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Research Update:

Russian Steel Pipe Maker OAO TMK Rating Cut To 'B' On Deteriorating Market; Outlook Negative

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Table Of Contents

Overview

Rating action

Rationale

Outlook

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Overview

- Global pipe markets deteriorated in the first half of 2009 and visibility for the rest of 2009 and 2010 is limited.
- We therefore expect OAO TMK's credit metrics to worsen below our previous expectations in 2009.
- We are lowering the corporate credit rating to 'B', and the outlook remains negative.
- We are also lowering the ratings on the bonds issued by TMK Capital S.A. to 'B' and placing them on CreditWatch with negative implications.

Rating action

On July 8, 2009, Standard & Poor's Ratings Services lowered the long-term corporate credit rating on Russia-based steel pipe producer OAO TMK to 'B' from 'B+' and the Russia national scale rating to 'ruBBB+' from 'ruA'. The outlook is negative.

At the same time, we lowered the senior unsecured debt ratings on the $300 million bond maturing in 2009 and $600 million bond maturing in 2011 issued by TMK Capital S.A. to 'B' from 'B+', and placed them on CreditWatch with negative implications. The recovery rating is '4'.

Rationale

The downgrade reflects our view that TMK's credit metrics will deteriorate substantially in 2009 due to lower demand for oil country tubular goods (OCTG) and industrial pipes in Russia and globally. In particular, in our conservative credit scenario we expect lower profits and cash flows in 2009 to lead to adjusted debt to EBITDA surpassing 4.5x and funds from operations (FFO) to adjusted debt falling below 10%. We also do not expect the company to generate significant positive free operating cash flow in 2009-2010 that could help it to meaningfully reduce debt.

In the first quarter of 2009, the company reported an 18% decrease in overall pipe volumes compared with 2008, despite consolidation of its U.S. operations. This followed substantial downward revision in capital expenditures of oil and gas companies following sharply lower oil prices as well as a slowdown in the Russian economy, which is impairing demand for pipes for industrial applications. Furthermore, weaker pricing as well as lower capacity utilization is putting pressure on TMK's margins.

Although we do not exclude the possibility of recovery in the OCTG market at the end of 2009 and in 2010 based on currently stronger oil prices, the visibility on the capital expenditure budgets of oil producers and ultimately TMK's profits remains limited.

On the positive side, however, we expect the company to improve its liquidity and debt maturity structure by attracting long-term financing from Russian and Western banks within the next three months. To do that, the company would need the consent of the holders of its $600 million notes, due in 2011, to amend certain covenants, including those related to limitations on the secured indebtedness. We do not view the tender offer related to the consent solicitation process as distressed (for further details see "Rating Implications Of Exchange Offers And Similar Restructurings, Update," published on May 12, 2009, on RatingsDirect). Our current rating action reflects solely concerns about the future financial performance of the company, as discussed above.

The rating on TMK reflects our view on the company's business risk profile as fair and its financial risk profile as highly leveraged. The business risk profile is constrained by the cyclicality of the steel pipe industry and exposure to Russian country risks, only partly offset by TMK's robust market positions and growing diversity of operations. TMK's financial risk profile is constrained by high leverage and still weak, albeit improving, liquidity. This is only partly mitigated by company's commitment to deleverage and willingness of the majority shareholder to support the company.

Liquidity

We consider TMK's liquidity to be weak, but manageable. We currently factor in our assessment that the company will be able to finalize important long-term facilities with Russian and Western banks over the next three months. This should help refinance the $300 million eurobond issue in the third quarter of 2009 and improve the overall maturity profile.

We still estimate, however, refinancing needs of several hundred million dollars for 2010, which in our opinion will not be offset by meaningful free operating cash flow.

We regard these refinancing challenges as manageable, however, given:

- Substantial, albeit uncommitted credit lines from state-owned JSC VTB Bank (BBB/Negative/A-3); and
- TMK's proven ability to roll over its short-term loans with state-owned banks, due in part to its important industry position.

There is a risk of a breach of covenants in the company's $600 million eurobonds in 2010 if the markets do not improve. We note, however, that these are incurrence covenants, rather than maintenance covenants.

Recovery analysis

The issue ratings on TMK's $300 million 8.5% bonds and $600 million 10% bonds have been lowered to 'B', the same level as the corporate credit rating and placed on CreditWatch with negative implications. The recovery ratings remain unchanged at '4', indicating our expectation of average (30%-50%) recovery in the event of a payment default.

The CreditWatch placement is linked to the company's intention to increase the proportion of secured indebtedness, which could materially diminish recovery prospects for unsecured bondholders. In the event that this leads to the recovery rating being revised to '5' (10%-30% recovery), the issue ratings on the bonds would be lowered one notch below the corporate credit rating.

Our review will, among other things, take into account the impact from changes to the group's capital structure and the balance between secured and unsecured debt that emerges as a result of that process.

For the full recovery analysis on the existing capital structure, please see "OAO TMK's Recovery Rating Profile," published Aug. 5, 2008, on RatingsDirect.

Outlook

The negative outlook reflects the possibility of a downgrade, if TMK does not address its liquidity difficulties in a timely manner as we currently anticipate, or if its financial performance deteriorates further.

We may revise the outlook to stable or to positive if the company is able to improve its credit metrics on the back of stabilization in the industry environment in 2010. In our view, ratios of adjusted debt to EBITDA of 3x and FFO to debt of about 20% would be consistent with a 'B+' rating.

Ratings List

	To	From
Downgraded/Outlook/CreditWatch action		
OAO TMK		
Corporate Credit Rating	B/Negative/--	B+/Negative/--
National scale rating	ruBBB+	ruA
Senior Unsecured Debt	ruBBB+	ruA
TMK Capital S.A.		
Senior unsecured debt*	B/Watch Neg	B+
Recovery rating	4	4
*Support from OAO TMK		

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