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Summary:
OAO TMK

Primary Credit Analyst:
Ekaterina Grinevich, Moscow (7) 495-783-4061; ekaterina_grinevich@standardandpoors.com

Secondary Contact:
Andrey Nikolaev, CFA, Paris (33) 1-4420-7329; andrey_nikolaev@standardandpoors.com

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Credit Rating: B+/Stable/--

Rationale

The ratings on Russia-based steel pipe producer OAO TMK reflect Standard & Poor's Ratings Services' 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 in 2009 on the back of the global economic downturn, high dependence of the company's financial performance on raw material price dynamics, and the capital spending of oil and gas companies, as well as TMK's exposure to the risks of operating in Russia.

In our view, these weaknesses are only partly offset by TMK's robust market positions, diverse operations, partial vertical integration, and expectations of investment spending growth in oil and gas industry, which supports future demand for pipes.

We consider that TMK's financial risk profile is constrained by the company's high leverage, which is, however, gradually improving. We also note the company's improved liquidity position and demonstrated access to financing from Russian state-owned banks.

S&P base-case operating scenario

In our base-case scenario, we anticipate that TMK's revenues will remain broadly stable in 2012 at the level of about $6.7 billion, primarily thanks to somewhat higher production and sales volumes, which should be offset by somewhat lower pipe prices compared with the record highs reached in 2011. The assumptions for revenues per metric ton of pipe that underpin our credit scenario are $1,600 in 2012 and 2013 (compared with $1,615 per metric ton in 2011).

TMK is only partly vertically integrated in steel, which constitutes about 70% of its costs, and it must purchase the rest of needed raw materials externally. Based on our expectations of steel prices softening in 2012, we factor in our base-case scenario that steel prices will decrease by about 7% compared with 2011. The positive impact of lower steel prices on the company's margins should, however, be somewhat offset by inflation of electricity, gas, and labor costs of approximately 5%-10%.

On this basis, we forecast midcycle EBITDA of about $1.0 billion-$1.1 billion in 2012-2013, which is in line with the $1.05 billion that TMK reported in 2011, but translates into a healthy margin of about 16%.

S&P base-case cash flow and capital-structure scenario

Under our scenario, we forecast that in 2012, TMK will reach a Standard & Poor's-adjusted debt-to-EBITDA ratio of about 3.3x, which should subsequently remain more or less stable, given TMK's sufficient capacity to generate funds from operations (FFO).

Free operating cash flow should remain positive, at about $220 million in 2012. This reflects our assumptions of Standard & Poor's-adjusted FFO of about $700 million-$720 million and capital spending of about $450 million in

2012. We assume the company will pay dividends at the level of 25% of consolidated net income in the next few years.

We expect that gross adjusted debt will be about $3.6 billion by the end of 2012 and only slightly decrease to about $3.4 billion by year-end 2013, from the $3.9 billion reported as of Dec. 31, 2011.

Liquidity

We currently view TMK's liquidity as "adequate". We base our assessment of TMK's liquidity on our estimated ratio of potential sources of liquidity to potential uses of liquidity over a two-year period, as well as demonstrated access to financing from Russian banks.

For the first year (starting Jan. 1, 2012), we estimate the ratio at about 1.27x, and for the second year (starting Jan. 1, 2013) at 1.24x.

As of Jan. 1, 2012, we estimate TMK's liquidity needs over the next 12 months to be about $1.05 billion, comprising:

- Debt maturities of about $553 million in the first year and $381 million in the second year;
- Capital expenditures of about $450 million; and
- Working-capital outflows of about $40 million.

We estimate TMK's liquidity sources to be about $1.3 billion. These include:

- Estimated surplus cash and short-term investments of about $141 million on Jan. 1, 2012. We exclude about $100 million in cash, which we consider tied to the operations;
- Long-term committed credit lines of about $472 million, most of which mature after 2013; and
- Funds from operations, which we estimate in our base-case credit scenario at about $700 million-$720 million

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 Jan. 1, 2012, test is comfortable and will remain so in 2012-2013, with debt to EBITDA closer to 3.3x under our base-case scenario. 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 recovery rating on TMK's $500 million loan participation notes (LPNs) issued through special-purpose vehicle (SPV) TMK Capital S.A. in January 2011 and due in 2018, and on its $413 million convertible bond (due 2015) issued by TMK Bonds S.A. and guaranteed by parent company OAO TMK is '3', indicating recovery prospects in the 50%-70% range. Issue ratings on both the LPNs and convertible bonds are 'B+', in line with the corporate credit rating.
- Our simulated default scenario contemplates a default in 2013, owing to TMK's inability to refinance following operating underperformance.
- TMK's substantial asset base and our view that the company would reorganize in the event of a default both support recovery prospects. However, we believe that TMK's complex capital structure, including an extensive array of debt facilities, would limit recovery.

- We estimate TMK's stressed enterprise value at $2.9 billion, leading to recovery prospects of 50%-70% for the LPNs and existing senior debtholders, resulting in a recovery rating of '3' and an issue rating of 'B+'.

For the full recovery analysis, please see "OAO TMK Recovery Rating Profile", published on Nov. 7, 2011, on RatingsDirect on the Global Credit Portal.

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 closer to 3.0x (under our base-case EBITDA of about $1.0 billion-$1.1 billion).

Ratings upside could follow further improving financial results and credit metrics in 2012-2013, 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, unless otherwise stated.

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria Guidelines For Recovery Ratings On Global Industrials Issuers' Speculative-Grade Debt, Aug. 10, 2009
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Standard & Poor's Revises Its Approach To Rating Speculative-Grade Credits, May 13, 2008
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008

Additional Contact:
Industrial Ratings Europe; CorporateFinanceEurope@standardandpoors.com