater complexity of the drilling being done as holes get deeper and the percentage of wells drilled using horizontal or unconventional drilling increases. In the US, where much of the horizontal drilling has been done thus far, the OCTG tubes used in a typical well can be two to three times as great as in a conventional well. Deeper wells and horizontal drilling also requires higher quality tubes and connections, which favours seamless pipe and producers with premium services, such as TMK's ULTRA threading and heat treating capabilities. Horizontal drilling technology is expanding outside of North America and is expected to become more common in Russia over the next few years.

However, this favourable long-term outlook is muted by a less robust near-term outlook. The near-term outlook for OCTG, LDP and industrial pipe has been adversely impacted by macroeconomic issues, reduced industrial activity and a lull in Russian long distance pipeline projects requiring LDP. Additionally, in 2012, Russian oil companies' cash flows will no longer benefit from one-off items such as custom duty holidays and mineral extraction tax subsidies so they may be more cautious about capital expenditures. As a result of these factors and others, starting in the third quarter of 2011, demand for OCTG began to flatten, steel and pipe prices began to weaken, and inventories increased. In the third quarter of 2011, TMK's sales increased 17.6% but its operating profit fell 30% compared to 3Q10 as a less favourable product mix, the processing and sale of higher cost inventory, additional costs related to maintenance at several of its Russian plants, and margin compression for welded pipe in the US combined to impact TMK's margins. In the first two quarters of 2011, TMK recorded EBITDA of US$308 million and US$320 million but this declined to US$216 million in the third quarter (all figures per Moody's adjustments). Moody's expects that market conditions will be somewhat soft for at least the first half of 2012, and it's possible that TMK's results in the fourth quarter of 2011 and the first half of 2012 will be similar to the third quarter of 2011.

RUSSIA'S LEADER FOR SEAMLESS AND WELDED PIPE

TMK is Russia's largest manufacturer and supplier of steel pipe and the largest supplier of seamless OCTG. In the first nine months of 2011, pipe demand in Russia grew by 25% to over 8.2 million tonnes. In the same time period, TMK delivered about 2 million tonnes of pipe into the Russian market, or about 62% of its tonnes sold. About 60% of its Russian pipe sales, by tons, are of seamless pipe and all of the OCTG it produces in Russia is seamless. In the first nine months of 2011, TMK increased its Russian sales of its core product, seamless OCTG tubes, and maintained its domestic market share at 58%. Its market share in Russia for seamless line pipe is currently around 69%. For LDP it has an estimated 15% of the domestic market and for seamless industrial pipe it has an estimated 33% of the domestic market but at times faces competition in this segment from importers, primarily from Ukraine. About 20% of TMK's sales volumes originate in North America, where its sales mix is about two-thirds welded pipe and one-third seamless pipe. TMK IPSCO has about 14% of the US market for OCTG.

HIGH LEVERAGE

A near-term decline in earnings and cash flow would temporarily, at the least, pressure TMK's leverage as measured by gross debt to EBITDA. For the 12 months ended 30 September 2011, it had debt/EBITDA of 3.5x as adjusted by Moody's (the ratio is 3.4x using the company's as-reported figures). Moody's believes this may rise to 4x or more in early 2012 due to the soft pipe market outlook we envision for the first half of 2012. However, a slowdown should be accompanied by a release of working capital and, therefore, either a reduction of debt or an increase of cash. More important for the rating and outlook than the debt ratio will be how readily TMK can refinance some of its maturing debt given current cautious credit markets. It has US$402 million to refinance or retire in 2012. It has the liquidity to cover this and more.

Moody's believes the company's absolute leverage is risky given the inherent volatility of its end markets. While TMK's debt initially jumped up with the 2008 acquisition of IPSCO, it has stayed high because of the company's strategic investment programme, which has totaled about US$2 billion since 2004. That high level of capex is essentially done - and maintenance capex could be as low as US$100 million for a short period of time - so TMK should be able to begin its deleveraging phase, which it says it is committed to doing. It has reduced debt by about US$100 million in the first nine months of 2011 but more than half of this reduction can be attributed to changes in currency rates.

Liquidity

TMK has good liquidity, including US$157 million of cash and access to US$738 million of unutilised committed borrowing facilities, primarily for its Russian operations. The company is committed to reducing debt but recently emphasized that, in the current market where financing is more difficult, building cash will take priority over reducing debt. In 2012, TMK plans to spend around US$400 million for capex, which is similar to 2011. It also has US$402 million of maturing debt, which includes US$314 million of bank loans and US$88 million of investment loans.

Rating Outlook

The stable rating outlook reflects the generally favourable outlook for the oil and gas industry in Russia and worldwide, TMK's strong market position, and its improved credit metrics since the unusually weak 2009 time period. The fact that it has largely completed its strategic investment programme and is committed to reducing debt also provides support for the stable outlook.

What Could Change the Rating - Up

TMK's rating could be upgraded were it to generate free cash flow, reduce the absolute level of debt to around US$3.2 billion or the ratio of debt to EBITDA to less than 2.75x on a sustainable basis (using Moody's adjustments), and maintains good liquidity and a relatively level debt maturity profile.

What Could Change the Rating - Down

A rating downgrade could be triggered by a failure to generate positive free cash flow on a rolling 12-month basis, leverage in excess of 4.0x EBITDA (using Moody's adjustments), a significant decline in oil and gas prices and O&G companies' capital spending, and if liquidity weakened, one aspect of which is the size of the company's near-term debt maturities.

Mapping to Rating Methodology Grid

Rating Factors

OAO TMK

Steel [1][2]	**Aaa**	**Aa**	**A**	**Baa**	**Ba**	**B**	**Caa**
Factor 1: Size And Diversity (35%)							

a) Size (Net Consolidated Sales in USD$ billions; most recent period)				$6.8			
b) Business Profile				4			
Factor 2: Operating Performance And Volatility (25%)							
a) EBIT Margin (3 year average)				11%			
b) Return on Average Tangible Assets (3 year average)	25%						
c) Volatility based on the Coefficient of Variation of CFO/Net Sales				56%			
Factor 3: Financial Policies (25%)							
a) Debt / Capital (most recent period)					65%		
b) Debt / EBITDA (3 year average)					3.5x		
Factor 4: Financial Strength (15%)							
a) EBIT / Interest (3 year average)						2.0x	
b) (CFO-Div) / Debt (3 year average)						10%	
c) FCF / Debt (3 year average)							-1%
Rating:							
a) Indicated Rating from Grid					Ba2		
b) Actual Rating Assigned						B1	

[1] All ratios are calculated using Moody's Standard Adjustments. [2] Based on financial data as of 9/30/2011(L); Source: Moody's Financial Metrics

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