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 pipe. In 2020, sales volumes of pipes used in oil and gas industry accounted for approximately 74% 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.

Thus, the decline in oil and gas exploration, drilling and production activities, prices for energy commodities and other economic factors beyond our control could adversely affect our results of operations.

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 pipe and steel coils and plates for the production of welded pipe. The demand for the principal raw materials we utilize is generally correlated with macroeconomic fluctuations, which in turn are affected by global economic conditions.

Prices for raw materials and supplies have a key influence on our production costs and are one of the main factors affecting our results of operations. There are many factors, which influence raw materials prices, including oil and gas prices, worldwide production capacity, capacity utilization rates, inflation, exchange rates, trade barriers and developments in steelmaking processes. We are negotiating new contract terms with our major clients based on pricing formulas, which secure us against growing raw materials prices. The share of raw materials and consumables costs in the total cost of sales in 2020 was 66%. In 2020, the cost of scrap metal for TMK’s plants in Russia in Rouble-terms increased on average by 6%, and the cost of coils decreased by 4%. The increase in prices for scrap, coils and other raw materials, if not passed to customers can adversely affect our profit, margins and results of operations.

Our plants also consume significant quantities of energy, particularly electricity and gas. In 2020, energy and utility costs comprised approximately 10% of our total cost of sales. The prices for electricity for our plants increased by 5% in Rouble-terms compared to 2019, while the average prices for domestic natural gas for our plants increased by 2% in Rouble-terms. If we are required to pay higher prices for gas and electricity in the future, our costs will rise and this could have a material adverse effect on our business, financial condition, results of operations and prospects.

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 2020, our five largest customers in Russia were Rosneft, Gazprom, Surgutneftegas, Gazpromneft and Lukoil, which together accounted for 41% of our total sales volumes. 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 deteriorates.

Our LDP business is largely dependent on one of our largest customers, Gazprom. In 2020, 31% of our LDP were sold for Gazprom projects. Increased competition in the supply of LDP or a change in relationships with Gazprom could negatively affect our competitive position in the large-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 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 LDP, and thus on the results of operations and financial position.

COMPETITION

The global market for steel pipe products, particularly in the oil and gas sector, is highly competitive. In the Russian and CIS markets, we face competition primarily from ChTPZ, OMK, Chinese pipe producers, as well as from ZTZ in the LDP segment.

After accession to the WTO Russia had adjusted its national legislation in full accordance with WTO rules and regulations, what allowed Russia along with the EEU (Eurasian Economic Union) to use WTO trade defense mechanism for the national market protection. To date, the following antidumping measures are effective in EEU: antidumping duties in the amount 18.9%-19.9% on imports of some types of steel tubes and pipes originated from Ukraine that were extended till 2021, anti-dumping duties ranging from 4.32% to 18.96% on imports of seamless corrosion resistant steel tubes and pipes originating from Ukraine, antidumping duties in the amount 19.15% on imports of cold-drawn stainless steel pipes originated from China and Malaysia, antidumping duties 12.23%-31% in respect to OGTG originated from China.

Outside Russia and the CIS, we compete against a limited number of premium-quality pipe products producers, including Tenaris, Vallourec, Sumitomo, Voestalpine and Chinese producers.

Higher competition could have a material adverse effect on our business, financial condition, results of operations and prospects.

FINANCIAL RISKS

LIQUIDITY RISK

Liquidity risk is the risk that we will not be able to meet our financial obligations as they fall due. Our approach to managing liquidity is to ensure that it will always have sufficient liquidity assets to meet its obligations when due.

We manage liquidity risk by maintaining adequate cash reserves and borrowing facilities, by continuously monitoring forecast and actual cash flows and matching the maturity profiles of financial assets and liabilities.

As of December 31, 2020, our total debt increased to 199,075[1] million roubles as compared to 186,058 million roubles at the end of 2019 as a result of the Rouble depreciation against the US dollar. Net repayment amounted to 1,426 million roubles. As of December 31, 2020, our Net-Debt-to-EBITDA ratio was 2.32x.

As of December 31, 2020, we committed credit lines in Russian, European and American banks with the available limit of 96,105 million roubles.

Nevertheless, there can be no assurance that our efforts to improve liquidity profile and reduce leverage will prove successful. The negative debt market reaction on deteriorating global political and financial situation, US and EU sanctions, economic situation in Russia may have an adverse impact on our ability to borrow in banks or on capital markets, and may put pressure on our liquidity, significantly increase borrowing costs, temporary reduce the availability of credit lines or lead to and possibility to incur financing on acceptable terms.

COMPLIANCE WITH COVENANTS

Certain amount of our loan agreements and public debt securities currently include financial covenants. Some covenants impose financial ratios that must be maintained, others impose restrictions in respect of certain transactions, including restrictions in respect of indebtedness, pledging of assets and material asset disposals. A breach of financial or other covenants in existing debt facilities, if not resolved by means such as obtaining a waiver from the relevant lender and/or making amendments to debt facilities, could trigger a default under our obligations.

We are in compliance with covenants.

Nevertheless, in case financial markets or economic situation on the markets, where we operate, deteriorate in the future, we may not comply with relevant covenants. In case of possible breach we will apply best efforts to obtain all necessary waivers or standstill letters. We do not expect the occurrence of such events in the near future.

[1] *Total debt is calculated as loans and borrowings less interest payable.*

INTEREST RATE RISK

Loans and borrowings at variable interest rate create an exposure to interest rate risk, that is, fluctuations of cash flows due to changes in market interest rates. The exposure of interest rate risk did not materialise for us in the reporting period, as substantially all of our loans and borrowings bore interest at fixed rates or the CBR key rate increased by a fixed margin.

CURRENCY RISK

Our products' prices as well as our costs are nominated both in Roubles and in other currencies (generally, in US dollars and euro). 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 2020, we incurred foreign exchange gain from spot rate changes in the total amount of 8,288 million roubles. In addition, we recognised the reclassification of foreign currency reserves to the income statement in the amount of 6,022 million roubles (net of income tax) in the statement of other comprehensive income. The reclassification was a result of IPSCO sale.Also we are exposed to currency risk on the borrowings that are denominated in currencies other than the functional currencies of the respective Group's members. The currencies in which these transactions are denominated are primarily Rubles, US dollars and euro. As of December 31, 2020, 20% of our loans were denominated in US dollar. In this regards, as well as taking into consideration continuing volatility of the Rouble against US dollar, the risk of losses owing to the Rouble devaluation remains sufficiently high. Depreciation of the Rouble against the US dollar could adversely affect our net profit as coherent losses will be reflected in our consolidated income statements. Nevertheless, we are partly secured from currency risks as foreign currency denominated sales occasionally are used to cover repayment of foreign currency denominated borrowings.

INFLATION RISK

A significant amount of our production activities are located in Russia, and a majority of direct costs are incurred in 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 2020, inflation in Russia increased to 4.9% as compared to 3.0% in 2019. In spite of the measures of the Russian government to contain inflation, growth of inflation rates may be significant in the short-term outlook. We may not be able to increase the prices sufficiently in order to preserve existing operating margins.

High rates of inflation, especially in Russia, could increase our costs, decrease our operating margins and adversely affect our business and financial position.

LEGAL RISKS

CHANGES IN TAX LEGISLATION AND TAX SYSTEM

Our subsidiaries make significant tax and non-budgetary funds payments, in particular, profit tax, VAT, property tax and payments to social security funds. Changes in tax legislation could lead to an increase in tax payments and, consequently, 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 legislation. The new laws generally reduce the number of taxes and the overall tax burden on business while simplifying tax legislation. Nevertheless, should the Russian taxation system suffer any changes related to increasing of tax rates, this could adversely affect our business.

Moreover, 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.

CHANGES IN ENVIRONMENTAL LAW

We meet the requirements of national environmental laws at our industrial capacities location areas: the directives and regulations of Russian, the European Union and Kazakhstan legislation.

The main ecological-and-economical risks of our Russian plants are related to changes and tightening of the Russian environmental protection laws. Environmental legislation in Russia is constantly developing. The imposition of a new law and regulation system may require further expenditures to install new technological and waste disposal equipment, pollution and wastewater control equipment, as well as will lead to growth of the rate of payments for negative impact on the environment. It is expected that compliance with the regulations will be accompanied by stricter control by state monitoring authorities.

We estimate that the environmental legislation of the European Union and Kazakhstan will not undergo any material changes in the near future. Nevertheless, if such changes arise, the cost of compliance with new requirements could have a material adverse effect on our business.

OTHER RISKS

EQUIPMENT FAILURES OR PRODUCTION CURTAILMENTS OR SHUTDOWNS

Our production capacities are subject to equipment failures and to the risk of catastrophic loss due to unanticipated events, such as fires, explosions and adverse weather conditions. Our manufacturing processes depend on critical pieces of steel-making and pipe-making equipment. Such equipment may, on occasion, be out of service as a result of unanticipated failures, which could require us to close part or all of the relevant production facility or cause us to reduce production on one or more of our production lines.

Any interruption in production capability may require us to make significant and unanticipated capital expenditures to effect repairs, which could have a negative effect on our profitability and cash flows. Any recoveries under insurance coverage that we may obtain may not offset the lost revenues or increased costs resulting from a disruption of our operations.

A sustained disruption to our business could also result in delays to or cancellations of customer orders and contractual penalties, which may also negatively impact our reputation among our customers. Any or all of these occurrences could have a material adverse effect on our business, results of operations, financial condition and prospects.

INSURANCE AGAINST ALL POTENTIAL RISKS AND LOSSES

We maintain insurance against losses that may arise in case of property damage including business interruption insurance, accidents, transportation of goods. We also maintain corporate product liability and directors and officers liability insurance policies.

We maintain obligatory insurance policies required by law and provide employees with medical insurance as part of our compensation arrangements with our employees.

Nevertheless, we do not carry insurance against all potential risks and losses, and our insurance might be inadequate to cover all of our losses or liabilities or may not be available on commercially reasonable terms.

ABILITY TO EFFECT STAFF ALTERATIONS AND SHORTAGES OF SKILLED LABOR

Our key 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 metallurgical companies and other industries. 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.