# Management Discussion and Analysis
## of the financial position and results of operations

*for the year ended 31 December 2012*

**CONTENT**

## *Forward-looking statement*

*The following review of our financial position and results of operations is based on, and should be read in conjunction with, our consolidated financial statements and related notes for the year ended 31 December 2012.*

*Certain information, including our forecasts and strategy, contains forward-looking statements and is subject to risks and uncertainties, domestically and internationally. In assessing these forward-looking statements, readers should consider various risk factors as the company's actual results may differ materially from the expected results discussed in this report.*

## *Rounding*

*Certain monetary amounts, percentages and other figures included in this report are subject to rounding adjustments. On occasion, therefore, amounts shown in tables may not be the arithmetic accumulation of the figures that precede them, and figures expressed as percentages in the text and in tables may not total 100 percent. Changes for periods between monetary amounts are calculated based on the amounts in thousands of U.S. dollars stated in our consolidated financial statements, and then rounded to the nearest million or percent.*

## Executive overview

We are one of the leading global manufacturers and suppliers of tubular products for the energy industry, as well as other industrial applications. We are also Russia's leading manufacturer and supplier of steel pipe for the energy industry. The largest share of our shipments comprises high-margin oil-country tubular goods (OCTG). Our sales mix also includes OCTG pipes with the entire range of premium connections.

We sell our products worldwide to major oil and gas, automotive, engineering, and power generation companies, and provide oilfield services. Our operations are geographically diversified with manufacturing facilities in Russia, the United States, Canada, Romania, Kazakhstan and the Sultanate of Oman. We operate R&D centers in Russia and the U.S. Our global market presence is supported by a wide distribution network. In 2012, we delivered 55% of our tubular products to our customers located in Russia and 26% in North America. We estimate our share on global market of seamless OCTG at 10%.

According to our estimates, in 2012 Russian pipe market fell by 9% as a result of lower demand for welded large diameter (LD) pipe, offset to a certain extent by increased consumption of seamless OCTG and seamless line pipe. Our sales increased slightly year-on-year, and we retained our leading position in the Russian pipe market with a 25% market share.

We are the largest exporter of pipes in Russia. Exports of pipes produced by our Russian plants accounted for 19% of our total sales in 2012 as compared to 14% in 2011.

In 2012, we sold 4,238 thousand tonnes of steel pipes. Seamless pipes comprise more than half of our sales volumes. Sales of seamless and welded OCTG reached 1,722 thousand tonnes, a 12% year-on-year increase, whereas sales of LD pipe dropped by 33% to 408 thousand tonnes following the completion of major pipeline projects in the second half of 2011 and the postponement of new projects by our customers.

Our total consolidated revenue was relatively flat year-on-year at $6,688 million as compared to $6,754 million in 2011, despite a $318 million decrease due to the negative currency translation effect[1]. Adjusted EBITDA[2] declined to $1,040 million as compared to $1,050 million. Adjusted EBITDA margin stayed flat at 16%.

In the fourth quarter of 2012, our sales volumes were higher by 3% as compared to the previous quarter while our revenue increased from $1,617 million to $1,631 million. Adjusted EBITDA declined by 5% to $230 million from $243 million in the previous quarter, while adjusted EBITDA margin decreased from 15% to 14%.

## Key events

### *Product development*

In January, we developed and introduced vacuum insulated tubing (VIT), a technologically unique product offered by a limited number of producers globally.

In February, TMK PF ET premium connections successfully passed qualification tests in accordance with ISO 13679 CAL IV standard for 100% gas tightness under the application of total compression force. Completion of this certification serves as confirmation of the world quality level of our threads.

[1] The currency translation effect on income/expense items illustrates the influence of different exchange rates we use to convert these items from functional currencies into the presentation currency, the U.S. dollar, in different reporting periods for financial reporting purposes.
[2] Adjusted EBITDA - See "Selected financial data".

In March, we started production of 13-Chrome steel casing pipe. 13-Chrome steel pipes have unique characteristics that allow using them in various aggressive environments.

In May, we shipped casing with ULTRA™ FJ Premium connections to Lukoil and Gazprom. This premium product was patented by our American division and manufactured at our Orsky Machine Building Plant. The shipments of our premium product, new for the Russian market, confirm our commitment to offer top-quality innovative products to our strategic partners.

In July, our company signed agreements on technology cooperation with Gazprom for 2012−2015. The Sci-Tech cooperation programme concentrates on developing and delivering substitutes for imported product and new types of tubular products with high performance characteristics that would meet the advanced needs of OAO Gazprom.

In January 2013, we run casing pipes with TMK PF premium connections in the onshore and offshore parts of the well at NOVATEK's Yurkharovskoye gas field, beyond the Arctic Circle.

***Production capacity***

In March, TMK IPSCO started development of a new pipe threading and service facility in Edmonton, Canada. The state-of-the-art production equipment at the facility will thread a full range of ULTRA™ Premium connections. In addition, it will offer accessories, services and repairs of pipes. We started experimental-industrial exploitation of the facility in early 2013. It will expand TMK's local presence and enable us to better serve our customers in North America.

In July, our Orsky Machine Building Plant qualified for compliance of their quality management system that covers both the plant and OCTG production with the American Petroleum Institute (API) standard. A thread line for casing with premium connections was commissioned in October 2011.

In September, TMK-INOX commissioned a new line manufacturing stainless steel and alloy-based welded precision pipe. The new pipe shop produces high-quality products conforming to world-class samples and standards, which are in great demand with car manufacturers, food, energy, and construction companies. We plan that after reaching their full production capacity the lines will annually produce several thousand tonnes of high-tech welded stainless steel and alloy pipes.

In October, TMK IPSCO launched its research and development center in Houston, Texas. The new state-of-the-art R&D center serves as the heart of our company's innovation initiatives – new product design and development, experimental and validation testing, and advanced metallurgical research – and is a key part of our company's long-term strategy to strengthen our position in oil and gas markets.

***Dividends***

In June, the annual shareholders' meeting approved payment of a final dividend for 2011 in the amount of 2,531 million Russian roubles ($76 million at the exchange rate on the date of approval) or 2.70 Russian roubles ($0.08) per ordinary share, of which 201 million Russian roubles ($6 million at the exchange rate on the date of approval) related to treasury shares in possession of TMK Group.

In November, the extraordinary general shareholders' meeting approved an interim dividend payment for the first six months of 2012 of 1.5 Russian roubles ($0.05) per ordinary share in the amount of 1.4 billion Russian roubles ($44.8 million at the exchange rate on the date of approval).

***Acquisitions and joint ventures***

In December, we acquired a 55% stake in Gulf International Pipe Industry (GIPI) plant in the Sultanate of Oman. The plant's annual capacity exceeds 200,000 tonnes of welded OCTG and welded line pipe shipped to oil and gas companies operating in the Gulf Cooperation Council countries.

We also launched a service joint venture, Threading and Mechanical Key Premium LLC, with EMDAD in Abu Dhabi, the United Arab Emirates, one of the leading service and support companies for the oil and gas industry in the Arabian Gulf region. The center will focus on repair of pipes and underground equipment, as well as threading of connections on various components of pipe columns. Its annual production capacity is approximately 10,000 tonnes of premium pipe. The commissioning of the center is set for the middle of 2013.

The plant acquisition and the launch of the service center have allowed our company to expand in the Middle East.

## Business structure

Our operating segments reflect TMK's management structure and the way financial information is regularly reviewed. For management purposes, TMK is organised into business divisions based on geographical location and has three reporting segments:

- *Russian division*: manufacturing facilities located in the Russian Federation, Kazakhstan and the Sultanate of Oman, and oilfield service companies and trading companies in Russia, Kazakhstan, Switzerland, the United Arab Emirates and South Africa. The Russian division is engaged in the production and supply of seamless and welded pipe, premium products and the provision of related services to oil and gas companies;
- *American division*: manufacturing facilities and trading companies located in the United States and Canada. The American division is engaged in the production and supply of seamless and welded pipe and premium products, including ULTRA™ connections;
- *European division*: manufacturing facilities located in Romania and trading companies located in Italy and Germany. The European division is engaged in the production and supply of seamless pipe and steel billets.

## Fourth quarter 2012 results

### Results of operations

In the fourth quarter of 2012, our results of operations declined, mostly driven by the weaker results of the American division.

| | 4 quarter 2012 | 3 quarter 2012 | Change | Change |
|---|---|---|---|---|
| | *in million dollars* | | *in million dollars* | *in %* |
| Sales volume *(in thousand tonnes)* | **1,082** | 1,050 | 32 | 3% |
| Revenue | **1,631** | 1,617 | 14 | 1% |
| Cost of sales | **(1,300)** | (1,265) | (35) | 3% |
| **GROSS PROFIT** | **331** | 352 | (20) | (6)% |
| *GROSS PROFIT MARGIN* | ***20%*** | *22%* | - | - |
| Net operating expenses [1] | **(197)** | (204) | 7 | (3)% |
| Impairment of assets | **(8)** | - | (8) | (100)% |
| Foreign exchange gain, net | **5** | 13 | (8) | (61)% |
| (Loss) / gain on changes in fair value of derivative financial instrument | **(7)** | 1 | (8) | n/a |
| Finance costs, net | **(70)** | (68) | (3) | 4% |
| **INCOME BEFORE TAX** | **53** | 94 | (40) | (43)% |
| Income tax expense | **(22)** | (25) | 3 | (13)% |
| **NET INCOME** | **32** | 69 | (37) | (54)% |
| **NET INCOME ADJUSTED FOR GAIN ON CHANGES IN FAIR VALUE OF DERIVATIVE INSTRUMENT** [2] | **38** | 67 | (29) | (43)% |
| *ADJUSTED NET INCOME MARGIN* [3] | ***2%*** | *4%* | - | - |
| **ADJUSTED EBITDA** | **230** | 243 | (13) | (5)% |
| *ADJUSTED EBITDA MARGIN* | ***14%*** | *15%* | - | - |

[1] Net operating expenses include selling and distribution, general and administrative, advertising and promotion, research and development, share of profit in associate, and net other operating expenses.
[2] For the purposes of this report, net income has been adjusted for the (loss) / gain on changes in fair value of the derivative financial instrument to reflect management's opinion in respect of the treatment of the conversion option (see "Change in fair value of derivative financial instrument"). We consider it an important supplemental measure of our performance.
[3] Adjusted net income margin is calculated as the quotient of Net Income adjusted for (loss) / gain on changes in fair value of derivative instrument divided by Revenue.

## Sales

Our revenue was relatively flat quarter-on-quarter. The unfavourable changes in seamless pipe pricing in our American division were offset by higher volumes of *welded LD* pipe in the Russian division, and the favourable currency translation effect.

Sales by reporting segments are as follows:

| | 4 quarter 2012 | 3 quarter 2012 | Change | Change |
|---|---|---|---|---|
| | *in million dollars* | | *in million dollars* | *in %* |
| Russia | **1,212** | 1,132 | 81 | 7% |
| America | **352** | 410 | (58) | (14)% |
| Europe | **67** | 75 | (8) | (11)% |
| **REVENUE** | **1,631** | 1,617 | 14 | 1% |

| | *in thousand tonnes* | | *in thousand tonnes* | *in %* |
|---|---|---|---|---|
| Russia | **826** | 797 | 29 | 4% |
| America | **211** | 214 | (3) | (1)% |
| Europe | **45** | 39 | 6 | 15% |
| **TOTAL PIPE** | **1,082** | 1,050 | 32 | 3% |

Sales by group of products are as follows:

| | 4 quarter 2012 | 3 quarter 2012 | Change | Change |
|---|---|---|---|---|
| | *in million dollars* | | *in million dollars* | *in %* |
| Seamless pipe | **999** | 993 | 6 | 1% |
| Welded pipe | **568** | 547 | 22 | 4% |
| **TOTAL PIPE** | **1,567** | 1,540 | 27 | 2% |
| Other operations | **65** | 77 | (13) | (17)% |
| **TOTAL REVENUE** | **1,631** | 1,617 | 14 | 1% |

| | *in thousand tonnes* | | *in thousand tonnes* | *in %* |
|---|---|---|---|---|
| Seamless pipe | **619** | 604 | 15 | 2% |
| Welded pipe | **463** | 446 | 17 | 4% |
| **TOTAL PIPE** | **1,082** | 1,050 | 32 | 3% |

***Russia.*** The division's revenue was up by 7% or $81 million, including a $37 million increase from the currency translation effect.

Revenue from sales of *seamless* pipe stayed relatively flat, as higher volumes of *seamless OCTG* were offset by lower volumes of *seamless industrial* pipe and worsened *seamless OCTG* sales mix.

Revenue from *welded* pipe sales was up by $36 million on higher volumes of *welded LD* pipe driven by our company's involvement, among other projects, in supplies for the construction of the Russian on-shore section of the South Stream pipeline.

***America.*** Revenue decreased by 14% or $58 million, reflecting a drop in revenue of *seamless* and *welded* pipe by $26 million and $25 million, respectively. The division's revenue dropped mainly as a result of reduction in prices across all product lines following declining rig count and temporary drop in demand as customers increasingly used their inventory and delayed purchases of the new stock, with reduction in *seamless OCTG* having the most significant effect.

***Europe***. Throughout the year, the European market was challenging, with weak demand and growing competition. We have managed to increase sales of *seamless industrial* pipe, yet sales of *steel billets* dropped dramatically. Besides, declining prices for all our product lines adversely affected revenue. As a result, the European division's revenue declined by 11% or $8 million. The currency translation effect was marginal.

## Gross profit

Our consolidated gross profit decreased by 6% or $20 million, mostly reflecting the results of operations in our American division. Gross profit margin was 20% as compared to 22% in the previous quarter.

Gross profit results by reporting segments are as follows:

| | 4 quarter 2012 | | 3 quarter 2012 | | Change |
|---|---|---|---|---|---|
| | *in million dollars* | *in %* | *in million dollars* | *in %* | *in million dollars* |
| Russia | **277** | **23%** | 282 | 25% | (5) |
| America | **42** | **12%** | 54 | 13% | (12) |
| Europe | **13** | **19%** | 16 | 21% | (3) |
| **GROSS PROFIT** | **331** | **20%** | 352 | 22% | (20) |

Gross profit results by group of products are as follows:

| | 4 quarter 2012 | | 3 quarter 2012 | | Change |
|---|---|---|---|---|---|
| | *in million dollars* | *in %* | *in million dollars* | *in %* | *in million dollars* |
| Seamless pipe | **246** | **25%** | 240 | 24% | 7 |
| Welded pipe | **72** | **13%** | 101 | 19% | (29) |
| **TOTAL PIPE** | **318** | **20%** | 341 | 22% | (23) |
| Other operations | **13** | **20%** | 10 | 13% | 3 |
| **GROSS PROFIT** | **331** | **20%** | 352 | 22% | (20) |

***Russia.*** The division's gross profit decreased by $5 million, while gross profit margin dropped from 25% to 23%. The effect of currency translation accounted for a $9 million increase in gross profit.

Despite higher sales volumes of *welded LD* pipe gross profit of *welded* pipe declined by $28 million mainly as result of worsened *welded LD* sales mix due to completion of deliveries for certain high-margin projects in CIS.

Gross profit of *seamless* pipe increased by $5 million on higher sales of *seamless OCTG*. Profitability of *seamless* pipe remained flat.

***America.*** Gross profit was lower by 22%, reflecting the decrease in gross profit of *seamless* and *welded* pipe by $6 million and $3 million, respectively, as a result of the following factors: (i) lower volumes and unfavorable pricing attributed to all *welded* tubular products partially offset by favourable sales mix due to improved volume of higher priced *welded OCTG*, and (ii) unfavourable pricing across all product lines of *seamless* pipe, however, partially offset by higher volumes. As a result, gross profit margin declined from 13% to 12%.

***Europe.*** Gross profit decreased by 19% or $3 million, reflecting lower gross profit of *steel billets* due to the weak market environment in the E.U. Gross profit of *seamless industrial* pipe was relatively flat. The currency translation effect was marginal. As a result, gross profit margin declined from 21% to 19%.

## Net operating expenses

Net operating expenses comprise selling, general and administrative, research and development, and other income and expenses.

In the fourth quarter of 2012, net operating expenses decreased by 3% or $7 million primarily because of the decline in freight cost as a result of lower share of sales with long distance delivery terms. The share of net operating expenses, expressed as a percentage of revenue, decreased to 12% from 13%.

The currency translation effect amounted to a $4 million increase in net operating expenses.

## Adjusted EBITDA

In the fourth quarter of 2012, adjusted EBITDA decreased by 5% or $13 million; adjusted EBITDA margin declined from 15% to 14%.

| | 4 quarter 2012 | | 3 quarter 2012 | | Change |
|---|---|---|---|---|---|
| | *in million dollars* | *in %* | *in million dollars* | *in %* | *in million dollars* |
| Russia | **195** | **16%** | 190 | 17% | 4 |
| America | **26** | **7%** | 42 | 10% | (16) |
| Europe | **9** | **14%** | 10 | 14% | (1) |
| **Adjusted EBITDA** | **230** | **14%** | 243 | 15% | (13) |

***Russia.*** Adjusted EBITDA increased by 2% or $4 million, mainly as a result of a slight decrease in selling, general and administrative expenses. Adjusted EBITDA margin was down from 17% to 16%.

***America.*** Adjusted EBITDA went down by 38% or $16 million mainly on lower gross profit. Adjusted EBITDA margin dropped from 10% to 7%, reflecting a higher selling, general and administrative expenses as a percentage of revenue.

***Europe.*** Adjusted EBITDA declined by 14% or $1 million following the decrease in gross profit. Adjusted EBITDA margin remained at the level of the previous quarter, primarily on lower selling, general and administrative expenses as a percentage of revenue.

## Impairment of assets

As of 31 December 2012, we determined in respect of certain non-production assets in the Russian division that the carrying value of cash-generating unit exceeded its value in use. As a result, we recognised the impairment of these assets in the amount of $8 million.

## Foreign exchange movements

In the fourth quarter, we recorded a $5 million foreign exchange gain as compared to a $13 million gain recognised in the previous quarter. We also recognised a foreign exchange gain from exchange rate fluctuations in the amount of $15 million (net of income tax) in the fourth quarter as compared to a $52 million (net of income tax) in the third quarter in the statement of other comprehensive income. The amount in the statement of comprehensive income represents the effective portion of foreign exchange gains or losses on our hedging instruments.

## Net finance costs

In the fourth quarter of 2012, our finance costs increased by 4% or $3 million as compared to the previous quarter substantially due to the currency translation effect. As of 31 December 2012, the weighted average nominal interest rate for our loans and borrowings decreased to 6.99%, which is a 1 basis point lower compared to the rate at 30 September 2012.

In the fourth quarter of 2012, our finance income remained flat.

As a result, our net finance costs increased by 4% or $3 million.

## Cash flows

The following table illustrates our cash flows for the periods presented:

| | 4 quarter 2012 | 3 quarter 2012 | Change | Change |
|---|---|---|---|---|
| | *in million dollars* | | *in million dollars* | *in %* |
| **Net cash provided by operating activities** | **390** | 226 | 164 | 72% |
| Payments for property and equipment | **(138)** | (109) | (29) | 27% |
| Acquisition of subsidiaries | **(27)** | (1) | (26) | n/a |
| Dividends received | **3** | 6 | (3) | (45)% |
| Other investments | **4** | 2 | 2 | 73%[1] |
| **Free Cash Flow[2]** | **232** | 125 | 107 | 86% |
| Change in loans | **(75)** | 1 | (76) | n/a |
| Interest paid | **(60)** | (70) | 10 | (14)% |
| Other financial activities | **6** | (2) | 8 | n/a |
| **Free Cash Flow to Equity[2]** | **104** | 54 | 49 | 91% |
| Dividends paid | **(8)** | (71) | 63 | (88)% |
| Effect of exchange rate changes | **3** | 6 | (2) | (44)% |
| Cash and cash equivalents at the beginning of period | **127** | 137 | (11) | (8)% |
| Cash and cash equivalents at period end | **225** | 127 | 99 | 78% |

Net cash flows provided by operating activities substantially increased, primarily due to a $176 million decrease in working capital in the fourth quarter of 2012, as compared to the $17 decrease in the third quarter of 2012.

Cash spent for acquisition of subsidiaries in the fourth quarter of 2012 relates to the acquisition of 55% of the voting shares of Gulf International Pipe Industry LLC, a company based in the Sultanate of Oman and specialising in the manufacturing of welded steel pipes.

In the fourth quarter of 2012, we paid $8 million of the interim dividend in respect of the six months of 2012 to the shareholders of OAO TMK. In the third quarter of 2012, we paid $68 million of the final dividend in respect of 2011 to the shareholders of OAO TMK.

## Net debt

With almost half of the debt portfolio denominated in the Russian rouble, our total debt is highly sensitive to exchange rates volatility. In the fourth quarter 2012 our total debt increased from $3,816 million to $3,885 million as a result of the appreciation of the Rouble against the U.S. dollar and acquisition of a subsidiary with a $98 million debt on its balance, while net repayment amounted to $75 million (including partial repayment of the acquired subsidiary's debt). At the same time our net debt[3] decreased by $30 million because of the significant growth of the cash balance at the end of the year. As a result, our Net debt-to-EBITDA ratio[1] improved to 3.5.

1 Please refer to "Rounding" for the details of calculation.

2 Free Cash Flow and Free Cash Flow to Equity are non-IFRS measures of financial performance, and they should not be considered as an alternative to cash flow from operating activities or as a measure of our liquidity. Other companies in the pipe industry may calculate Free Cash Flow and Free Cash Flow to Equity differently and therefore comparability may be limited.

3 For Net Debt and Adjusted EBITDA, please, refer to "Selected financial data". Net-Debt-to-EBITDA ratio is defined as the quotient of Net Debt at the end of the given reporting date divided by Adjusted EBITDA for the 12 months immediately preceding the given reporting date.

## Year ended 31 December 2012 results

### Results of operations

Our revenue, gross profit, and EBITDA have not changed significantly year-on-year. Net profit in 2012 was substantially lower as a result of the impairment of assets and changes in fair value of the derivative financial instrument. However, profitability ratios remained relatively flat.

| | 2012 | 2011 | Change | Change |
|---|---|---|---|---|
| | *in million dollars* | | *in million dollars* | *in %* |
| Sales volume *(in thousand tonnes)* | **4,238** | 4,185 | 53 | 1% |
| Revenue | **6,688** | 6,754 | (66) | (1)% |
| Cost of sales | **(5,204)** | (5,307) | 103 | (2)% |
| **GROSS PROFIT** | **1,483** | 1,446 | 37 | 3% |
| *GROSS PROFIT MARGIN* | ***22%*** | *21%* | - | - |
| Net operating expenses [1] | **(811)** | (743) | (68) | 9% |
| (Impairment) / Reversal of impairment of assets | **(8)** | 68 | (77) | n/a |
| Foreign exchange gain/(loss), net | **23** | (1) | 24 | n/a |
| (Loss)/gain on changes in fair value of derivative financial instrument | **(7)** | 45 | (52) | n/a |
| Finance costs, net | **(275)** | (271) | (4) | 1% |
| **INCOME BEFORE TAX** | **405** | 544 | (139) | (26)% |
| Income tax expense | **(123)** | (159) | 37 | (23)% |
| **NET INCOME** | **282** | 385 | (103) | (27)% |
| **NET INCOME ADJUSTED FOR GAIN/(LOSS) ON CHANGES IN FAIR VALUE OF DERIVATIVE INSTRUMENT** [2] | **290** | 340 | (50) | (15)% |
| *ADJUSTED NET INCOME MARGIN* [3] | ***4%*** | *5%* | - | - |
| **ADJUSTED EBITDA** | **1,040** | 1,050 | (10) | (1)% |
| *ADJUSTED EBITDA MARGIN* | ***16%*** | *16%* | - | - |

[1] Net operating expenses include selling and distribution, general and administrative, advertising and promotion, research and development, impairment of goodwill, share of loss in associate, gain on disposal of assets held for sale and net other operating income/(expense).

[2] For the purposes of this report, net income has been adjusted for gain or loss on changes in fair value of the derivative financial instrument to reflect management's opinion in respect of the treatment of the conversion option (see "Change in fair value of derivative financial instrument"). We consider it an important supplemental measure of our performance.

[3] Adjusted net income margin is calculated as the quotient of Net Income adjusted for gain or loss on changes in the fair value of derivative instrument divided by Revenue.

## Sales

In 2012, our consolidated revenue decreased as a result of the negative currency translation effect. Excluding the unfavourable currency translation impact of $318 million, total revenue growth is $252 million.

Sales by reporting segments are as follows:

| | 2012 | 2011 | Change | Change |
|---|---|---|---|---|
| | *in million dollars* | | *in millions dollars* | *in %* |
| Russia | **4,714** | 4,788 | (74) | (2)% |
| America | **1,650** | 1,590 | 60 | 4% |
| Europe | **324** | 375 | (51) | (14)% |
| **TOTAL REVENUE** | **6,688** | 6,754 | (66) | (1)% |

| | 2012 | 2011 | Change | Change |
|---|---|---|---|---|
| | *in thousand tonnes* | | *in thousand tonnes* | *in %* |
| Russia | **3,159** | 3,115 | 44 | 1% |
| America | **903** | 892 | 11 | 1% |
| Europe | **176** | 178 | (2) | (1)% |
| **TOTAL PIPE** | **4,238** | 4,185 | 53 | 1% |

Sales by group of products are as follows:

| | 2012 | 2011 | Change | Change |
|---|---|---|---|---|
| | *in million dollars* | | *in millions dollars* | *in %* |
| Seamless pipe | **4,134** | 3,911 | 224 | 6% |
| Welded pipe | **2,257** | 2,536 | (279) | (11)% |
| **TOTAL PIPE** | **6,391** | 6,446 | (55) | (1)% |
| Other operations | **296** | 307 | (11) | (4)% |
| **TOTAL REVENUE** | **6,688** | 6,754 | (66) | (1)% |

| | 2012 | 2011 | Change | Change |
|---|---|---|---|---|
| | *in thousand tonnes* | | *in thousand tonnes* | *in %* |
| Seamless pipe | **2,495** | 2,342 | 153 | 7% |
| Welded pipe | **1,743** | 1,843 | (100) | (5)% |
| **TOTAL PIPE** | **4,238** | 4,185 | 53 | 1% |

***Russia***. The division's revenue decreased by 2% or $74 million year-on-year, primarily because of the negative currency translation effect in the amount of $274 million.

Sales of *seamless* pipe increased by $435 million mainly due to higher demand from Russian oil and gas companies driving an increase in sales volumes. Better pricing and sales mix, especially an increase in share of *seamless OCTG,* also had a significant positive effect on the revenue dynamics.

Revenue from sales of *welded* pipe decreased by $231 million on lower volumes and unfavourable sales mix as a result of an expected decrease in demand for *LD* pipe after completion of major pipeline projects and the postponement of new projects by our customers.

***America.*** In the American division, revenue increased by 4% or $60 million year-on-year.

Sales of *welded* pipe increased by $33 million on higher volumes of primarily *welded OCTG* and *welded line* pipe due to favourable market conditions in the U.S. in the first half of 2012.

In spite of a decline in sales volumes of *seamless* pipe, revenue from sales of this group of products was higher by $3 million, reflecting a favourable changes in sales mix, particularly higher share of *seamless OCTG*. Prices mostly stayed flat year-on-year as a result of a growth in the first half and a decrease in the second half of 2012.

Revenue from other operations, mainly from premium threading services and sales of fishing tools, increased by $24 million.

***Europe.*** In the European division, revenue decreased by 14% or $51 million year-on-year, primarily on the unfavourable currency translation effect and weaker pricing.

Revenue from sales of *seamless industrial* pipe increased by $6 million as compared to the last year. The adverse effect from lower volumes and unfavourable pricing in the weak E.U. market was compensated by improved sales mix as we sold more expensive pipe to the customers in North America in the first half of 2012.

Revenue from other operations, mostly from sales of *steel billets*, declined by $13 million as compared to last year as a result of the worsening market environment in the second half of the year.

## Gross profit

In 2012, our consolidated gross profit amounted to $1,483 million, a 3% increase as compared to last year, despite the unfavourable currency translation effect of $76 million. Gross profit margin improved to 22%.

Gross profit results by reporting segments are as follows:

| | 2012 | | 2011 | | Change |
|---|---|---|---|---|---|
| | *in million dollars* | *in %* | *in million dollars* | *in %* | *in million dollars* |
| Russia | **1,124** | **24%** | 1,036 | 22% | 88 |
| America | **285** | **17%** | 311 | 20% | (26) |
| Europe | **75** | **23%** | 100 | 27% | (25) |
| **TOTAL GROSS PROFIT** | **1,483** | **22%** | 1,446 | 21% | 37 |

Gross profit results by group of products are as follows:

| | 2012 | | 2011 | | Change |
|---|---|---|---|---|---|
| | *in million dollars* | *in %* | *in million dollars* | *in %* | *in million dollars* |
| Seamless pipe | **1,088** | **26%** | 1,074 | 28% | 14 |
| Welded pipe | **343** | **15%** | 344 | 14% | (1) |
| **TOTAL PIPE** | **1,431** | **22%** | 1,418 | 22% | 13 |
| Other operations | **52** | **18%** | 29 | 9% | 24 |
| **TOTAL GROSS PROFIT** | **1,483** | **22%** | 1,446 | 21% | 37 |

***Russia.*** The division's gross profit increased by $88 million, despite a $65 million negative currency translation effect. Gross profit margin improved from 22% to 24%.

Gross profit of *seamless* pipe increased by $122 million, to a large extent driven by higher volumes of *seamless OCTG*. Profitability of *seamless* pipe stayed flat.

Gross profit of *welded* pipe increased by $8 million. The adverse effect from drop in sales of *welded* pipe, specifically *LD* pipe, was fully compensated by improved profitability, following a significant drop in the average purchase price for steel coil.

Gross profit from other operations increased by $23 million.

***America.*** The American division's gross profit decreased by $26 million as compared to 2011; gross profit margin declined to 17% from 20%, primarily reflecting a negative sales mix impact from growth in sales of lower-margin *welded* pipe as opposed to drop in sales of higher-margin *seamless* pipe, and a decline in gross profit margin of *seamless* pipe.

Gross profit of *welded* pipe increased by $6 million as result of slight growth in sales volumes and prices, and changes in sales mix. Profitability was relatively flat.

Growth in the average cost per tonne of *seamless* pipe outpaced growth in the average selling price, and together with declining volumes of *seamless* pipe resulted in a $41 million decline in gross profit. Profitability was affected by higher fixed costs absorption.

Gross profit from other operations increased by $8 million mainly due to higher volume of premium threading services and higher sales of fishing tools.

***Europe.*** Given the weak trends in the E.U. market, gross profit in the European division decreased by $25 million; profitability decreased from 27% to 23%. The currency translation effect provided a $10 million decrease in gross profit.

## Net operating expenses

Net operating expenses were higher by 9% or $68 million; the share of net operating expenses, expressed as a percentage of revenue, increased to 12% from 11%.

The increase in net operating expenses was primarily due to a $52 million growth in freight costs in the Russian division as a result of increased transportation tariffs and higher share of sales with long distance delivery terms. Our staff costs rose by $18 million. Other expenses growth by $16 million was due to losses on disposal of certain items of property, plant and equipment.

In addition, in 2011, we received a $19 million gain from sale of TMK Hydroenergy Power S.R.L., which reduced our net operating expenses for the period. No such gain was recognised in 2012.

The currency translation effect accounted for a $38 million decrease in net operating expenses.

## Adjusted EBITDA

In 2012, adjusted EBITDA margin remained flat at 16%.

| | 2012 | | 2011 | | Change |
|---|---|---|---|---|---|
| | *in million dollars* | *in %* | *in million dollars* | *in %* | *in million dollars* |
| Russia | **766** | **16%** | 721 | 15% | 45 |
| America | **222** | **13%** | 265 | 17% | (43) |
| Europe | **52** | **16%** | 64 | 17% | (12) |
| **TOTAL ADJUSTED EBITDA** | **1,040** | **16%** | 1,050 | 16% | (10) |

***Russia.*** Adjusted EBITDA was higher by 6% or $45 million. Gross profit increase of $88 million was partially offset by increase in selling, general and administrative expenses. Adjusted EBITDA margin increased from 15% to 16%.

***America.*** Adjusted EBITDA decreased by 16% or $43 million as a result of both lower gross profit and higher other operating expenses. Adjusted EBITDA margin declined from 17% to 13%.

***Europe.*** Adjusted EBITDA decrease by 19% or $12 million. Gross profit increase of $25 million was partially offset by increase in selling, general and administrative expenses. Adjusted EBITDA margin dropped from 17% to 16%.

## Impairment of assets

As of 31 December 2012, we determined in respect of certain non-production assets in the Russian division that the carrying value of cash-generating unit exceeded its value in use. As a result, we recognised the impairment of these assets in the amount of $8 million.

As of 31 December 2011, we determined that the value in use of the European division cash-generating unit significantly exceeded its carrying value. As a result, we reversed the impairment loss recognised in 2008 and 2009 in respect of property, plant and equipment of the European division in the amount of $73 million.

## Foreign exchange movements

In 2012, we recorded a foreign exchange gain in the amount of $23 million as compared to a $1 million loss in 2011. In addition, we recognised a foreign exchange gain from exchange rate fluctuations in the amount of $48 million (net of income tax) in 2012 as compared to a $54 million loss (net of income tax) in 2011 in the statement of other comprehensive income. The amount in the statement of comprehensive income represents the effective portion of foreign exchange gains or losses on our hedging instruments.

## Net finance costs

Finance costs decreased by 2% or $6 million as result of the repayment of part of the debts in 2012 and the currency translation effect. At the same time, the weighted average nominal interest rate remained relatively flat at 6.92% as of 31 December 2011 as compared to 6.99% as of 31 December 2012.

Finance income decreased by 30% or $10 million due to a decrease in dividend income from an investee.

As a result, our net finance costs increased by 1% or $4 million year-on-year.

## Income tax

TMK, as a global company with production facilities and trading companies located in Russia, the CIS, the United States, and Europe, is exposed to local taxes charged to businesses. In 2011 and 2012, the following corporate income tax rates were in force in the countries where our production facilities are located: 20% in Russia, 35% (federal rate) in the United States and 16% in Romania.

In 2012, a pre-tax income of $405 million was reported as compared to $544 million in 2011; an income tax expense of $123 million was recognised as compared to $159 million in 2011. Our effective income tax rate increased by 1% to 30% year-on-year.

## Cash flows

The following table illustrates our cash flows:

| | 2012 | 2011 | Change | Change |
|---|---|---|---|---|
| | *in million dollars* | | *in million dollars* | *in %* |
| **Net cash provided by operating activities** | **929** | 787 | 141 | 18% |
| Payments for property and equipment | **(445)** | (402) | (43) | 11% |
| Acquisition of subsidiaries | **(33)** | (4) | (29) | n/a |
| Dividends received | **14** | 25 | (11) | (44)% |
| Other investments | **9** | 4 | 5 | 147%[1] |
| **Free Cash Flow** | **474** | 410 | 64 | 16% |
| Change in loans | **(148)** | 4 | (152) | n/a |
| Interest paid | **(263)** | (286) | 23 | (8)% |
| Other financial activities | **1** | (4) | 5 | n/a |
| **Free Cash Flow to Equity** | **64** | 124 | (60) | (48%) |
| Dividends paid | **(79)** | (49) | (30) | 62% |
| Effect of exchange rate changes | **10** | (2) | 12 | n/a |
| Cash and cash equivalents at the beginning of period | **231** | 158 | 73 | 46% |
| Cash and cash equivalents at period end | **225** | 231 | (6) | (2)% |

Net cash flows provided by operating activities increased by 18% to $929 million from $787 million in 2011, mainly due to a much higher increase in working capital in 2011 as compared to the moderate growth in 2012. In 2012, working capital increased by $34 million, while in 2011 it grew by $156 million.

A net repayment of borrowings totalled $148 million as compared to $4 million of net proceeds from borrowings last year.

1 Please refer to "Rounding" for the details of calculation

Cash spent for acquisition of subsidiaries in 2012 relates primarily to the acquisition of 55% of the voting shares of Gulf International Pipe Industry LLC, a company based in the Sultanate of Oman and specialising in the manufacturing of welded steel pipes.

In 2012, we paid a full year dividend in respect of 2011 and interim dividend in respect of the first half of 2012 in the total amount of $76 million to the shareholders of OAO TMK. In 2011, we paid a full year dividend in respect of 2010 and an interim dividend in respect of the first half of 2011 in the total amount of $47 million. We paid dividends in the amount of $3 million and $2 million to our non-controlling interest owners in 2012 and 2011, respectively.

## Indebtedness

The following table illustrates the maturity profile of our total financial debt:

| | 1 year or less | 1 to 3 years | Over 3 years | Unamortised debt issue costs | Total debt |
|---|---|---|---|---|---|
| | | | *in millions of U.S. dollars* | | |
| As of 31 December 2012 | 1,073 | 1,351 | 1,474 | (14) | 3,885 |
| As of 31 December 2011 | 602 | 1,468 | 1,740 | (23) | 3,787 |

Our overall financial debt increased from $3,787 million as of 31 December 2011 to $3,885 million as of 31 December 2012. The appreciation of the Rouble against the U.S. dollar resulted in an increase of the U.S. dollar equivalent of the Rouble-denominated loans and borrowings as of December 31, 2012. The acquisition of a subsidiary with a $98 million debt on its balance also increased our debt. During 2012, the net repayment of loans and borrowings was $148 million (including partial repayment of the acquired subsidiary's debt).

As of 31 December 2012, our debt portfolio comprised diversified debt instruments, including bank loans, bonds, convertible bonds, and other credit facilities. As of 31 December 2012, our Rouble-denominated portion of debt represented 46%, the U.S. dollar-denominated portion of debt represented 48%, euro-denominated portion of debt represented 5%, and other currencies represented less than 1% of our total debt.

The share of short-term portion of debt increased to 27% as of 31 December 2012 as compared to 16% as of 31 December 2011, as the convertible bond liability was included in our short-term portion of debt as of 31 December 2012 due to the bondholders' right to request redemption of convertible bonds on the third anniversary following the issue date. However at the time of the issuance of this management discussion and analysis, we are aware that no bondholders have executed or will execute their rights to request redemption of the bonds[1], and at the closest reporting date the convertible bonds will be classified as the long-term liability.

As of 31 December 2012, our debt portfolio comprised fixed and floating interest rate debt facilities. Borrowings with a floating interest rate represented $667 million or 17% of total debt, and borrowings with a fixed interest rate represented $3,165 million or 83% of our total debt.

As of 31 December of 2012, our weighted average nominal interest rate was 6.99%, which was a 7 basis point increase compared to 31 December 2011.

[1] According to IAS 10 "Events after the Reporting Period", this is a non-adjusting event.

Our most significant credit facilities as of 31 December 2012 were as follows:

| Type of borrowing | Bank | Original currency | Outstanding principal amount | Maturity period |
|---|---|---|---|---|
| | | | *in millions of U.S. dollars* | |
| 7.75% LPN | | USD | 500 | January 2018 |
| Loan | Sberbank of Russia | RUR | 489 | September 2015 |
| 5.25% convertible bonds | | USD | 413 | February 2015 |
| Loan | Gazprombank | USD | 400 | January 2017 |
| Loan | Alfa-Bank | RUR | 336 | November 2016 |
| Loan | Nordea Bank | USD | 200 | January 2017 |
| Bonds, series БО-01 | | RUR | 165 | October 2013 |
| Loan | Gazprombank | RUR | 151 | March 2014 |
| Loan | Sberbank of Russia | RUR | 145 | April 2016 |
| Loan | Wells Fargo | USD | 121 | August 2016 |
| Loan | Gazprombank | RUR | 113 | February 2014 |
| Loan | Gazprombank | RUR | 112 | January 2014 |
| | | | **3,143** | |
| Other credit facilities | | | 674 | |
| **TOTAL LOANS AND BORROWINGS** | | | **3,817** | |

## Capital expenditure

Throughout the year, we continued our strategic capital expenditure programme, which focused principally on increasing our share of high value-added products, enhancing our production capacity for premium products, and reducing unit costs.

| | 2012 | 2011 | Change | Change |
|---|---|---|---|---|
| | *in million dollars* | | *in millions dollars* | *in %* |
| Russia | 347 | 248 | 99 | 40% |
| America | **95** | 64 | 31 | 48% |
| Europe | **45** | 14 | 31 | 223% |
| **CAPITAL EXPENDITURE** | **487** | 326 | 161 | 49% |

The majority of the strategic capital projects are undertaken in the Russian division. Our key projects are:

- ongoing replacement of the open hearth furnaces with EAF steelmaking facilities at TAGMET in order to reduce steel-making costs and increase an annual billet-production capacity. Commissioning is planned in 2013;
- ongoing construction of a new Fine Quality Mill ("FQM") at STZ. Commissioning is planned in 2014.

At the same time, we implement several less expensive projects which also help us to maintain our production flexibility, efficiency and to sustain competitive advantage:

- installation of additional non-destructive testing instrumentation, the new hydro-press and pipe-threading facilities at SinTZ as part of their programme to improve the quality of OCTG. The project is planned to be completed in 2013;
- construction of the mill for production of stainless steel seamless pipe measuring up to 30 meters in length at TMK-INOX. The project completion is scheduled at the end of 2013;
- construction of the new line for coating application at TMK Oilfield Services. The project is planned to be completed in 2013.

During 2012, we completed some projects including:

- modernisation of the longitudinally welded large diameter pipe mill at VTZ. It has significantly enhanced our production capacity for high grade welded pipe;
- modernisation of a hot-rolled mill at VTZ was completed in late 2012. It has significantly enhanced production capacity for hot-rolled pipe at VTZ and increased the quality of pipe produced;
- a new line to produce premium threaded casing was constructed at our Orsk Machine-Building Plant. The line was commissioned in the third quarter of 2012.

The following projects will enable TMK IPSCO to strengthen its position in the segment of premium connections for horizontal and directional drilling in North America:

- launch of the research and development center in Houston, Texas in October 2012. The new state-of-the-art R&D center serves as the heart of our company's innovation initiatives – new product design and development, experimental and validation testing, and advanced metallurgical research;
- consolidation of threading operations at the production facility located in Odessa, TX is underway. The project completion is scheduled for 2013;
- development of a new pipe threading and service facility in Edmonton, Canada. The state-of-the-art production equipment at the facility will thread a full range of ULTRA™ Premium connections. The facility commissioning is planned in early 2013.

At the same time, TMK IPSCO continues to improve cost efficiency and increase production capacities. The following projects, among others, serve this purpose:

- installation of a slitting line in Wilder, KY. The line was commissioned in the second half of 2012;
- launch of a programme to expand finishing capacities at Koppel, PA, including heat treatment and, nondestructive testing. The project completion is scheduled for 2014.

During 2012, TMK-RESITA completed renovation of gas cleaner facilities as part of its environmental protection programme.

TMK-ARTROM launched a programme to increase the share of high value added product sales. Under this project, construction of a new pipe finishing shop was completed in 2012.

**Development trends**

In early 2013, the Russian division sees a strong order backlog for the beginning of the year, particularly in OCTG and line pipe, as a result of growing exploration and production activity of oil and gas companies. However, the drilling environment in the U.S. and economic conditions in Europe remain challenging, and therefore the Company conservatively expects the results of the first quarter of 2013 to be approximately in line with the results of the fourth quarter of 2012.

Given the anticipated improvements in the subsequent quarters of 2013 the Company expects to compensate slower pace of the first quarter of 2013 with better operational performance for the remainder of the year to be in line with the 2012 results with some upside potential.

## Selected financial data

### Adjusted EBITDA

Reconciliation of income before tax to Adjusted EBITDA for the twelve months ended:

| | 31 December 2012 | 30 September 2012 | 30 June 2012 | 31 March 2012 | 31 December 2011 |
|---|---|---|---|---|---|
| | | | *in million dollars* | | |
| Income before tax | **405** | 497 | 442 | 539 | 544 |
| Depreciation and amortisation | **326** | 322 | 327 | 335 | 336 |
| Finance costs, net | **275** | 265 | 263 | 274 | 271 |
| Impairment of assets/(Reversal of impairment of assets) | **8** | (72) | (72) | (68) | (68) |
| Loss/(gain) on changes in fair value of derivative financial instrument | **7** | 0 | (27) | (53) | (45) |
| Foreign exchange (gain)/loss, net | **(23)** | (21) | 29 | 3 | 1 |
| Loss/(gain) on disposal of property, plant and equipment | **17** | 13 | 8 | (16) | (17) |
| Movement in allowances and provisions | **24** | 28 | 21 | 19 | 28 |
| Other non-cash items | **0** | 0 | 0 | 0 | 0 |
| **Adjusted EBITDA** | **1,040** | 1,033 | 991 | 1,034 | 1,050 |

Adjusted EBITDA is not a measure of our operating performance under IFRS and should not be considered as an alternative to gross profit, net profit or any other performance measures derived in accordance with IFRS or as an alternative to cash flow from operating activities or as a measure of our liquidity. In particular, Adjusted EBITDA should not be considered to be a measure of discretionary cash available to invest in our growth. Adjusted EBITDA has limitations as analytical tool, and potential investors should not consider it in isolation, or as a substitute for analysis of our operating results as reported under IFRS. Some of these limitations include:

• Adjusted EBITDA does not reflect the impact of financing or finance costs on our operating performance, which can be significant and could further increase if we were to incur more debt;

• Adjusted EBITDA does not reflect the impact of income taxes on our operating performance;

• Adjusted EBITDA does not reflect the impact of depreciation and amortisation on our operating performance. The assets that are being depreciated and/or amortised will have to be replaced in the future and such depreciation and amortisation expense may approximate the cost to replace these assets in the future. By excluding this expense from Adjusted EBITDA, it does not reflect our future cash requirements for these replacements; and

• Adjusted EBITDA does not reflect the impact of other non-cash items on our operating performance, such as foreign exchange (gain)/loss, impairment/(reversal of impairment) of non-current assets, movements in allowances and provisions, (gain)/loss on disposal of property, plant and equipment, (gain)/loss on changes in fair value of financial instruments, share of (profit)/loss of associate and other non-cash items. Other companies in the pipe industry may calculate Adjusted EBITDA differently or may use it for other purposes, limiting its usefulness as comparative measure.

We compensate for these limitations by relying primarily on our IFRS operating results and using Adjusted EBITDA only supplementally.

## Net Debt

Net debt has been calculated as of the dates indicated:

| | 31 December 2012 | 30 September 2012 | 30 June 2012 | 31 March 2012 | 31 December 2011 |
|---|---|---|---|---|---|
| | | | *in million dollars* | | |
| Loans and borrowings | **3,833** | 3,764 | 3,658 | 3,866 | 3,751 |
| Liability under finance lease | **52** | 52 | 52 | 54 | 36 |
| **TOTAL DEBT** | **3,885** | 3,816 | 3,710 | 3,920 | 3,787 |
| *Net of:* | | | | | |
| Cash and short-term financial investments | **(229)** | (131) | (141) | (223) | (235) |
| **NET DEBT** | **3,656** | 3,686 | 3,569 | 3,697 | 3,552 |
| **NET DEBT TO EBITDA (LTM[1])** | **3.5** | 3.6 | 3.6 | 3.6 | 3.4 |

Net Debt is not a measure under IFRS, and it should not be considered to be an alternative to other measures of financial position. Other companies in the pipe industry may calculate Net Debt differently and therefore comparability may be limited. Net Debt is a measure of our operating performance that is not required by, or presented in accordance with, IFRS. Although Net Debt is a non IFRS measure, it is widely used to assess liquidity and the adequacy of a company's financial structure. Management believes Net Debt provides an accurate indicator of our ability to meet our financial obligations, represented by gross debt, from available cash. Net Debt demonstrates investors the trend in our net financial position over the periods presented. However, the use of Net Debt assumes that gross debt can be reduced by cash. In fact, it is unlikely that all available cash will be used to reduce gross debt all at once, as cash must also be available to pay employees, suppliers and taxes, and to meet other operating needs and capital expenditure requirements. Net Debt and the ratio of net debt to equity, or leverage, are used to evaluate our financial structure in terms of sufficiency and cost of capital, level of debt, debt rating and funding cost.

These measures also make it possible to evaluate if our financial structure is adequate to achieve our business and financial targets. Management monitors the net debt and the leverage ratio or similar measures as reported by other companies in Russia or abroad in order to assess our liquidity and financial structure relative to such companies. Management also monitors the trends in our Net Debt and leverage in order to optimise the use of internally generated funds versus borrowed funds.

[1] Net Debt-to-EBITDA ratio is defined as the quotient of Net Debt at the end of the given reporting date divided by the Adjusted EBITDA for the 12 months immediately preceding the given reporting date. Adjusted EBITDA – see "Selected financial data".

## Change in fair value of derivative financial instrument

In February 2010, we issued convertible bonds in the amount of $413 million due 2015, convertible into TMK's Global Depositary Receipts (GDR). The bonds carry a coupon with a 5.25 interest rate per annum, payable quarterly. The convertible bonds represent a combined financial instrument containing two components: (i) a bond liability and (ii) an embedded derivative representing a conversion option in foreign currency combined with an issuer call. In accordance with IFRS, a bond liability of $368 million (net of transaction costs of $9 million) and the liability under the embedded conversion option of $35 million were recognised at the initial recognition date.

As of 31 December 2012, the carrying value of the bond liability and the fair value of the embedded conversion option were $412 million and $11 million, respectively. As of 31 December 2011, the carrying value of the bond liability and the fair value of the embedded conversion option were $386 million and $3 million, respectively. As a result, we recognised a loss of $7 million on the change in the fair value of the embedded derivative in 2012 as compared to a $45 million gain last year.

As of 30 September 2012, the carrying value of the bond liability and the fair value of the embedded conversion option were $406 million and $4 million, respectively. In the fourth quarter of 2012, we recognised a $7 million loss on the change in the fair value of the embedded derivative as compared to a $1 million gain in the previous quarter.

Management believes that the IFRS accounting treatment of the conversion option of the bond does not reflect the expected outflow of resources under the conversion rights. The conversion option, whether exercised or expired, will not result in cash outflows. In the event of the bond not being converted, the liability under the conversion option will be recognised as a gain in our income statement. In the event of the exercise of the option, the liability will be transferred to equity (together with the carrying value of the converted bonds); no gain or loss will be recognised on the transaction. Additionally, the accounting treatment of the conversion option requires that changes in fair value of the embedded instrument be recognised in the income statement. The price and volatility of TMK's GDRs have significant impact on fair value of the embedded derivative. In the event the GDRs perform well, the liability under the conversion option will increase and result in losses in the income statement. Changes in fair value may be material in comparison to our net income and may cause distortions in the income statement.

As such, for the purposes of this report, in addition to net income as reflected in the consolidated income statement, it has been decided to present, in this report, an adjusted net income so that it does not reflect gain or loss on changes in fair value of the derivative financial instrument with respect to the embedded derivative component of the convertible bond. The adjusted net income is an alternative performance measure that is not reflected in our consolidated financial statements and has not been audited or reviewed in accordance with ISA.

## Principal risks and uncertainties

### Industry risks

***Dependence on the oil and gas industry***

The oil and gas industry is the principal consumer of steel pipe products worldwide and accounts for most of our sales, in particular sales of OCTG, line pipe and large-diameter welded pipe. In 2012, sales volumes of pipes used in oil and gas industry (mainly OCTG, line pipe and large-diameter pipe) accounted for approximately 75% of our tubular products. The oil and gas industry has historically been volatile and downturns in the oil and gas markets can adversely affect demand for our products, which largely depends on the number of oil and gas wells being drilled, completed and reworked, the depth and drilling conditions of wells and the construction of oil and gas pipelines. The level of such industry specific activities in turn depends on the level of capital spending by major oil and gas companies. The level of investment activities of oil and gas companies, which is largely driven by prevailing prices for oil and natural gas and their stability, significantly affects the level of consumption of our products. In case of significant and/or sustained decline in oil and natural gas prices energy companies could reduce their levels of expenditures. As a result, the demand for oil and gas pipes can substantially decrease, leading to the tightening of competition and a possible decrease of market prices for tubular products. Thus, the decline in oil and gas exploration, drilling and production activities and prices for energy commodities could have a negative impact on our results of operations and financial position.

***Increases in the cost of raw materials***

We require substantial quantities of raw materials to produce steel pipes. The principal raw materials used in production processes include scrap and ferroalloys for use in steelmaking operations, steel billets used for the production of seamless pipes and steel coils and plates for the production of welded pipes. The demand for the principal raw materials we utilise is generally correlated with macroeconomic fluctuations, which are in turn affected by global economic conditions.

In 2012, the costs of raw materials and consumables accounted for 66% of total cost of production. Prices for raw materials and supplies are one of the main factors affecting our results of operations. They are influenced by many factors, including oil and gas prices, worldwide production capacity, capacity utilisation rates, inflation, exchange rates, trade barriers and improvements in steelmaking processes. Costs of the principal types of raw materials that we consume decreased in 2012 as compared to 2011. In 2012, in the Russian division, the average purchase costs of coils and metal scrap decreased 11% and 1%, respectively, though the average purchase cost of steel plates increased 7% as compared to 2011. In the American division, the average purchase costs of metal scrap and coils used in production decreased 2% and 3%, respectively, as compared to 2011. The average purchase costs of metal scrap in the European division were lower by 5% in 2012 than those in 2011. As a result of the decrease in prices for raw materials, our costs of raw materials and consumables decreased from \$3,721 million in 2011 to \$3,352 in 2012 and thus decreased the share of raw materials' and consumables' costs in the total cost of production from 69% in 2011 to 66% in 2012.

Raw materials prices continue to have a key influence on our production costs. The increase in prices for scrap, coils and other raw materials, if not passed on to customers in a timely fashion, can adversely affect our margins and results of operations.

Our plants also consume significant quantities of energy, particularly electricity and gas. In 2012, energy costs and utilities amounted to 8% of the total cost of production. Average natural gas tariffs in Russia increased by 6% in 2012. Further price increases for energy resources will increase our costs of production and could have an adverse effect on results of operations and financial results.

### *Dependence on a small group of customers*

As we focus on supplying primarily the oil and gas industry, our largest customers are oil and gas companies. In 2012, our five largest customers were Rosneft, Surgutneftegas, Lukoil, TNK BP and Gazprom (excluding Gazprom Neft), which together accounted for 26% of our total sales volumes. We maintain strong business relationships with key customers and expect this concentration of customers in Russia to continue for the foreseeable future. The increased dependence of pipe sales on a single large customer bears the risk of an adverse effect on results of operations in the event that our relationship with any of these major customers deteriorated. In the United States, TMK IPSCO cooperates with a wide range of distributors in North America, whose shares in our total sales are not significant.

Our large-diameter welded pipe business is largely dependent on one of our largest customers, Gazprom, and is subject to increasing competitive pressure. Gazprom is one of our largest customers for 1,420 mm diameter welded pipes used for construction of gas trunk pipelines. Increased competition in the supply of large-diameter pipes or a change in relationships with Gazprom could negatively affect our competitive position in the 1,420 mm diameter pipe market, resulting in decreased revenues from sales of these products and adversely affecting our business, financial position and results of operations. Additionally, large-diameter welded pipe business depends significantly upon the level of construction of new oil and gas pipelines in Russia and the CIS. The delay, cancellation or other changes in the scale or scope of significant pipeline projects, or the selection by the sponsors of such projects of other suppliers could have an adverse effect on our sales of large-diameter welded pipes, and thus on the results of operations and financial position. We mitigate this risk by developing cooperation with new customers from CIS countries.

### *Competition*

The global market for steel pipe products, particularly in the oil and gas sector, is highly competitive and primarily based on compliance with technical requirements, price, quality and related services. In the Russian and CIS markets, we face competition primarily from ChTPZ, which produces both welded and seamless pipes, OMK, which produces welded pipes, and the Ukrainian pipe producers. In the second half of 2012, Russia joined WTO. Due to WTO regulation Russian import duties for steel pipes were decreased for 5-10% to the level of 5-15%. These changes could have an adverse impact on TMK market position, opening Russian borders for imported steel pipes. Outside Russia and the CIS, we compete against a limited number of producers of premium-quality principally seamless steel pipe products, including Tenaris, Vallourec, Sumitomo and a limited number of Chinese producers, including Baosteel and TPCO. In the United States, TMK IPSCO faces competition primarily from Boomerang, Tenaris, U.S. Steel and V&M Star, a subsidiary of Vallourec, as well as from imported OCTG and line pipe products, principally from Asia, Canada and Mexico. Moreover, several large producers including TPCO America Corp., Tenaris and Evraz declared their plans to construct new facilities in the U.S. Once these capacities are commissioned the competition may become tougher, which could have an adverse effect on our business.

## Financial risks

### *Liquidity risk*

As a result of borrowings undertaken for the acquisition of TMK IPSCO in 2008, as well as a result of continued large-scale capital expenditure program, our leverage remains significant. As of December 31, 2012, our total debt amounted to $3,885 million as compared to $3,787 million at the end of 2011. The increase of our total debt in 2012 was primarily attributable to the acquisition of Gulf International Pipe Industry LLC and inclusion of its debt in our balance sheet, and the appreciation of the rouble against the U.S. dollar. As a result our leverage increased and Net-Debt-to-EBITDA ratio increased to 3.5 as of December 31, 2012.

In 2012, we continued to concentrate on improving our liquidity profile and optimising financial performance. We negotiated extensions of credit terms and lower interest rates in order to improve our financial position and overall debt maturity profile. Nevertheless due to inclusion of our 2015 convertibles to short-term debt owing to the put option, which could be exercised in February 2013, the share of short-term debt in the total credit portfolio increased to 27% as of December 31, 2012 as compared to 16% at the end of 2011. Anyway as of the date of 2012 IFRS statement disclosure no Bonds were redeemed and full issue was left outstanding.

Improving liquidity profile remains one of our priorities, and we continue to carry out measures to maintain sufficient liquidity and improve loan portfolio structure. Nevertheless, there can be no assurance that our efforts to improve liquidity profile and reduce leverage will prove successful. The negative market reaction on deteriorating global financial situation may have an adverse impact on our ability to borrow in banks or capital markets, and may put pressure on our liquidity, increase borrowing costs, temporary reduce the availability of credit lines and lead to unavailability of financing on acceptable terms.

***Compliance with covenants***

Certain of our loan agreements and public debt securities currently include financial covenants. For example, some covenants are set in relation to leverage, total indebtedness and tangible net worth, and impose financial ratios that must be maintained. Other covenants impose restrictions in respect of certain transactions, including restrictions in respect of indebtedness. A breach of a financial or other covenant in existing debt facilities, if not resolved by means such as obtaining a waiver from the relevant lender, could trigger a default under our obligations.

In 2012, we complied with the terms of our debt instruments and plan to be in compliance over next fiscal year.

Nevertheless, in case financial markets or economic environment deteriorate in the future, we may not comply with relevant covenants. Though, historically, we have successfully secured from the relevant lenders all necessary waivers or standstill letters to address possible breaches of financial covenants, we may not be able to secure such necessary waivers or standstill letters during future reporting periods if not in compliance with financial covenants. We do not expect the occurrence of such events in the foreseeable future.

***Interest rate risk***

Interest expenses are the prevailing part of our finance costs. In 2012, our finance costs decreased 2% or $6 million and amounted to $297 million as compared to $303 million in 2011. Our weighted average nominal interest rate as of December 31, 2012 increased by 7 basis points as compared to December 31, 2011. Although we currently benefit from relatively low interest rates, there can be no assurance that rates will stay low in the future. The cost of funding for Russian and international banks may increase in the future, which can increase our interest expense and adversely affect our financial position.

Additionally, certain part of our loan portfolio is represented by loans taken out at floating interest rates. As of December 31, 2012, loans with floating interest rates represented $667 million or 17% of our total credit portfolio. The underlying rates in current loans with floating interest rates are LIBOR and EURIBOR. In 2012, floating interest rates remained close to their historical lows, which kept our interest expense on the relevant loans low. Taking into account low levels of interest rates, we considered to hedge a part of interest rate risks at the beginning of 2012 and thus reducing the share of variable-rate debt to 11% as of the end 2012. Nevertheless, several loans with floating interest rates still exist in our credit portfolio and, should floating interest rates increase in the future, interest expenses on relevant loans will increase.

***Currency risk***

Our products are typically priced in roubles for Russian sales and in U.S. dollars and euros for CIS, U.S. and other international sales. Our direct costs, including raw materials, labour and transportation costs are largely incurred in roubles and U.S. dollars. Other costs, such as interest expense, are currently incurred largely in U.S. dollars and roubles, and capital expenditures are incurred principally in roubles, euros and U.S. dollars.

We hedge our net investment in operations located in the Unites States against foreign currency risks using U.S. dollar denominated liabilities. Gains or losses on the hedging instruments relating to the effective portion of the hedge are recognised as other comprehensive income while any gains or losses relating to the ineffective portion are recognised in the income statement. In 2012, we incurred foreign exchange gains from spot rate changes in the total amount of $83 million, including $23 million recognised in the income statement and $60 million recognised in the statement of other comprehensive income. Gains in the statement of other comprehensive income from foreign exchange difference relating to hedged financial instruments arose from the revaluation of U.S. dollar denominated loans attracted by Russian companies of the Group.

The rouble remains volatile. Our debt is currently largely denominated in U.S. dollars, and the possible devaluation of the rouble against the dollar in the future could result in foreign exchange losses. The share of U.S. dollar denominated loans in the loan portfolio in 2012 remained flat and equaled to 48% as of December 31, 2012. If the U.S. dollar appreciates against the rouble in the future, this could adversely affect our net profit as coherent losses will be reflected in our consolidated income statements.

***Inflation risk***

A significant amount of our production activities are located in Russia, and a majority of direct costs are incurred in Russian roubles. We tend to experience inflation-driven increases in certain costs, such as raw material costs, transportation costs, energy costs and salaries that are linked to the general price level in Russia. In 2012, inflation in Russia reached 6.6% as compared to 6.1% in 2011. In spite of the intention of the Russian government to reduce rates of inflation in the coming years, inflation may increase in the future. We may not be able to increase the prices sufficiently in order to preserve existing operating margins.

Inflation rates in the United States, with respect to TMK IPSCO operations, are historically much lower than in Russia. In 2012, inflation in the United States decreased to 1.7% in comparison to 3.0% in 2011. High rates of inflation, especially in Russia, could increase our costs, decrease our operating margins and materially adversely affect our business and financial position.

**Legal risks**

***Changes in tax legislation and tax system***

Our subsidiaries make significant tax payments, in particular, profit tax, VAT, social security payments and property tax. Changes in tax legislation could lead to an increase in tax payments and, as a result, to a lowering of financial results. As significant part of the operations is located in Russia, the main risks relate to changes in the legislation of the Russian tax system. The Russian Government continually reviews the Russian tax system and passes a number of laws to carry out tax reforms. The new laws generally reduce the number of taxes and the overall tax burden on business while simplifying tax legislation. Despite measures to improve the tax system, tax legislation continues to give wide latitude to local tax authorities and leaves a multitude of unresolved problems which may have a negative effect on our operating results.

For several years one of the main changes in Russian taxation system relates to social security tax, which was revised and increased from 26% to 34% in 2011. In 2012, the regressive taxation system has come into effect and the upper bound of social security tax has been limited to 30%.

In addition, the Russian oil industry is subject to substantial taxes, including significant resources production taxes and significant export customs duties. Changes to the tax regime and customs duties rates may adversely affect the level of oil and gas exploration and development in Russia, which can adversely affect the demand for our products in Russia.

Should the Russian taxation system suffer any further changes, this could adversely affect our business.

***Changes in environmental law***

We meet the requirements of national environmental regulations at our Russian plants, the directives and regulations of the European Union and Romanian legislation at our Romanian plants, and the U.S. environmental laws.

The main ecological-and-economical risks are related to expected changes and tightening of Russian environmental protection laws. Environmental legislation in Russia is currently undergoing significant change. The imposition of a new environmental law and regulation system may require further expenditures to modernize production operations, install pollution control equipment, perform site clean-ups and reclamation, pay fees and fines or make other payments if not in compliance with new environmental laws and regulations. Stricter regulations will also lead to increases in the rate of payments for negative impact on the environment and the use of increasing payment coefficients. Compliance with the regulations will be accompanied by stricter control by state monitoring authorities. Such changes in existing legislation may lead to additional costs or unforeseen environmental liabilities, which could have a material adverse effect on our financial position and results of operations.

We are also responsible for compliance with stringent U.S. environmental laws. The environmental protection regime in the United States is more onerous than what we face with respect to operations in Russia and other countries and compliance with these U.S. laws may expose us to additional costs. We estimate that the environmental legislation of the European Union and the United States will not undergo any material changes in the near future. Nevertheless, there can be no assurance that the European Union will not impose new environmental regulations or that Romanian state authorities will not change national environmental laws in the future.

Although we don’t anticipate any significant environmental matters in the United States, Russia and Romania, if such matters arise, the cost of compliance could have a material adverse effect on our business.

**Other risks**

***Equipment failures or production curtailments or shutdowns***

Our production capacities are subject to the risk of equipment failures due to unanticipated events, such as fires, explosions and adverse weather conditions. Manufacturing processes depend on critical pieces of steelmaking and pipe-making equipment. Such equipment may, on occasion, be out of service as a result of unanticipated failures could require us to close part of the relevant production facility or cause to reduce production on one or more of production lines. Any interruption in production capability may require us to make significant and unanticipated capital expenditures to affect relevant repairs, which could have a negative effect on our profitability and cash flows. We currently maintain insurance against losses that may arise in case of property damage, accidents and transportation of goods. We also maintain corporate product liability and directors’ and officers’ liability insurance policies. Nevertheless, any recoveries under insurance coverage that may be obtained in the future may not offset lost revenues or increased costs resulting from a disruption of operations.

***Insurance against all potential risks and losses***

We do not carry insurance against all potential risks and losses that may arise in connection with the quality of our products, property damage, work-related accidents and occupational illnesses, natural disasters and environmental contamination. We currently maintain no business interruption insurance. Losses or liabilities arising from these or other events could increase our costs and could adversely affect our business, financial position and operating results.

***Ability to effect staff alterations and shortages of skilled labor***

Our Russian subsidiaries are in many regions the largest employers in the cities in which they operate, such as Volzhsky, Taganrog, Kamensk-Uralsky and Polevskoy. While we do not have any specific legal social obligations or responsibilities with respect to these regions, the ability to effect alterations in the number our employees may nevertheless be subject to political and social considerations. Any inability to make planned reductions in the number of employees or other changes to operations in such regions could have an adverse effect on the results of operations and prospects.

Competition for skilled labor in the steel pipe industry remains relatively intense, and labor costs continue to increase moderately, particularly in the CIS, Eastern Europe and the United States. We expect the demand and, hence, costs for skilled engineers and operators will continue to increase, reflecting the significant demand from other industries and public infrastructure projects. Continual high demand for skilled labor and continued increases in labor costs could have a material adverse effect on our business, financial position and results of operations.

Furthermore, any work stoppages, strikes or other labor-related developments could have an adverse effect on our business, financial position and results of operations.

**Responsibility statement**

We confirm to the best of our knowledge that:

1. the consolidated financial statements prepared in accordance with International Financial Reporting Standards and presented together with this Management Discussion and Analysis of financial condition and results of operation give a true and fair view of the assets, liabilities, financial position and profit or loss of OAO "TMK" and its consolidated subsidiaries, taken as a whole; and

2. the Management Discussion and Analysis includes a fair review of the development and performance of the business and the position of OAO "TMK" and its consolidated subsidiaries, taken as a whole.

Alexander G. Shiryaev
Chief Executive Officer, OAO "TMK"

Tigran I. Petrosyan
Chief Financial Officer, OAO "TMK"

6 March 2013