STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

RatingsDirect®

Research Update:

Russian Steel Pipe Producer OAO TMK Outlook Revised To Negative On Weaker Margins; 'B+' and 'ruA' Ratings Affirmed

Primary Credit Analyst:
Svetlana Ashchepkova, Moscow +7 495 783-4014; svetlana.ashchepkova@standardandpoors.com

Secondary Contact:
Alexander Griaznov, Moscow (7) 495-783-4109; alexander.griaznov@standardandpoors.com

Table Of Contents

Research Update:

Russian Steel Pipe Producer OAO TMK Outlook Revised To Negative On Weaker Margins; 'B+' and 'ruA' Ratings Affirmed

Overview

- TMK's margins have weakened due to ruble depreciation, and we believe that potential weakening of Russian oil and gas market conditions in 2015 may put further pressure on profits.
- The company continues to have high debt with concentration of maturities in 2016 and we see a risk that its leverage will further increase in the next 12 months.
- We are therefore revising our outlook on TMK to negative from stable and affirming the 'B+' and 'ruA' ratings.
- The negative outlook reflects our view that TMK's leverage may further increase if market conditions in Russia and its key oil and gas end markets deteriorate.

Rating Action

On Nov. 10, 2014, Standard & Poor's Ratings Services revised its outlook on Russian steel pipe producer OAO TMK to negative from stable and affirmed its 'B+' long-term corporate credit rating on TMK. At the same time, we also affirmed the 'ruA' Russia national scale rating on TMK.

Rationale

The outlook revision reflects the weakening of TMK's margins in the first half of 2014, and the risk that this might persist through the second half and in 2015, leading to higher leverage. The company's ratio of adjusted debt to EBITDA had already increased to 5.1x as of June 30, 2014 (on an annualized basis), compared with 4.0x for full-year 2013. In addition, we see a risk that the company's liquidity may weaken, given the important concentration of debt maturities in 2016 (US$855 million in bank loans), as well as limited free operating cash flow (FOCF) and Russian issuers' currently constrained access to global financial markets.

TMK's Standard & Poor's-adjusted EBITDA margin, at about 12% in first-half 2014 versus 14%-15% in the full years of 2012 and 2013, has been largely affected by ongoing and significant ruble depreciation. This is because much of TMK's revenues comes from sales of pipes to Russian companies, mostly in the oil and gas sector, and is in rubles. At the same time, the cost of scrap and steel--the main feedstock--is partly foreign currency linked. At the same

1368421 | 302073238

time, we understand that part of TMK's contracts include partial adjustment for foreign exchange fluctuations, which should to some extent protect its margins from continuing ruble depreciation, although with a time lag.

Another risk we see is a potential reduction or delay of capital spending in the Russian oil and gas sector because of the lower crude oil price, which is currently below US$90 per barrel, and weaker access to funding. That said, we believe that the largest Russian oil and gas projects would likely not be hit by the changing oil price.

The rating continues to be supported by TMK's leading position in the Russian market and partial vertical integration in raw materials, as well as its diverse asset base with four integrated plants in Russia and 15 small and midsize plants internationally, mostly in the U.S. We also note TMK's broad product mix and strong demand for its higher-value-added premium pipe connections for the oil and gas industry, where there is certain potential for import substitution.

Additionally, TMK has completed its largest capital expenditure projects, and capital spending will now be contained at US$340 million-US$380 million per year (including moderate spending on mergers and acquisitions [M&A]), compared with US$380 million-US$440 million in 2011-2013. This should allow TMK to remain marginally FOCF positive in 2014-2015.

In our base case, we assume:

- Low-single-digit decline of volumes in 2014, but very gradual improvement starting from 2015 thanks to continuing projects and import substitution in Russia, and also due to stronger fundamentals in the U.S. market;
- Low-single-digit price decline in U.S. dollar terms in 2014-2015, given ruble depreciation in Russia, but taking into account a relatively more supportive price environment in the U.S.;
- Capital spending of US$340 million-US$380 million per year (including moderate M&A); and
- Dividends of US$35 million-US$50 million per year.

Based on these assumptions, we arrive at the following credit measures for TMK:

- An adjusted EBITDA margin of 12%-14% in 2014-2015, compared with 14.5% in 2013;
- Adjusted debt to EBITDA of between 4.0x-5.0x in 2014-2015 compared with 4.0x in 2013; and
- Marginally positive FOCF in 2014-2015 (compared with US$57 million in 2013).

According to our base case, we do not expect significant deleveraging in second-half 2014 through 2015 from the company's approximately US$3.7 billion adjusted debt on June 30, 2014.

We continue to apply a one-notch negative adjustment to our rating on TMK to reflect our comparable rating analysis, because some of its its credit metrics (in particular, funds from operations [FFO] to adjusted debt) are at the lower end of the "aggressive" category and we see a risk that they may decline further over the next 12 months.

We have revised our assessment of TMK's country risk to "high," in line with that of Russian Federation, because the share of EBITDA generated by the Russian assets has increased to more than 80% on the back of lower EBITDA of the U.S. assets in full-year 2013 through June 30, 2014, compared with about 70% previously. This doesn't affect our overall assessment of TMK's business risk profile, however.

Liquidity

We assess TMK's liquidity as "adequate," in accordance with our criteria. As of June 30, 2014, liquidity sources exceeded liquidity uses by 1.2x. We see a risk, however, that it may weaken to "less than adequate," if the company doesn't arrange additional funding and refinance part of its 2016 debt maturities well in advance.

Liquidity sources for the 12 months from June 30, 2014, include:

- About US$120 million of cash and equivalents;
- About US$600 million of undrawn long-term committed bank lines; and
- About US$450 million of FFO, as per our base case.

Liquidity uses for the same period include:

- About USD 525 million of short-term maturities, including US$328 million of convertible bonds due in February 2015;
- About US$200 million of capital spending, which we consider nondiscretionary; and
- About US$80 million of intrayear working capital outflow.

TMK has several maintenance covenants in its credit agreements. We understand that its key lenders have reset the covenants for full-year 2014 and TMK will likely remain compliant until year-end 2014. However, covenants tighten again in 2015. The company has a track record of proactive management of its financial covenants. If we see a near-term risk of a covenant breach, we will revise the company's liquidity to "less than adequate."

Outlook

The negative outlook on TMK reflects our view that the company's leverage may further increase if market conditions in Russia and its key oil and gas end markets deteriorate. Additionally, TMK is not fully protected from ruble depreciation, which negatively affects its margins.

Downside scenario

We would consider lowering our ratings on TMK if the company's adjusted debt to EBITDA increases to more than 5x or if it generates negative FOCF. We will also downgrade TMK if its liquidity weakens.

Upside scenario

We would revise the outlook to stable if the company manages to improve its margins and reduces the refinancing risk related to its high 2016 debt maturities. A debt-to-EBITDA ratio of 4.0x-5.0x under current market conditions would be commensurate with a 'B+' rating.

Ratings Score Snapshot

Corporate Credit Rating: B+/Negative/--

Business risk: Fair
- Country risk: High
- Industry risk: Intermediate
- Competitive position: Fair

Financial risk: Aggressive
- Cash flow/Leverage: Aggressive

Anchor: bb-

Modifiers
- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Negative (-1 notch)

Recovery Analysis

Key analytical factors

- TMK's US$500 million loan participation notes (LPNs) due 2018 issued through special-purpose vehicle TMK Capital S.A., its US$500 million LPNs due 2020 (also issued through TMK Capital), and its $413 million convertible bond due 2015 issued by TMK Bonds S.A. and guaranteed by parent company OAO TMK are rated 'B+' with a '3' recovery rating.
- The recovery rating is supported by TMK's substantial asset base and our view that the company would reorganize in the event of a default. However, we believe that TMK's complex capital structure, including an extensive array of debt facilities, the unsecured nature of the bonds, and Russia's less-creditor-friendly jurisdiction limit recovery prospects.
- The LPNs are secured by an assignment of rights over the loan to OAO TMK. Guarantors of the loan, accounting for more than 85% of group EBITDA, guarantee performance of all obligations under the loan. The convertible bond is unsecured, but shares the same guarantee package as the loan.

- In our simulated default scenario, we contemplate a default owing to TMK's inability to refinance following operating underperformance.

Simulated default assumptions

- Year of default: 2017
- EBITDA at emergence: $710 million
- Implied enterprise value multiple: 4.0x
- Jurisdiction: Russia

Simplified waterfall

- Gross enterprise value at default:$2.8 billion
- Administrative costs: $142 million
- Net value available to creditors: $2.7 billion
- ------------------------------------
- Priority claims: $74 million
- Secured debt claims: $1.39 billion*
- Unsecured debt claims: $2.3 billion*
- --Recovery expectation: 50%-70% (lower end of range)

*All debt amounts include six months of prepetition interest.

Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Jan. 2, 2014
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Key Credit Factors for the Capital Goods Industry, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria Guidelines For Recovery Ratings On Global Industrials Issuers' Speculative-Grade Debt, Aug. 10, 2009

Ratings List

Outlook Action; Ratings Affirmed

	To	From
OAO TMK		
Corporate Credit Rating	B+/Negative/--	B+/Stable/--

Ratings Affirmed

OAO TMK	
Russia National Scale	ruA/--/--
Senior Unsecured	B+
Recovery Rating	3
TMK Bonds S.A.	
Senior Unsecured*	B+

```
   Recovery Rating                       3

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

*Guaranteed by OAO TMK.
```

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

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.