Mechel Open Joint Stock Company (MTL)

MECHEL is a STRONG BUY

Ticker symbol: MTL (NYSE)

CURRENT PRICE: $32.74 PRICE TARGET: $46.50

Initial Opinion STRONG BUY

Equity I Russia I Steel & Mining
20 April 2007

Rutgers Business School
NEWARK AND NEW BRUNSWICK

Elena Makovskaya – (609) 274-6249

Graduate MBA Student
Rutgers Business School
elena_makovskaya@ml.com

INVESTMENT CASE

SUPERIOR BUSINESS MODEL – VERTICAL INTEGRATION AND INTERNAL SOURCING

Mechel has a very sound business model operating in two market segments – mining and steel. Vertical integration is Mechel's core competency. Besides, Mechel has a lot of other competitive advantages, but the two most important ones are low costs of production and ability to internally source raw materials for the steel segment.

+ STEEL AND MINING INDUSTRIES: POSITIVE TRENDS IN BOTH

Both industries are cyclical in nature, but the cycles are not at the top yet. We believe the positive pricing trends will continue in the steel segment, while mining and coal segments will be able to sustain current price levels for now and grow in the future.

+ FINANCIAL INDICATORS

Among Mechel's main financial strengths are: strong financial performance, solid financial position and a very attractive dividend yield and rates of return for the stock. The drawbacks include: the ownership structure, where most shares are held in the hands on one single insider and the limited share liquidity.

+ EARNINGS PROJECTIONS, CURRENT AND FUTURE VALUATIONS

We believe that even with current trailing P/E, P/B and Price/Sales and Price/Cash Flow ratios the stock is highly undervalued. EPS projections are below. Based on the three different methods - 33.33% P/E (ttm), 33.33% P/E 1-year forward and 33.33% Growth Dividend Stock Model – the overall price target if $46.50, which means that MTL stock is significantly underpriced even now.

+ CATALYSTS

Mechel's steel segment will definitely benefit from Russia's future real estate market and the recent imposition of duties against EU steel imports. Russia's future construction market has a lot of potential and will drive the demand for Mechel's steel products, while duties imposed against EU steelmakers will keep the domestic supply and prices under control. Major catalyst for Mechel's mining segment will be the inevitable natural gas shortage in the country's energy portfolio. Mechel's is investing about $750,000 into the mining segment in order to take advantage of this huge opportunity.

- INVESTMENT RISKS

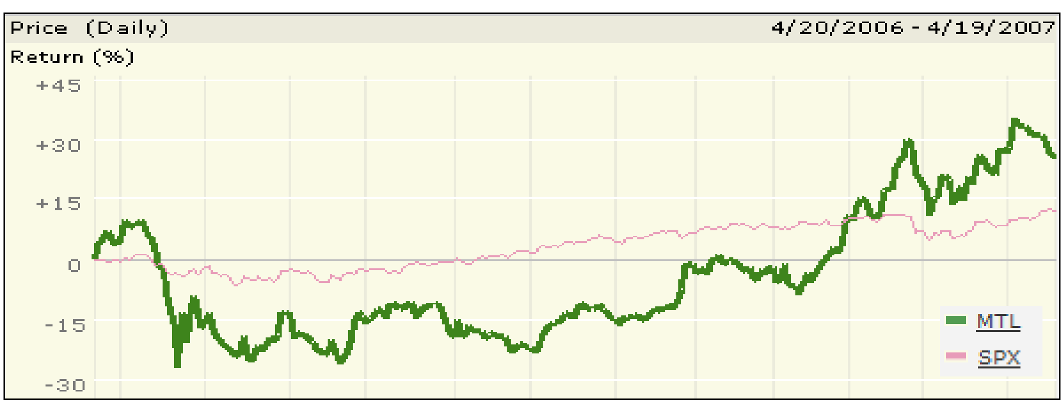
Since company has a strong growth and appreciation potential – it also comes with increased risks. Even though there are plenty risks involved in this investment, the potential returns are still greater thus making the stock a value. All risks pertaining to MTL can be divided into 3 broad categories: risks relating to the company's business and its industry, political risks and risks relating to the economic environment in Russia. Any of those risks can potentially adversely affect Mechel's business and lead to the price decline.

= STRONG BUY

MARKET PROFILE

VALUATION MEASURES	
Market Cap:	4.44B
Enterprise Value (20-Apr-07):	4.92B
Trailing P/E (ttm, intraday):	10.10
Forward P/E (fye 31-Dec-07):	7.83
Price/Book (mrq):	1.70
FINANCIAL HIGHLIGHTS	
Profit Margin (ttm):	10.87%
Operating Margin (ttm):	13.86%
Return on Assets (ttm):	8.91%
Return on Equity (ttm):	18.25%
Div & Yield:	1.43 (4.3%)
STOCK PRICE HISTORY	
Beta:	1.89
52wk Range:	18.59-36.15
SHARE STATISTICS	
Average Volume (3 month):	426,411
Average Volume (10 day):	248,556
Shares Outstanding:	135.51M
Float:	48.96M
% Held by Insiders:	259.42%
% Held by Institutions:	17.60%

Source: Yahoo! Finance, Student Estimates



Source: Morningstar

EARNINGS PROJECTIONS

YEAR	EPS
2006	$3.66
2007	$4.18
2008	$4.69
2009	$5.18
2010	$5.72

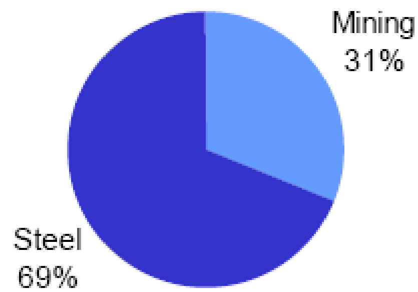
Source: Student Estimates

I. SUPERIOR BUSINESS MODEL – VERTICAL INTEGRATION AND INTERNAL SOURCING

OVERVIEW

Mechel Open Joint Stock Company is a low-cost vertically integrated steel and mining group focused on the production of steel products, as well as mining products. Both segments – mining and steel – are analyzed later in the report. Total revenue breakdown by business segment is shown in Figure 1 below:

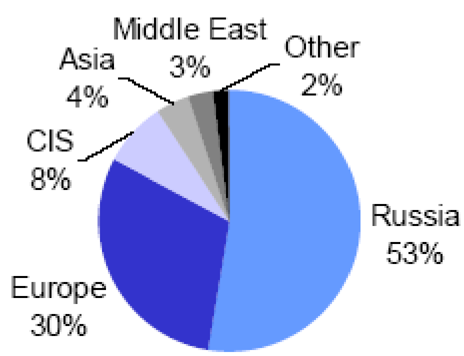
Figure 1: Revenue breakdown by segment, 9M06.



Source: Management Results Presentation for 9 months 2006 - www.mechel.com

Geographically Mechel operates primary in Russian market also trying to maintain strong relationships with significant export customers. Although Mechel is mainly focused on maintaining its market position within Russia, export sales, which constituted 47% of the total sales in the 9 month period of 2006, allow the company to diversify sales and reduce reliance on the Russian market in the event that it were to experience a downturn. See Figure 2 for the full picture of revenue breakdown by region:

Figure 2: Revenue breakdown by region, 9M06.



Source: Management Results Presentation for 9 months 2006 - www.mechel.com

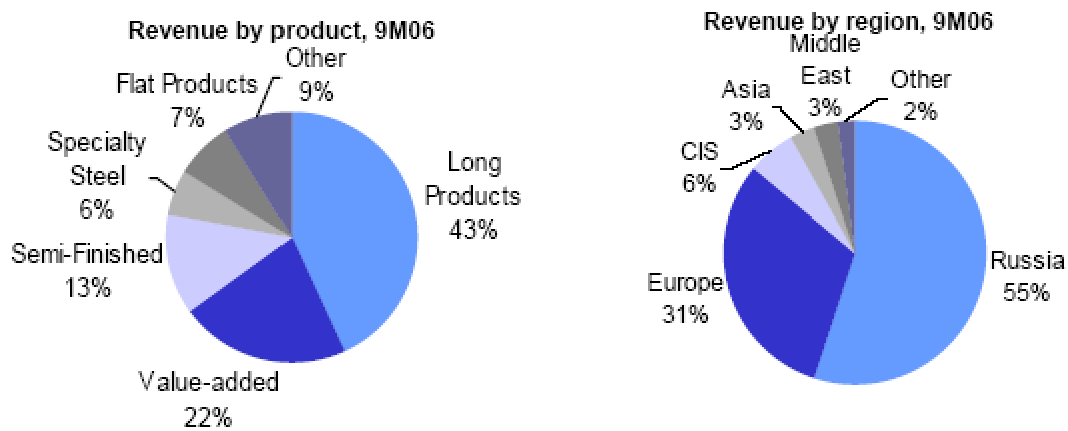
The main source of Mechel's strength is its vertical integration model – the model that is becoming extremely popular nowadays in the steel and mining industries. Mechel has been acquiring companies all along the vertical business line since the company was formed: mining companies, steel factories that use mining products, specialty steel plants, transport companies and even ports to transport its own products to the final consumers. The most recent one is the power plan that uses coal to produce another value added product – electricity. The main two businesses are of course – steel and mining as they are extremely interconnected and those will be described next. The final part of this chapter is devoted to Mechel's key competitive strengths resulting from synergies of recent acquisitions and from the chosen vertical business model.

STEEL SEGMENT

Mechel's steel business comprises production and sale of semi-finished steel products, carbon and specialty long products, carbon and stainless flat products, and value-added downstream metal products including hardware, stampings and forgings. Within these product groups, Mechel is further able to tailor steel grades to meet specific end-user requirements. The company's steel business is heavily supported by its mining business described below.

The company is the largest and most comprehensive producer of specialty steels and alloys in Russia, producing 52% of total Russian specialty steel output, over three times as much as the nearest competitor. Mechel is also the second largest producer of long products in Russia. Figure 3 below shows the revenue breakdown by the product type and by the region:

Figure 3: Steel segment – snapshot.



Source: Management Results Presentation for 9 months 2006 - www.mechel.com

Table 1 below shows Mechel's steel segment output in thousand tonnes and percentage change compared to the previous year over the past 4 years that the company has public data. The table shows that 2004 year – the year of the IPO – was a good year for the company, while in 2005 the output declined. 2006 so far has produced pretty good results:

Table 1: Steel segment output.

Product, *thousand tonnes*	**2006**	**2005**	**2004**	**2003**
Coke	2,570	2,589	2,942	2,617
% change	*-0.73%*	*-12.00%*	*12.40%*	
Pig iron	3,631	3,349	3,880	3,152
% change	*8.42%*	*-13.69%*	*23.10%*	
Steel	5,950	5,899	6,196	5,314
% change	*0.86%*	*-4.79%*	*16.60%*	
Rolled products (flat, long, semi-finished)	4,714	4,600	4,937	4,084
% change	*2.48%*	*-6.83%*	*20.90%*	
Hardware	611	557	593	466
% change	*9.69%*	*-6.02%*	*27.10%*	

Source: www.mechel.com

The next table – Table 2 – shows steel segment's brief financial results. From this table we can clearly see improvement in margins. While in the output section the production volume for the full year of 2006 has shown only a small increase, the financial results for only 9 month of 2006 are really impressive and comparable to the whole year of 2005 with the whole full 4th quarter left yet to be reported. Net income for only 9M2006 is already greater that the net income in Mechel's best year – 2004.EBITDA margin has sharply increased to 18.60% - the highest it's ever been. These great results can be explained by two major factors – high steel prices in 2006 (not-sustainable) and the fact that Mechel's capital investments from previous years aimed at improving efficiency and profitability finally started paying off.

Table 2: Steel segment results.

US$ thousand	9M2006	FY 2005	FY 2004	FY 2003
Revenues from external customers	2,166,273	2,710,213	2,757,538	1,614,108
% change		*-1.72%*	*70.84%*	
Net income	233,016	67,443	214,374	114,011
% change		*-68.54%*	*88.03%*	
EBITDA	406,748	260,542	449,661	245,820
% change		*-42.06%*	*82.92%*	
EBITDA margin	18.60%	9.60%	16.30%	15.20%

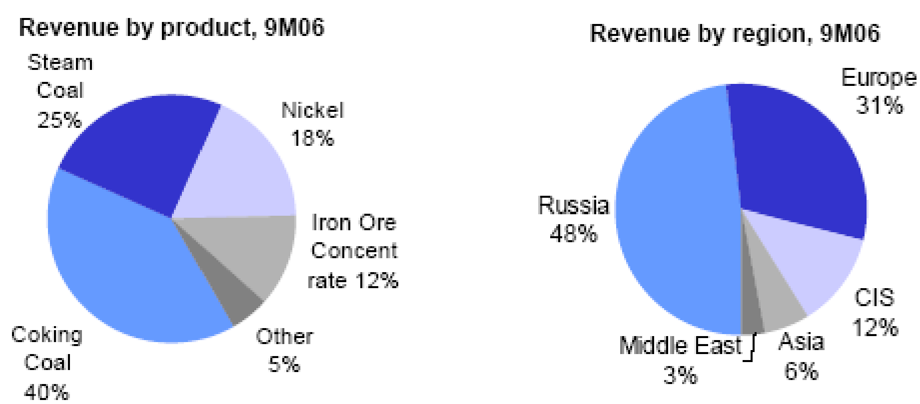
Source: www.mechel.com

MINING SEGMENT

Mechel has substantial coal, iron ore and nickel mining interests in Russia and Kazakhstan, with the flexibility to supply our own steel production or sell to third parties depending on price differentials between purchases from local suppliers and sales to foreign and domestic customers.

Mechel is capable of internally sourcing all of the coking coal, 92% of the iron ore and 55% of the nickel requirements of its steel segment. In addition, *Mechel is the only specialty steel manufacturer in the world capable of internally sourcing all three of these raw materials.* The company is the second largest producer of coking coal in Russia, with a 12% market share. Mechel also controls 24% of the coking coal washing capacity in Russia. Figure 4 represents Mechel's revenue breakdown by product and by region in the mining sector:

Figure 4: Mining segment – snapshot.



Source: Management Results Presentation for 9 months 2006 - www.mechel.com

Table 3 below shows Mechel's mining segment output in thousand tonnes and percentage change compared to the previous year over the past 4 years that the company has public data. If steel segment experienced a downturn in 2005 – this was not the case with the mining business. So, even from this fact we can see that these two businesses – steel and mining – work well with each other. If steel is down in a cycle – steam coal and iron – are often not and this fact can be very beneficial for a company trying to make decent profit and hit analysts' EPS estimates.

Table 3: Mining segment output.

Product, *thousand ton*	2006	2005	2004	2003
Coal	17,013	15,646	15,644	14,183
% change	*8.74%*	*0.01%*	*10.30%*	
Coking coal	9,697	8,583	9,363	8,645
% change	*12.98%*	*-8.33%*	*8.30%*	
Steam coal	7,316	7,063	6,281	5,529
% change	*3.58%*	*12.45%*	*13.60%*	
Iron ore concentrate	4,976	4,522	3,876	3,511
% change	*10.04%*	*16.67%*	*10.40%*	
Nickel	14.40	12.60	12.70	13.50
% change	*14.29%*	*-0.79%*	*-5.90%*	

Source: *www.mechel.com*

Table 4 below shows financial results for the past 3 full years and 9M2006 for Mechel's mining segment. These financial results just prove the point above that while steel was down in 2005, mining segment picked up the financial burden and contributed to net income and EPS numbers greatly.

Table 4: Mining segment results.

US$ thousand	9M2006	FY 2005	FY 2004	FY 2003
Revenues from external customers	975,381	1,094,782	878,417	413,943
% change		*24.63%*	*112.21%*	
Net income	139,099	313,736	328,350	29,497
% change		*-4.45%*	*1013.20%*	
EBITDA	261,791	465,710	458,068	95,652
% change		*1.67%*	*378.90%*	
EBITDA margin	21.40%	42.50%	52.10%	23.10%

Source: *www.mechel.com*

COMPETITIVE STRENGTHS

Mechel's main competitive strengths are the following:

1. **Low-Cost Producer**. Mechel's base of operations in Russia and integrated status allow the company to take advantage of a number of cost advantages vis-à-vis most foreign producers.
   - *Low-Cost Raw Materials*. Mechel internally sources all of the coking coal and a significant portion of the iron and nickel requirements of its steel segment. Company's mines, processing facilities and steel production facilities have long and established operating histories, and it continues to find additional cost savings through internally sourcing these raw materials. Having the ability to internally source also gives Mechel a better bargaining position with the outside suppliers and allows controlling raw material costs.
   - *Inexpensive Energy*. Mechel internally satisfies about 38% of its electricity needs from its own co-generation facilities, and purchases most of the remainder at low, regulated prices. Mechel also purchases natural gas from Gazprom at low, regulated prices for its production needs.
   - *Low Labor Costs*. Russia has very low labor costs, including few, if any, pension obligations, as compared to the United States, Western Europe, Japan and South Korea.
   - *Cost Management*. The company views strict cost management and increases in productivity as fundamental aspects of the day-to-day operations, and continually reassesses and improves the efficiency of the mining and steel-making operations. With many recent acquisitions in the past few years, Mechel has established a track record of turning around underperforming steel-making and mining products facilities by implementing improved operational and management practices, leading to reductions in production costs and improved product quality.

2. **<u>Ability to Internally Source Significant Amounts of Raw Materials</u>**. Mechel is capable of internally sourcing 100% of the coking coal, 92% of the iron ore and 55% of the nickel requirements of its steel segment. While other steel producers have certain captive raw-materials suppliers, Mechel is *the only steel manufacturer in the world with its own nickel production facilities*. We believe that Mechel's captive supply of coking coal, iron ore and nickel provides the company with significant advantages over other steel producers, such as higher stability of operations, better control of quality of end products, reduced production costs, improved flexibility and planning latitude in the production of steel and value-added steel products and the ability to respond quickly to market demands and cycles. Moreover, in recent years, the supply of iron ore and coal, the two primary raw materials inputs into the steel-making process, has been increasingly concentrated among fewer companies, resulting in weaker bargaining positions for steel makers. Mechel's vertical integration strategy has allowed the firm to minimize the adverse effect of such concentration, and keep the raw materials costs down. In addition, the ability to source raw materials internally and within Russia means that the company is not exposed to the expected shortages in worldwide shipping capacity.
3. **<u>Ability to Improve Cost Efficiency with Relatively Modest Capital Expenditures</u>.** We believe that relatively modest capital improvements will allow Mechel to decrease its production costs and improve the margins. Right now Mechel is a lot more labor intensive than its competitors due to the fact that most of its factories and plants still have old equipment from the Soviet years. This fact suggests potential huge opportunities in terms of capital expenditures and improved margins.
4. **<u>Ability to Increase Current Production Cost Efectively</u>**. Mechel has a significant competitive advantage over the competitors in its ability to increase its production capacity relatively cost effectively because its substantial existing infrastructure can accommodate new facilities and production lines through brownfield development. Moreover, due to Mechel's integration, experience and location in Russia, which has some of the largest reserves of coal and iron in the world, the firm is better positioned than its European competitors to secure raw materials for any increases in steel production.
5. **<u>Well-Situated for Construction Market</u>**. The location of Mechel's primary steel manufacturing facility, Chelyabinsk Metallurgical Plant, in the southern Urals makes it better situated, compared to company's primary competitor in this market, to serve the Russian construction market, which we believe is still yet to experience its biggest boom in the nearest future (for complete analysis see chapter "Catalysts").
6. **<u>Value-Added Product Line</u>**. Mechel produces long products for a broad range of end uses, including forgings and stampings, wire rod for metal cord production and a wide range of hardware (wires, nails, nets, ropes and rope products). Downstream production provides the company with higher-margin opportunities.
7. **<u>Track Record of Successful Acquisitions</u>**. In the last few years Mechel has acquired several metal finishing and hardware manufacturing operations that it can supply with its steel. With each of the completed acquisitions, Mechel implements improved operational and management practices, and is generally able to realize significant increases in production efficiency and volume with only modest, targeted capital expenditures. Mechel also devotes the management, technological and logistical resources necessary to integrate new acquisitions into all aspects of its business, including the supply of raw materials and steel, production methodologies and sales and distribution.
8. **<u>Increasing Control over Logistics</u>**. Mechel's increasing internal logistics capabilities, currently centered on the railway freight and forwarding company, and enhanced by the recent acquisition of Port Posiet, located on the Sea of Japan, help the company to optimize its transportation expenses.
9. **<u>Strong and Focused Management Team</u>**. Mechel's current management team has significant experience in all aspects of its businesses and has successfully transformed the company from a small coal trading operation to a large, integrated steel producer – publicly traded on NYSE. Mechel's founding shareholder – Mr. Zuzin – remains significantly involved in the management of our business. The Chief Operating Officer, Alexey Ivanushkin, has significant experience from his previous positions at Glencore International and as chief executive officer at Chelyabinsk Metallurgical Plant. Many of Mechel's directors and officers began their careers in floor jobs or in mines and moved up into management positions over the course of their careers.

II. STEEL AND MINING INDUSTRIES: POSITIVE TRENDS IN BOTH

Both steel and mining industries are cyclical. Both of them have been doing really good lately. In spite of this fact in our opinion the industries are still not even approaching the cycle downturn. In the mining industry we will only concentrate on coal segment, as the other two mining components of Mechel's output – nickel and iron ore – are closely related to the steel industry. For company browse across both industries – please, reference Appendix 2 & 3.

GLOBAL STEEL INDUSTRY OVERVIEW

Steel is one of the most important, multi-functional and adaptable materials in use today, and is considered to be the backbone of industrial development. Steel's versatility is attributable to the fact that it is hot and cold formable, weldable, hard, resistant to corrosion, water and heat, 100% recyclable and has good machinability. Among the myriad industries in which steel is used are the construction, transportation and engineering industries. Steel is also used in the production of power lines, pipelines, white goods and containers. See table 5 for the complete picture of all industries that use steel:

Table 5: Steel using sectors.

Sectors of economy	% weight in total steel consumption of each sector
Constructions	24
Structural steelwork	10
Mechanical engineering	13
Automotive	18
Domestic appliances	4
Shipyards	1
Tubes	12
Metalware	13
Miscellaneous	5
TOTAL	**100**

Source: E U R O F E R – European Confederation of Iron and Steel Industries, February 6, 2007 report.

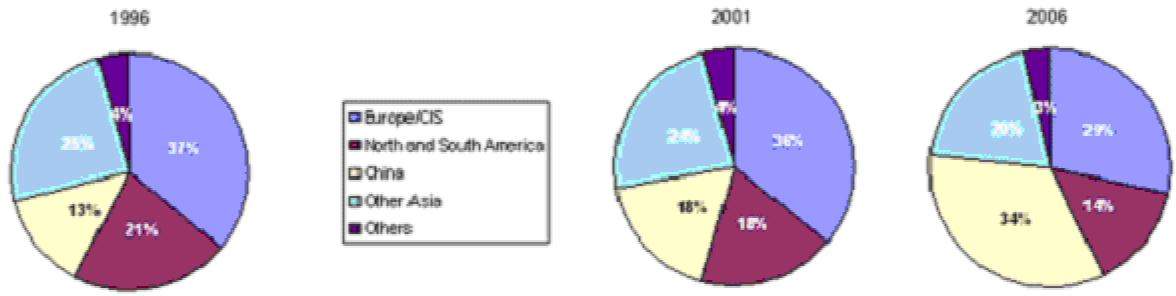
Steel products are broadly subdivided into two categories – flat and long products. Flat products are those products such as slabs, which may be converted into hot rolled or cold rolled coils and/or coated sheets. They are used primarily in manufacturing industries, such as the white goods and automotive industries. Long products are used for construction-type applications (beams, rebars).

The steel industry is affected by a combination of factors, including periods of economic growth or recession, worldwide production capacity and the existence of, and fluctuations in, steel imports and protective trade measures. Steel prices respond to supply and demand and have fluctuated in response to general and industry-specific economic conditions.

The steel industry operates predominantly on a regional basis given the high cost of transporting steel. For example, the top five producers in each of Japan and the EU control more than 60% of their respective regional markets. However, despite the limitations associated with transportation costs, as well as the restrictive effects of protective tariffs, duties and quotas, global imports and exports have increased in the last decade. While steel production has been historically concentrated in the EU, North America, Japan and the former Soviet Union, steel production in China and the rest of Asia has grown in importance over the past decade. In 2006, China was the largest single producer of steel as well as the largest consumer of steel. China imports steel to meet its requirements, and is expected to remain a net importer of steel over the next decade, even after taking into account the planned increases in its production capacity. The EU, the United States and Japan are the next largest producers and consumers of steel. Russian steel production substantially declined between 1990 and 1998, but has steadily recovered since then.

The International Iron and Steel Institute (IISI) has announced that world crude steel output reached 1,239.5 million metric tons for the year 2006. This is an increase of 8.8% on 2005. The total represents the highest level of crude steel output in history. 2006 is also the third consecutive year in which crude steel output has been above 1 billion tons. 2006 production is 65.3% above the total production for the world ten years ago. It is also 45.7% above the total five years ago. However, over the past ten years the most remarkable growth has been in China and the Asia region – see Figure 5 and Table 6 for the full picture of the trend and current production breakdown by country:

Figure 5: Trend of world and Chinese crude steel production



Source: International Iron and Steel Institute

Table 6: Top 10 crude steel producing countries

Rank 2006	Rank 2005	Country	2006	2005	% Change
1	1	China	418.8	355.8	17.7
2	2	Japan	116.2	112.5	3.3
3	3	USA	98.5	94.9	3.8
4	4	Russia	70.6	66.1	6.8
5	5	South Korea	48.4	47.8	1.3
6	6	Germany	47.2	44.5	6.1
7	7	India	44	40.9	7.6
8	8	Ukraine	40.8	38.6	5.7
9	10	Italy	31.6	29.4	7.5
10	9	Brazil	30.9	31.6	-2.2

Source: International Iron and Steel Institute

Recently, the growth and consolidation of both steel consumers and raw material suppliers has weakened the bargaining power of steel producers and put further pressure on their margins. Steel producers have responded with a phase of industry consolidation. Usinor, Arbed and Aceralia in Europe merged to form Arcelor, the world's largest steel company, as did Kawasaki Steel and NKK in Japan, creating JFE. Nucor acquired Birmingham Steel and ISG acquired Acme, LTV and Bethlehem Steel in the United States. Consolidation has enabled the steel companies to lower their production cost and allowed for a more stringent supply-side discipline, including through selective capacity closures.

Mechel has followed the same path with its history of acquisitions. But in Mechel's case this trend has a little twist – not only the company is trying to consolidate small steelmakers all over the country, it also is trying to target vertical integration – another recent trend in the world steel industry. By being vertically integrated world steel companies are trying to insure themselves against price increases in raw materials used in steel production – iron ore, coal and coke.

Now, how about the steel prices and the future price projections? Table 7 below shows monthly price index on steel demolition scrap in Europe starting from 1999. Bases on this data we ran a regression analysis in Excel (see Appendix 1 for details) to come up with price forecasts for the next 2 years – 2007 and 2008. As a result, we forecast 9.72% and another 8.39% increase in steel prices in 2007 and 2008 respectively. One can also see the clear upward trend in prices based on historical data for the past 8 years: even though in several stand alone years the prices experienced sharp declines (year 2005, Mechel's worst year as well) – on the big long-term picture the upward trend is clearly seen:

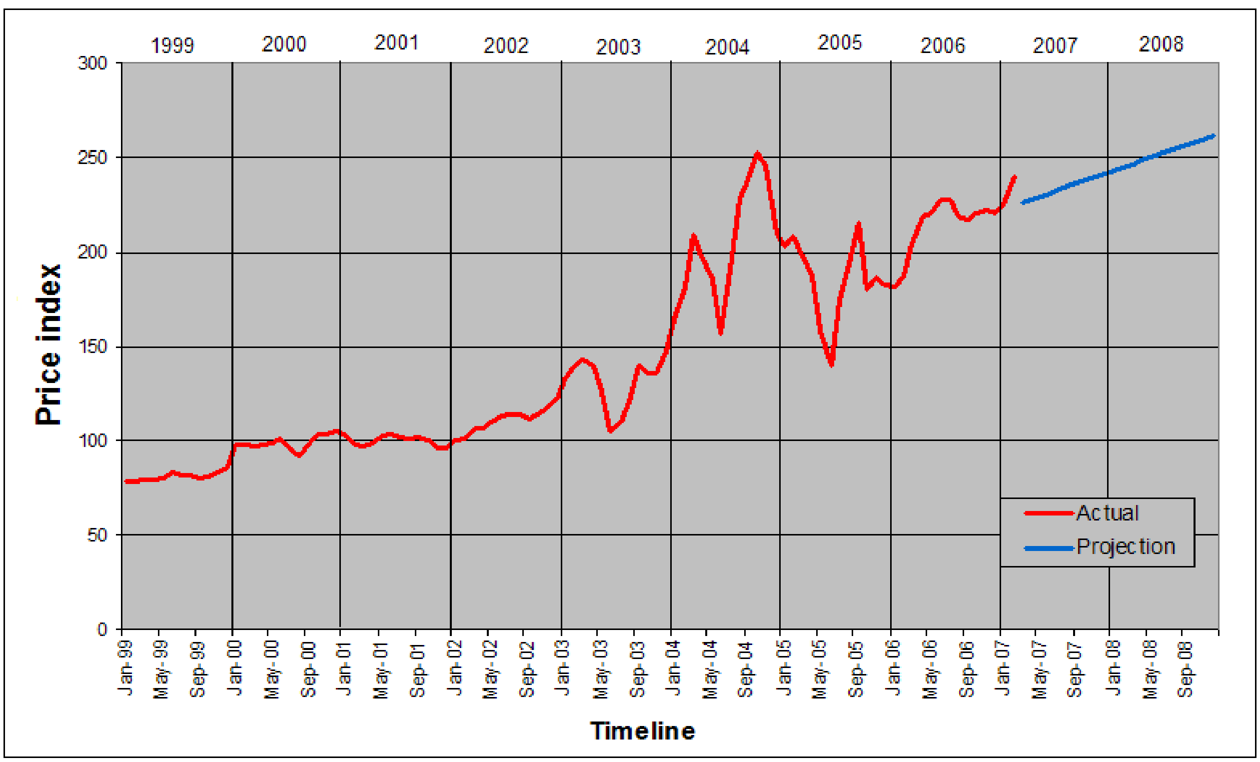
Table 7: Steel demolition scraps price trends in Europe (2002-2008).

Index (2001= 100) calculated on the basis of the average price in €
for the following countries: France, Germany, Italy, Spain, and UK.

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
January	78	98	103	100	133	164	202	182	225	243
February	78	98	98	101	139	182	208	187	240	245
March	79	97	97	107	143	209	196	204	226	246
April	79	98	99	107	139	198	187	218	228	248
May	80	99	103	110	126	185	158	220	230	250
June	83	101	104	113	105	156	139	228	231	252
July	82	94	102	114	110	190	174	228	233	253
August	82	92	101	114	121	229	194	218	235	255
September	80	99	102	111	139	238	216	217	236	257
October	81	104	100	114	136	252	180	220	238	258
November	83	104	96	117	136	246	186	222	240	260
December	86	105	96	122	147	210	183	220	241	262
% change									**+9.72**	**+8.39**

Source: actual prices - E U R O F E R - European Confederation of Iron and Steel Industries - Steel Statistics

Figure 6: Steel demolition scraps price trends in Europe (2002-2008).



Source: actual prices - E U R O F E R - European Confederation of Iron and Steel Industries - Steel Statistics

So, based on all the recent trends in steel consumption and prices, according to World Steel Dynamics, an industry monitor, 2000-2015 could turn out to be the third longest period of sustained growth in steel consumption in history. The previous two occurred during the surge in industrialization in Europe and North America in 1875-1900 and the postwar reconstruction of 1950-70.

RUSSIAN STEEL INDUSTRY OVERVIEW

Soviet steel industry has experienced the wave of steel industry privatizations of the 1990s – another major event in the history of world steel business. Before – during the 70 years of Soviet Era – around 10% of the world steel output was subject to state control and output quotas that were absolutely irrelevant to real demand. After perestroika and market reforms of 1990s the business is now under the aegis of conventional companies with shareholders to satisfy and profits to deliver. That makes the steelmaking businesses less inclined to flood the market with cheap material to maintain former output quotas – a process that in the past has encouraged price volatility and jeopardized long-term profitability. So, based on this factor alone we can definitely say that market reforms in the old Soviet steel industry have had a major positive impact on the world picture.

As a result of privatization following the collapse of the Soviet Union, the Russian steel industry suffered a substantial decline in production from over 77 million tonnes in 1991 to 44 million tonnes in 1998 – natural reaction to state controls and quotas being abandoned. This didn't last long though. Since then, output has increased by nearly 60%, and in 2006, Russia produced 70.6 million tonnes of raw steel, or 5.7% of world production, making it the world's fourth largest producer of crude steel. Overall, the Russian steel industry sells over 51% of its output abroad and benefits from healthy global markets, particularly in Asia, which is the most important market for Russian producers.

Domestic consumption is also on the rise, driven by both upstream and downstream industries. Russian steel producers tend to focus on vertical integration, which allows them a stable supply of certain raw materials (e.g., coking coal for pig iron and non-ferrous metals for stainless steel products) and stable demand from customers up the product chain. In addition, Russian companies are modernizing former state-owned steel production facilities, achieving significant reductions in manufacturing costs, placing their costs well below those of Western European producers, and improving product quality and technology. Mechel is a perfect example of both of these trends and both are its core competencies as already discussed before.

The Russian steel industry is characterized by a relatively high concentration of production, with the five largest steel companies accounting for 82% of Russia's total steel products. These five companies can be divided into two groups by product type. MMK, Severstal and Novolipetsk Iron & Steel Works, or NLMK, focus mainly on flat products, while EvrazHolding and Mechel Steel Group produce primarily long products. Mechel is the second largest producer of long products in Russia after EvrazHolding.

That being said, Mechel is very well positioned on the Russian market. It is also the largest comprehensive producer of specialty steels and alloys in Russia. Besides us, there are a number of relatively small companies — for example, Oskol Electric Metallurgical Works, or OEMK, Zlatoust Metallurgical Plant, or ZMK, and Electrostal — that make various specialty steels and alloys. However, each of these competitors produces only a limited range of products and lags significantly behind Mechel in terms of overall production of specialty steels.

GLOBAL COAL INDUSTRY OVERVIEW

Types of coal. There are two principal types of coal: steam (thermal) coal and coking (metallurgical) coal. Coal is used by a variety of sectors – including power generation, iron and steel production, cement manufacturing and as a liquid fuel. The majority of coal is either utilized in power generation – steam coal or lignite – or iron and steel production – coking coal. Coking coal is harder than steam coal and it swells when heated in blast furnaces, which characteristic is essential in steel making operations.

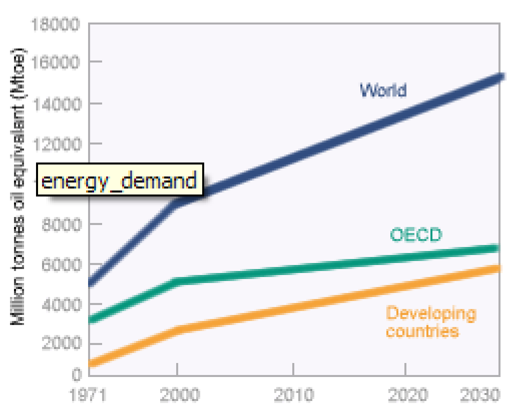
Coal production. Over 4973 Mt of coal is currently produced – a 78% increase over the past 25 years. Coal production has grown fastest in Asia, while Europe has actually seen a decline in production. The largest coal producing countries are not confined to one region – the top five producers are China, the USA, India, Australia and South Africa. Much of global coal production is used in the country in which it was produced; only around 18% of hard coal production is exported. Global coal production is expected to reach 7 billion tonnes in 2030 – with China accounting for around half the increase over this period.

Coal consumption. Coal plays a vital role in power generation and this role is set to continue. Coal currently fuels 40% of the world's electricity and this proportion is expected to remain at similar levels over the next 30 years. Consumption of steam coal is projected to grow by about 1.5% until 2030. Demand for coking coal in iron and steel production is set to increase by 1% per year over this period. The biggest market for coal is Asia, which currently accounts for 54% of global coal consumption – although China is responsible for a significant proportion of this. Many countries do not have natural energy resources sufficient to cover their energy needs, and therefore need to import energy to help meet their requirements. Japan, Chinese Taipei and Korea, for example, import significant quantities of steam coal for electricity generation and coking coal for steel production.

Consolidation. Coal is a global industry, with coal mined commercially in over 50 countries and coal used in over 70. In recent years, the global coal industry has consolidated partly as a result of oil companies and other non-mining companies leaving the sector. The top five export coal producers (Rio Tinto, BHP Billiton, Anglo-American, Xstrata and Drummond) now supply 40% of the total traded coal market, with the top ten producers controlling 60%. As a result, coal suppliers have gained more pricing power.

Future of the coal. Meeting the challenge of sustainable world development will lead to a growing demand for energy. The International Energy Agency (IEA) estimates that by 2030 global energy demand will increase by almost 60%. Two thirds of the increase will come from developing countries – by 2030 they will account for almost half of total energy demand – see Figure 7:

Figure 7: Projected energy demand.



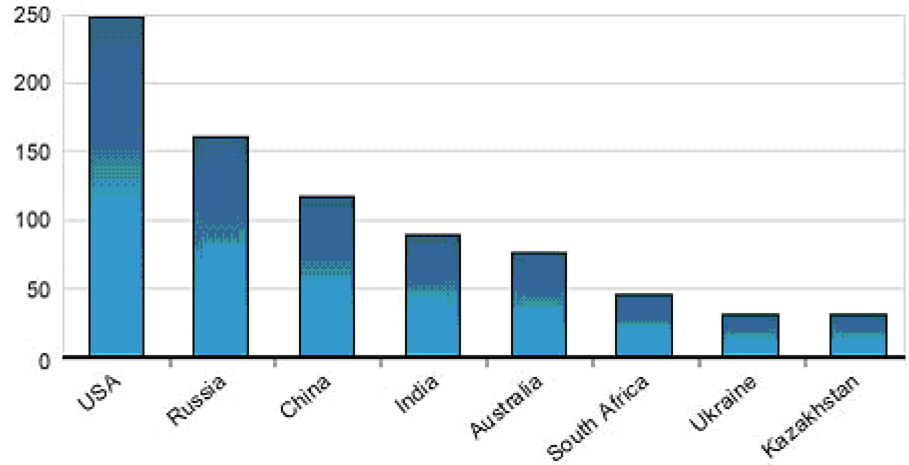
Source: World Coal Institute - http://www.worldcoal.org

All sources of energy will be needed to meet future energy demand, including coal. As the most important fuel for electricity generation and a vital input into steel production, coal will have a major role to play in social and economic development worldwide. Growth in both the steam and coking coal markets will be strongest in developing Asian countries, where demand will increase as incomes rise.

RUSSIAN COAL INDUSTRY OVERVIEW

Russia and Russian coal produces (including Mechel) will be major players in future world coal markets. Even though Russia right now is not one of the largest coal producers, it possesses the world's second largest coal reserves after the United States (see Figure 8) leaving it *plenty of room for growth*. Russian proven coal reserves total 157 billion tonnes, accounting for 16% of the world's proven coal reserves:

Figure 8: Countries with the largest reserves of coal (2005, billion tonnes)



Source: World Coal Institute - http://www.worldcoal.org

Global coal reserves are expected to last for another 155 years at current production levels. In contrast, proven oil and gas reserves are equivalent to around 41 and 65 years at current production levels respectively. About 75% of Russian coal output is steam coal and the balance is coking coal. Approximately 70% of Russia's coking coal output is controlled by Russian steel producers (Mechel's case as well).

Russian coal industry has a lot of potential for the next several years. First, as construction sector expands (details and reasons explained in the CATALYSTS part), steam coal will be much needed for the new and expanded housing projects. Steam coal plays major role in the heating industry. Second, in the energy sector coal will play an increasingly important role as more and more power plants are substituting expensive natural gas with cheaper coal. Up until right now Russia has enjoyed the fact that the country has plenty of natural gas of its own and the usage of it in the energy sector has exceeded all the limits. Right now government is realizing two things: first, the shortage of natural gas is inevitable given the current levels of consumption and only coal can be considered as a substitute in the nearest future; second, it is more advantageous money wise to export the important resource and use coal instead. More on that is also in the CATALYSTS part of the report. That being said, Mechel is very well positioned in the domestic industry and is investing heavily in the mining sector of the business.

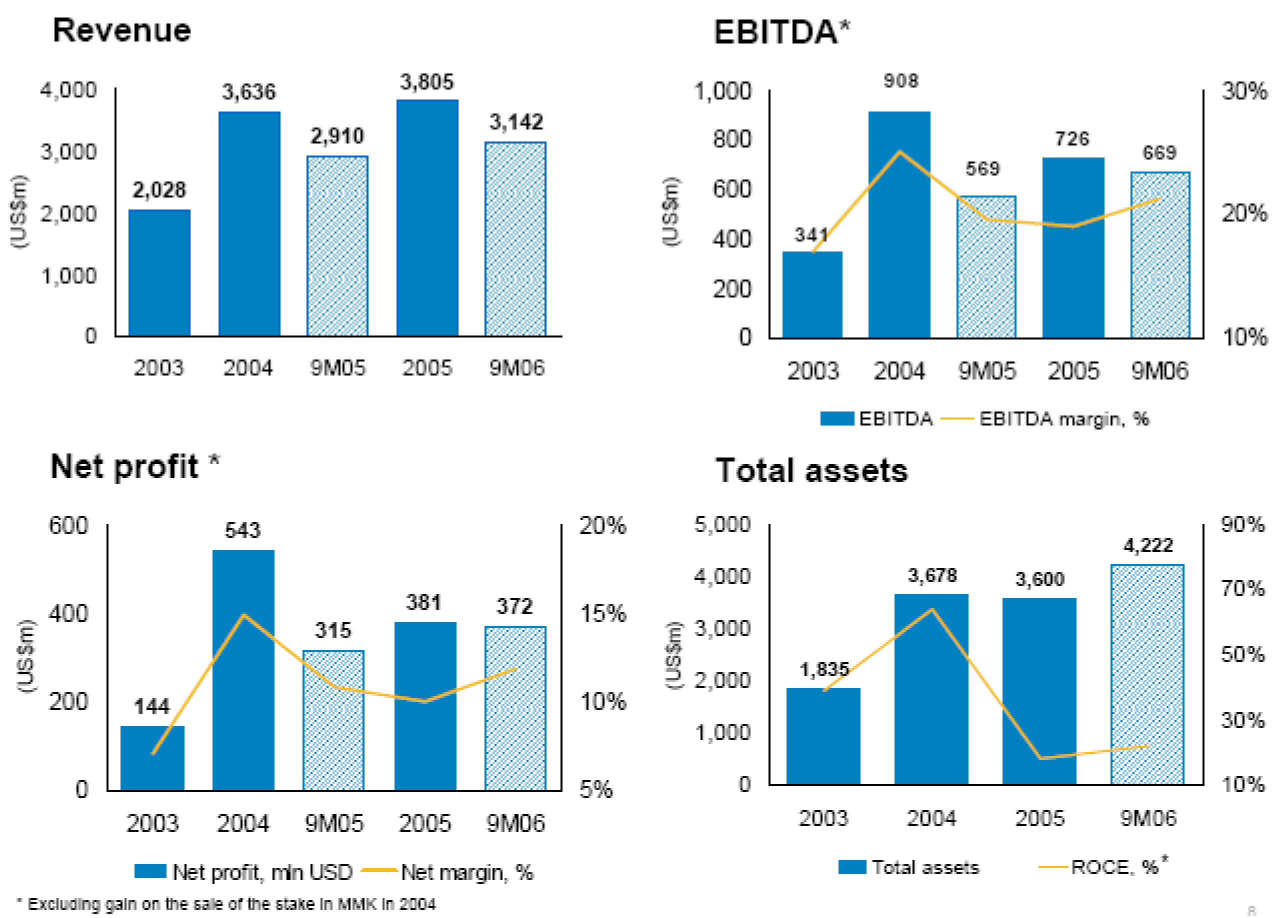
III. FINANCIAL INDICATORS

Among Mechel's main financial strengths are: strong financial performance, solid financial position and attractive dividend yield and rates of return for the stock. The drawbacks include: the ownership structure, where most shares are held in the hands on one single insider and the limited share liquidity. All of the factors are discussed in detail below.

STRONG FINANCIAL PERFORMANCE

Mechel has been a public company trading on NYSE for only the past 4 years, so the trend and comparison analysis might have limited data. Appendix 4, 5 & 6 have all 3 Mechel's consolidated financial statements. But from what we can see below in Figure 9, we can notice that the company's revenues are steadily growing and margins have been improving over time:

Figure 9: Mechel's financial overview and trends.



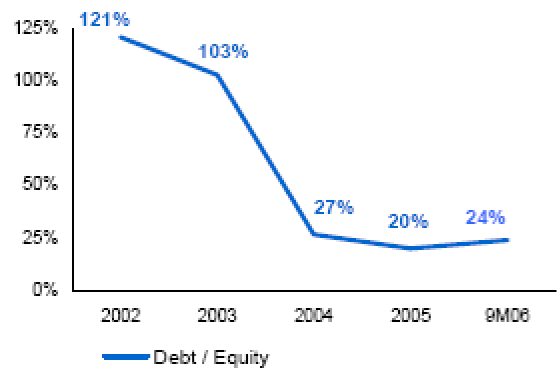
Source: Management Results Presentation for 9 months 2006 - www.mechel.com

While the revenues for 9M 2006 are comparable to the 9M 2005 in dollar values, the net profit for the same period is almost equal to the profit for the full year 2005. This fact clearly shows noticeable improvement in the company's net margins as well as growth prospects. Another factor that contributed to this improvement is previous CAPEX has just started yielding the results – all the acquisitions that are seen on Mechel's cash flow statements from 2003 (Appendix 6) finally started paying off. Based on favorable and stable marker and industry outlook we expect these positive trends to continue in the future.

SOLID FINANCIAL POSITION

Mechel looks really good in comparison to its industry peers when it comes to the amount of debt the company has – see Appendix 2 & 3, long-term debt to equity ratios. Mechel's ratio is 0.24, while the weighted averages for steel and mining companies on the list are 0.64 and 0.38 respectively. This does speak positively about the company's financial health. See also figure 10 below for the picture of the overall trend in the area:

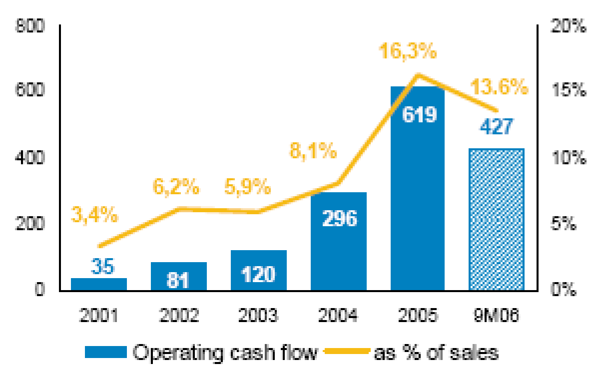
Figure 10: Mechel – debt to equity trend over time.



Source: Management Results Presentation for 9 months 2006 - www.mechel.com

Another factor that speaks in favor of Mechel's financial health is the amount of cash the company is able to generate from its core business activities – operating cash flow. Figure 11 below shows the clear upward trend:

Figure 11: Mechel – operating cash flow trend over time.



Source: Management Results Presentation for 9 months 2006 - www.mechel.com

So, based on the numbers and charts above, on the comparison company browse tables for steel and mining and on the three consolidated financial statements in Appendix sections, we can definitely conclude that Mechel is very well positioned financially compared to the industry and the trends over time have been clearly positive.

DIVIDEND YIELD & RATES OF RETURN

Mechel has a very attractive dividend yield compared to other companies in both – steel and mining industries. See Appendix 2 & 3 for comparisons. Mechel's current dividend yield is 4.3, while average for steel companies is 1.86, and for mining companies - 2.04. Mechel's yield is therefore double the average. Table 8 below also summarizes the dividend history of the stock and compares year-end stock's yields to S&P 500:

Table 8: Dividend history

	2003	2004	2005	2006	2007
Dividend History	**12-02**	**12-03**	**12-04**	**12-05**	**12-06**
Dividend $	0.00	0.00	0.00	1.46	1.42
Year-end Yield %	0.00	0.00	0.00	6.06	5.58
S&P 500 Yield %	1.67	1.39	1.46	1.51	1.65

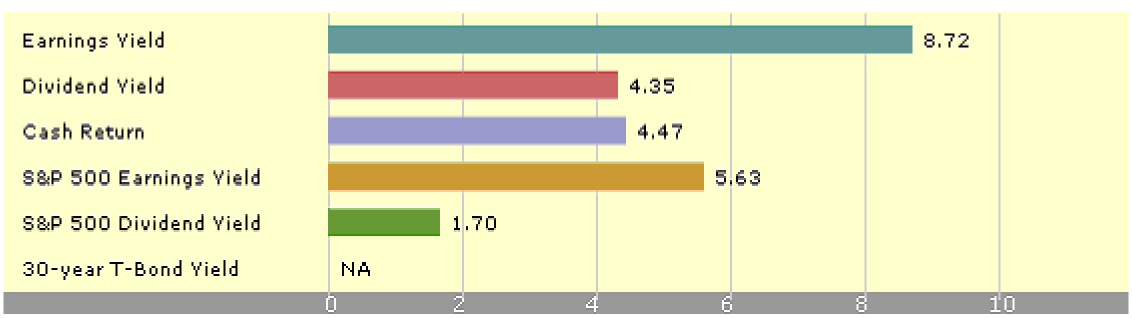
5 Year History	**Splits and Dividends**	**Amount Per Share**
05-31-06	Cash Dividend	1.4220
06-02-05	Cash Dividend	1.4636

Source: Morningstar

Mechel as most ADRs only pays dividend once a year – around May-June time. Initially in the IPO prospectus Mechel was going to pay out at least 15% of its profits as dividends. Recently, however, the company's board decided that the payout ratio will be 50% each year. From one hand, it might signal that company has limited growth prospects and has no projects with positive NPV to invest the money into. But based on the financial facts discussed above, the history of company's acquisitions, its future plans and catalysts described further in the report – the limited growth is definitely not the case for Mechel. The company is making acquisitions on a regular basis and growing its business. So, the fat dividend payout then must be a signal of very healthy earnings and commitment to keep the share value for shareholders.

From the Figure 12 below we can also see that so far Mechel stock has been delivering superior returns so far compared to S&P 500 and risk-free rates:

Figure 12: Current rates of return (as of 4/19/2007)



Source: Morningstar

So, to sum up on this section, we must say that the dividend yield alone can be a very attractive factor in our BUY recommendation. As long as the earnings are sustainable – 50% of them are coming back to the shareholders as cash.

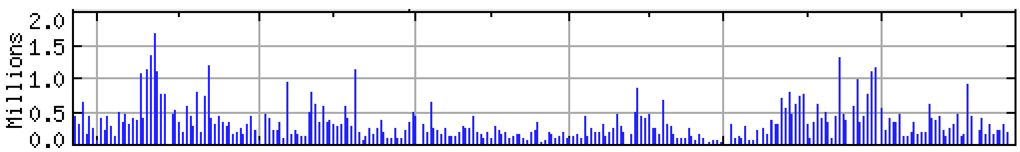
HIGHLY CONSENTRATED OWNERSHIP STRUCTURE

Mechel went public in October 2004. At that time only 11% of shares represented free float. Right now we have about 36% of all ADR shares outstanding representing a free float – the largest share out of all Russian public steelmakers and mining companies. The rest of the shares (64%) are held by the insider – CEO and the chairman of the board – Igor Zuzin. So, compared to its Russian peers, Mechel is the most publicly traded company out of all and the most open in terms of financial reporting. But on the NYSE platform – compared to other US and global public companies – investors do not like when too many shares are concentrated in the hands of one single person. The future and the growth prospects of the company can therefore be determined by the will of one person.

LIMITED SHARE LIQUIDITY BASED ON LOW TRADING VOLUME

Average 3 month daily volume of the stock is about ½ million shares a day, which is not a lot at all. This impacts stocks liquidity and the liquidity premium that investors demand from the required return in order to be compensated for limited liquidity. The daily volume is also not stable at all: sometimes it can be just 200,000 shred traded a day, while on some days the volume goes over a million shares. See Figure 14 for the full picture of the trend:

Figure 14: Mechel's daily volume (1 year history).



Source: Yahoo! Finance.

One of the reasons for thin trading volume might be the ownership structure described above and the limited float as it is. This factor though has been improving overtime and as a result right now Mechel's float is 36% - the highest is has ever been since the IPO. The other reason for the limited liquidity is the factor that the company is relatively young and does not have much data for analysis and as a result not many analysts are covering the stock. We believe that the interest to the company will grow over time as more financial performance numbers are released and more funds will be interested in buying. One more reason for limited trading is the fact that investment has a lot of risks associated with the environment in Russia. The last chapter is solely devoted to those. As the country moves towards the marker economy – these will hopefully become less obvious.

IV. EARNINGS PROJECTIONS, CURRENT AND FUTURE VALUATIONS

CURRENT VALUATION

We believe that even with current trailing P/E, P/B and Price/Sales and Price/Cash Flow ratios the stock is highly undervalued. See Table 9 below for the brief snapshot of stock's price valuation picture compared to both industries and the S&P 500:

Table 9: Current valuation ratios.

Valuation Ratios	Stock	Steel Industry	Mining Industry	S&P 500
Price/Earnings	10.1	13.94	15.46	20.7
Price/Book	1.7	3.57	8.40	4.5
Price/Sales	1.2	3.5	3.8	3
Price/Cash Flow	7.3	15.8	16.5	15.1
Dividend Yield %	4.3	1.86	2.04	1.7

Source: Morningstar, Yahoo! Finance

Just based on the table above we can see that there might be some arbitrage opportunity in the stock current price. But of course, before we make a decision to buy the stock we cannot just look at the past performance, but in addition – we have to come up with some earnings projections and value the stock based on forward earnings along with some other methods of valuation – differential combined with constant growth dividend stock model in our case.

EARNINGS PROJECTIONS

Table 10 below represents our steel sector revenue projections. We started from the estimated 2006 revenue, which is based on Table 2 actual 9M revenue. For projection purposes, we assumed that the 4th quarter 2006 will have the average revenue for the previous 3 quarters: ($2,166,273/3) x 4 = $2,888,364. The 2007 & 2008 steel price changes were predicted in Table 7 using regression analysis. 2009 and 2010 price changes represent our estimates from the same regression formula. Since Mechel's revenue depend mainly on domestic demand and European demand – it made sense to estimate those separate, also adding Asia. The breakdown mainly comes from Figure 3 in the business overview section. The demand change in each region separately is predicted by International Iron & Steel Institute. The revenue from each block is calculated separately and the total for each year is produced:

Table 10: Steel sector revenue projections

STEEL SECTOR	2006E	2007E	2008E	2009E	2010E
Sector prices change (%)		**9.72%**	**8.39%**	**7.74%**	**7.19%**
Russia & CIS block:					
% Revenue from Russia & CIS	61%	61.00%	61.00%	61.00%	61.00%
% Demand change - CIS		9%	5%	5%	5%
Revenue from block	$1,761,902	$2,114,876	$2,406,930	$2,722,887	$3,064,596
% Revenue change		*20.03%*	*13.81%*	*13.13%*	*12.55%*
Asia block:					
% Revenue from Asia	3%	3%	3%	3%	3%
% Demand change - Asia		10.4%	8.4%	8.4%	8.4%
Revenue from block	$86,651	$104,961	$123,324	$144,030	$167,354
% Revenue change		*21.13%*	*17.49%*	*16.79%*	*16.19%*
Europe block:					
% Revenue from Europe	36%	36%	36%	36%	36%
% Demand change - Europe		1%	2.3%	2.3%	2.3%
Revenue from block	$1,039,811	$1,152,289	$1,277,693	$1,408,248	$1,544,219
% Revenue change		*10.82%*	*10.88%*	*10.22%*	*9.66%*
Total STEEL revenue projection	**$2,888,364**	**$3,372,126**	**$3,807,946**	**$4,275,165**	**$4,776,169**
% Revenue change		*16.75%*	*12.92%*	*12.27%*	*11.72%*

Source: International Iron & Steel Institute, Student estimates

Next we have to do exactly the same thing for the mining sector revenue projections. We do not predict any major price increases. In fact the price of coal is expected actually slightly decrease over years, but for other Mechel's mining products – nickel and iron ore – the prices are increasing. So, to be conservative, we leave the price changes at 0% - no changes. Table below represents the results. The demand changes over the 3 regional blocks are predicted by the World Coal Institute as well as by the Russian government for the Russian block. The results are below in Table 11:

Table 11: Mining sector revenue projections

MINING SECTOR	2006E	2007E	2008E	2009E	2010E
Sector prices change (%)		**0.00%**	**0.00%**	**0.00%**	**0.00%**
Russia & CIS block:					
% Revenue from Russia & CIS	60%	60.00%	60.00%	60.00%	60.00%
% Demand change - CIS		15%	15%	10%	10%
Revenue from block	$780,305	$897,351	$1,031,953	$1,135,148	$1,248,663
% Revenue change		*15.00%*	*15.00%*	*10.00%*	*10.00%*
Asia block:					
% Revenue from Asia	6%	6%	6%	6%	6%
% Demand change - Asia		10.0%	10.0%	10.0%	10.0%
Revenue from block	$78,030	$85,834	$94,417	$103,859	$114,244
% Revenue change		*10.00%*	*10.00%*		
Europe block:					
% Revenue from Europe	34%	34%	34%	34%	34%
% Demand change - Europe		1.5%	1.5%	1.5%	1.5%
Revenue from block	$442,173	$448,805	$455,537	$462,370	$469,306
% Revenue change		*1.50%*	*1.50%*	*1.50%*	*1.50%*
Total MINING revenue projection	**$1,300,508**	**$1,431,989**	**$1,581,907**	**$1,701,377**	**$1,832,214**
% Revenue change		*10.11%*	*10.47%*	*7.55%*	*7.69%*

Source: Student estimates

Now, once we know the revenues from both sectors and assuming that the net margins will stay the same as for the period of 9M-2006, we can calculate the projected net income part for each segment and combine them into the total net income. Assuming the number of ADRs outstanding will also stay the same, we calculate the EPS numbers and the percentage as well as dollar contribution to EPS from each segment separately (we will need these numbers for future valuation part.) The results are again below in Table 12:

Table 12: Earnings – actual & projections

	2003A	2004A	2005A	9M2006A	2006E	2007E	2008E	2009E	2010E
STEEL SECTOR									
Revenue	$1,614,108	$2,757,538	$2,710,213	$2,166,273	$2,888,364	$3,372,126	$3,807,946	$4,275,165	$4,776,169
Net Margin	7.06%	7.77%	2.49%	10.76%	10.76%	10.76%	10.76%	10.76%	10.76%
Net Income	$114,011	$214,374	$67,443	$233,016	$310,688	$362,724	$409,603	$459,860	$513,751
MINING SECTOR									
Revenue	$413,943	$878,417	$1,094,782	$975,381	$1,300,508	$1,431,989	$1,581,907	$1,701,377	$1,832,214
Net Margin	7.13%	37.38%	28.66%	14.26%	14.26%	14.26%	14.26%	14.26%	14.26%
Net Income	$29,497	$328,350	$313,736	$139,099	$185,465	$204,216	$225,596	$242,633	$261,292
TOTAL COMPANY									
Revenue	$2,028,051	$3,635,955	$3,804,995	$3,141,654	$4,188,872	$4,804,116	$5,389,854	$5,976,542	$6,608,383
Net Margins	7.08%	14.93%	10.02%	11.84%	11.84%	11.84%	11.84%	11.84%	11.84%
Net Income	**$143,508**	**$542,724**	**$381,179**	**$372,115**	**$496,153**	**$566,940**	**$635,199**	**$702,493**	**$775,042**
Steel – NI, %	79.45%	39.50%	17.69%	62.62%	62.62%	63.98%	64.48%	65.46%	66.29%
Mining - NI, %	20.55%	60.50%	82.31%	37.38%	37.38%	36.02%	35.52%	34.54%	33.71%
PER SHARE VALUES									
# of ADRs outst.	122,059,605	124,657,104	134,372,893	135,507,395	135,507,395	135,507,395	135,507,395	135,507,395	135,507,395
EPS per ADR	**$1.18**	**$4.35**	**$2.84**	**$2.75**	**$3.66**	**$4.18**	**$4.69**	**$5.18**	**$5.72**
EPS change %	*270.30%*	*-34.84%*	*-3.20%*	*33.33%*	*14.27%*	*12.04%*	*10.59%*	*10.33%*	*270.30%*
Steel EPS	$0.93	$1.72	$0.50	$1.72	$2.29	$2.68	$3.02	$3.39	$3.79
Mining EPS	$0.24	$2.63	$2.33	$1.03	$1.37	$1.51	$1.66	$1.79	$1.93

Source: Student estimates

FUTURE VALUATION

Now, since we have our EPS projections we can value the stock using three different methods: 33.33% P/E (ttm), 33.33% P/E 1-year forward and 33.33% Growth Dividend Stock Model. The dividend model itself made a lot of sense with Mechel's stock especially as Mechel's dividend payout ratio is known at 50% and the dividend itself is important and considerable.

- **P/E (ttm) valuation** presented in Table 13 below suggests a fair price target of $47.00 for MTL stock:

Table 13: P/E (TTM) valuation.

Industry	% of EPS	Contribution to EPS (TTM)	Industry P/E (TTM)	Value per share
Steel	62.62%	$2.03	13.94	$28.30
Mining	37.38%	$1.21	15.46	$18.71
TOTAL	**100.00%**	**$3.24**	**14.51**	**$47.00**

Source: Student Estimates.

Since we have been analyzing the stock's earnings and revenues in 2 industries separately – it only makes sense to use the same approach in the valuation models. $3.24 EPS number is the trailing last 12 month EPS combined. Percentages of EPS contributions come from Table 12 above. The fair industry P/E multipliers for both industries are from tables in Appendix 2 & 3 again.

- **Forward 2007 P/E (FY1) valuation** presented in Table 14 below suggests a fair price target of $43.30 for Mechel's stock:

Table 14: Forward 2007 P/E (FY1) valuation.

Industry	% of EPS	Contribution to EPS (FY1)	Industry P/E (FY1)	Value per share
Steel	63.98%	$2.68	9.57	$25.62
Mining	36.02%	$1.51	11.73	$17.68
TOTAL	**100.00%**	**$4.18**	**10.35**	**$43.30**

Source: Student Estimates.

The method of valuation is the same as above. EPS 2007 number and percentages – both come from Table 12, while P/E multipliers – from Appendix 2 &3.

- **Growth Dividend Stock Model** – differential combined with constant – suggests that Mechel's stock price target should be $49.20. To illustrate this model, we should first come up with appropriate discount rate for Mechel's stock. See Table 15 for the discount rate calculation:

Table 15: WACC calculation

Risk free rate					5%	
Beta					1.89	
S&P 500 average 10-year return					8.20%	
Market premium					3.20%	
Cost of Equity					11.05%	
Capital structure:		%	Pretax	Tax rate	After-tax	Weighted average cost
DEBT	1,616,803	38.29%	8.57%	25%	6.43%	2.46%
EQUITY	2,605,315	61.71%			11.05%	6.82%
Total	4,222,118	100.00%				
WACC						**9.28%**

Source: Company financial statements, Yahoo! Finance

Now that we know the appropriate discount rate, we have to calculate the annual dividends based on our estimated EPS numbers, 50% promised payout rate discussed above. Once that is done, each annual dividend is discounted to present using 9.28% rate calculated in Table 15. We assume that dividends will fluctuate at different considerable growth rates for another 4 years – until 2010 – and then 4% forward constant growth rate is applied. The stock price at the end of year 4 (2010) is calculated using known formula $\mathbf{P_0 = Div_1/(r\text{-}g)}$ **–** *Constant Growth Dividend Stock model* – and then discounted to the present using the same discount rate applied to dividends. The results are below in the Table 16:

Table 16: Growth Dividend Stock Model

Period	0	1	2	3	4	Forward
Year	2006	2007	2008	2009	2010	
EPS	$3.66	$4.18	$4.69	$5.18	$5.72	
Payout ratio, %	50%	50%	50%	50%	50%	
Dividend	$1.83	$2.09	$2.34	$2.59	$2.86	$2.97
Growth, %		*14.27%*	*12.04%*	*10.59%*	*10.33%*	*4%*
Discounted value (div)	$1.83	$1.91	$1.96	$1.99	$2.01	*(assumption)*
SUM of discounted div values	**$9.70**					
Stock value					$56.33	
Discounted stock value	**$39.50**					
TOTAL SUM	**$49.20**					

Source: Student Estimates.

Now we can calculate our price target based on the three different methods: 33.33% P/E (ttm), 33.33% P/E 1-year forward and 33.33% Growth Dividend Stock Model. See Table 17 below:

Table 17: Overall price target calculation.

Model	Price Target	Weight	OVERAL TARGET
P/E (ttm)	$47.00	33.33%	**$46.50**
P/E (FY1)	$43.30	33.33%	
Growth Div Stock	$49.20	33.33%	

Source: Student Estimates.

Our overall price target of $46.20 for Mechel's stock suggests a potential price appreciation of 40.87% over time. This is the current price target and not the future one, meaning that even now the stock is significantly mispriced. But since, the stock has a lot of risks, low liquidity and is relatively young and new to US investors – we are reluctant to say that the stock will achieve this price in the nearest future. We do think though that 1 year horizon is pretty real and achievable, especially if the company comes up with good earning reports in the next couple month. The company as of April 19 still hasn't reported 4th quarter 2006 financial results, along with the full year. Based on the solid operating results – if the financials meet investor's expectations – the stock can move towards our price target fairly quickly. See also the next chapter – catalysts – for the analysis of the future trends that will definitely help Mechel stay profitable and meet expectations.

V. CATALYSTS

RUSSIAN HOUSING MARKET WILL DRIVE DEMAND FOR STEEL

Russian housing market has just experienced a boom in the last couple years, when the prices of existing homes, new homes and the square meter have soared. This boom was based mainly on the high end income population. There are couple reasons why we think so: first, the population in Russia is still very much divided into very rich and very poor, where middle class is almost not represented at all; second, in order to afford 20-30% down payments and interest rates of 18-20% - you do have to be rich. In order to understand what is going on in the Russian housing market now and make projections for the future – you have to look back into the Soviet era and into the post-perestroika years.

During the Soviet era there was no real estate market at all. In order to get housing one had to prove to the government that there is a need for extra square meters due to whatever reasons (government had certain limits in place). Once approved – the person had to sign up on the waiting list which used to last on average 10-15 years. In the meantime government was in charge of the homebuilding sector and once the new apartment buildings were built – the apartments were distributed according to the waiting list. This resulted in the situation when 7-8 people of 2-3 generations lived in small apartments with no hope to ever move out.

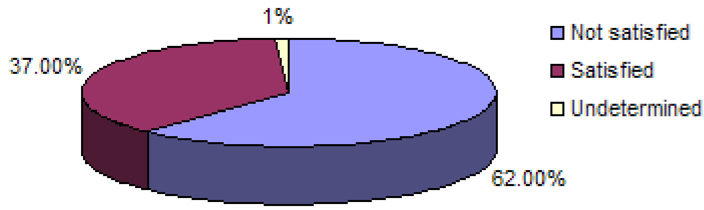
After perestroika the waiting lists ended and housing market entered into a market economy. In order to get an apartment to live one now has to come up with money in cash (USD preferably). There are no dealers and all buy, sells and exchanges are done directly between the parties involved. Imagine for one second if all car dealerships in US are gone one day and in order to sell your car and buy a new one you have to post an ad in a paper and find the second party who would want to transact with you. So, the two major characteristics of this period were: first, no banks to lend money and the need for 100% cash payment; second, no dealers (real estate agents). As a result we have very illiquid housing market with very few transactions happening. As widely known, illiquid means discount to price. Apartment prices and prices per square meter did rise during this period, but not as much.

Third period started few years ago, when old Soviet real estate laws were finally updated by the legislative brunch and allowed for real estate agent to appear. Dealer market has started and added huge chunk of liquidity to the whole market. This has lead to rising prices. At the same time banking system has developed enough to allow for house financing and mortgages for population. This has opened a whole new opportunity for those people who need a place to live and do not have 100% of the price in cash, but still have some money for the down payment. The government is also no longer in charge of the home building and private sector is building to meet the increased demand which is still there from the Soviet times. We still have one problem though – there is no way for banks who lend the money to differentiate between borrowers. As widely known, some people pay their debts on time, while others do not. As a result of not being able to differentiate, banks decide to pass this risk to everyone making everyone subject to very high interest rates – 18-20% – as well as high initial down payments. This, in turn, resulted in the housing boom that was based on high income population who were able to afford this payments structure with banks. So, that was the most recent housing boom in Russia and the whole former Soviet Union.

At the same time – couple years ago – when the whole mortgage system started, Russian government adopted the individual credit history within the banking sector. The Russian system is just like the US credit system, where all financial information for all individuals is corrected by a credit agency and then is sold to lenders. As a result, lenders will eventually be able to distinguish between borrowers and assign personal interest rates to people based on their personal risk of default. Before this system starts bringing real results – several years of financial information are needed. Eventually this will drive the interest rates down and the housing will be more affordable for the middle class, which is also expected to expand by then. The demand will still be there in even greater scope and a whole new housing and real estate boom will start driving the construction sector to the new highs. There will be a huge need for new construction and Russia definitely has the geographical space for this.

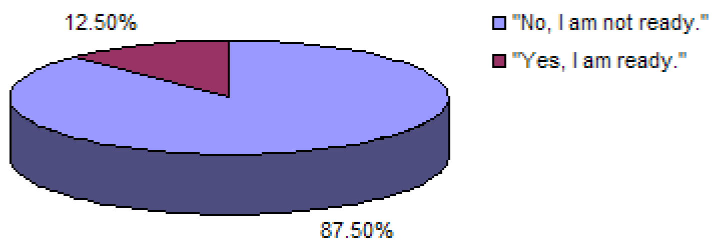
To prove this point, look at the two diagrams below. The first one represents the huge potential that is still left in the Russian real estate market – 62% of people are not satisfied with their living conditions and would like to expand. The second diagram shows that 87.5% of the Russian population are still not ready to apply for mortgage for various reasons. When asked about reasons three most popular answers were: low income, high interest rates, uncertainty in stable income.

Figure 15: Satisfaction of Russian people with their living conditions.



Source: National Agency of Financial Research.

Figure 16: Readiness of Russian population to use mortgage to buy a house.



Source: National Agency of Financial Research.

What will all the above mean for Mechel? It will simply mean that its steel segment will have to be 100% ready for this turn in the economy as steel prices will most likely be high around the time when the construction market booms again in Russia. From what we can see Mechel is planning to expand its position as a leading producer of carbon long products in Russia – those are heavily used in construction. MTL has already built a solid presence in this sector, including a market-leading position in engineering steel and strong sales in rebar and wire rod. Mechel intends to improve these positions further, including the addition of substantial new production capacity achieved by targeted, cost-effective capital expenditures. The company plans to increase its raw steel and rolled steel production capacity to 8.2 million and 7.1 million tonnes in 2007, respectively, primarily at our Chelyabinsk Metallurgical Plant. Besides, substantial infrastructure repairs and industrial upgrade needs should also drive demand for Mechel's steel products.

RECENT IMPOSITION OF DUTIES AGAINST EU STAINLESS-STEEL IMPORTS

The Russian government has recently decided to impose a three-year anti-dumping duty of 840 euros per tonne on steel with nickel content of 2.5% or higher imported from the European Union, according to a government resolution. The duty enters into effect a month after its official publication in Rossiiskaya Gazeta on February 20.

The Russian Economic Development and Trade Ministry started the anti-dumping probe on October 27, 2004 following a complaint filed by the Mechel steel group's Chelyabinsk Iron & Steel Works on behalf of Russian stainless steel producers. Russia's producers claimed that imported stainless steel was being sold in Russia for half its price on the EU market.

The duty's pretty huge. The export-grade stainless steel sheet in the EU is currently sold at $4,350 a ton, which means the Russian levy would increase the price by a quarter. European steelmakers likely to be affected by the duties include Arcelor Mittal and Finland's Outokumpu Oyj, though the impact on their sales is likely to be marginal because Russia's market for stainless steel sheet is small, analysts said.

What will this mean for MTL? The decision to impose the duty will mean Russian stainless producer Mechel, which has been lobbying the government on the issue for the past three years, will be able to produce around 40 percent more stainless flat products in 2007 and even more in 2008. Right now this type of products only represents 7% of the revenues in the steel segment (Figure 3), leaving it plenty of room to expand. In 2006 Mechel produced 400,000 tonnes of flat products and this represented 28% increase above the 2005 production level – biggest percentage increase out of all product types for Mechel. Just the fact itself that Mechel took the time to lobby this issue for 3 years, while its current revenues do not depend that much on steel production, tells us about the company's future plans in regards to the steel segment.

MINING SEGMENT: ONLY COAL CAN REPLACE GAS IN THE ENERGY SECTOR

We believe that Mechel's coal business will experience a period of growth in the nearest future. The reason for that would be an increased demand for coal in Russia and as a result an increased price for the product. One of the demand drives will be the same housing market that will drive the steel segment. The second factor is that only coal can substitute natural gas in the energy sector use in the nearest future.

Russian president Putin has just mentioned in one of his very recent meetings with the business leaders, that energy sector will have to slowly adopt coal in its usage due to a growing natural gas deficit. On December 20, 2006 in Moscow a conference took place, which was fully devoted to problems arising from the shortage of natural gas and future prospects of the Russian energy sector. So, the issue is being taken very seriously and is address on the highest level.

The main problem here is that by the year 2010 the natural gas deficit in Russia is estimated to be between 30 and 120 billion of cubic meters. Due to many reasons there is no possible way increase the production of the natural gas, but there are still other ways to decrease the deficit – substitution and saving.

According to experts, the main consumer of the natural gas is the energy sector in Russia. That being said, if Russian business leaders and the government target this sector alone – the biggest substitution effect will be achieved. That is exactly what is going on right now in the sector. The government claims right now that in the short-term prospective only coal can be used to substitute the natural gas usage in the energy sector. One can argue that atom and hydro energy generation can also be an alternative. These two sources of energy have a lot of issues around them and besides it takes really long construction time and high initial capital investments to build an atom- or hydro- energy generator. As a result, the development of steam coal production as a future energy source becomes a priority.

The main drawback of the coal sector is the high cost of transportation. Major coal production centers are away from the final consumers and the transportation cost is then incorporated into the final price for the final consumer. Right now, the fare to transport coal only covers about one half of the real cost. Transport companies indirectly transfer the remaining cost to other products and services and are more profitable. As a result, the coal transportation lacks adequate financing and it will make it more difficult to keep up with the volume that will need to be transported in the near future.

What the business leaders and the government are thinking about is creation of a transportation company that will deal exclusively with coal transportation. Specialized equipment is also being developed that will be used solely to transport coal. Along those lines, government might have to subsidize some of the transportation costs and the funds for this can come from natural gas exports and price increases of natural gas for domestic consumers, since some of the natural gas will be freed for export by this time.

So, all that being said, one can clearly see that the coal production sector in Russia has a lot of room for growth and Mechel clearly sees this great opportunity. Mechel is spending about $1.1 billion investing in its both segments – steel and mining – but about 75% of this money will go into the coal segment. By 2001 Mechel is planning to increase its coal production level to 25 mil tones.

FUTURE MECHEL'S POWER SEGMENT

On March 29, 2007 Mechel OAO announced winning the auction to acquire 93.35% of the shares of Southern Kuzbass Power Plant OAO. The acquisition of Southern Kuzbass Power Plant is in line with Mechel's strategy to further develop its mining segment and its successful vertical integration strategy. The objective of acquiring Southern Kuzbass Power Plant is to increase Mechel's performance through the possibility of producing high value added product in the form of electric power using Mechel's own steam coal. The acquisition of the new power generating asset is also aimed at developing the power component of Mechel's business, which, in particular, includes reduction of production cost by generating Mechel's own electric power, growth of the Company's capitalization, and making additional profit from marketing the generated electric and heat energy.

As a result of the auction Mechel-Energo OOO owned by Mechel OAO has taken up 93.35% of the charter capital of Southern Kuzbass Power Plant OAO for approximately US$ 265 mln.
Being now a part of Mechel Group, Southern Kuzbass Power Plant OAO will secure its continuous and efficient work by stable steam coal supply from Southern Kuzbass OAO owned by Mechel OAO. The annual demand of the power station in steam coal, which is planned to be covered by deliveries from Southern Kuzbass OAO, amounts to about 1-1.2 million tonnes of coal. With further increase of the production capacity of Southern Kuzbass Power Plant OAO, coal supply from Southern Kuzbass OAO can reach 2 million tonnes annually. The competitive advantage of the power plant is its location close to the coal mining sites, the largest power consuming steelmaking works in the region, coal and ore mining companies, and presence of such major consumer as the Southern Kuzbass region's public utilities, which altogether ensure consistent load of the power plant.

It is the first time Mechel has acquired a large power generating asset, thus confirming its serious intentions to single out power production into a separate business segment and to broaden and strengthen synergy relations between the group's subsidiaries. Mechel's power business is a logical stage in the Company's vertical development. Coal is the main product Mechel manufactures and markets and now Mechel will be able to produce another finished product in the form of electric and heat energy from Mechel's own steam coal.

VI. INVESTMENT RISKS

Investment in ADRs I general and especially in growth stocks involve a high degree of risk. As widely known – high potential return always comes with increased risk. But if the expected return adequately reflects all the risks involved – the stock is not a catch at all. In this case investors demand lower stock price and therefore higher potential returns in order to get compensated for the high risk involved. We do believe that Mechel ADR is not this case. Even though there are plenty risks involved in this investment, the potential returns are still greater thus making the stock a value. All risks pertaining to MTL can be divided into 3 broad categories: risks relating to the company's business and its industry, political risks and risks relating to the economic environment in Russia. Any of those risks can potentially adversely affect Mechel's business and lead to the price decline.

RISKS RELATING TO THE BUSINESS AND INDUSTRY

- ***Mechel operates in a cyclical industry and any local or global downturn in the steel industry may have an adverse effect on company's results of operations and financial condition.***

The steel industry is cyclical in nature because the industries in which steel customers operate are cyclical and sensitive to changes in general economic conditions. The demand for steel products thus generally correlates to macroeconomic fluctuations in the economies in which steel producers sell products, as well as in the global economy. The prices of steel products are influenced by many factors, including demand, worldwide production capacity, capacity-utilization rates, raw-material costs, exchange rates, trade barriers and improvements in steel-making processes. Steel prices have experienced, and in the future may experience, significant fluctuations as a result of these and other factors, many of which are beyond company's control.

Mechel's mining business also sells significant amounts of coal, iron ore and nickel to third parties. Cyclical and other uncontrollable changes in world market prices of these commodities could affect the results of our mining activities. The changes in these prices result from factors, such as demand and transportation costs, which are beyond our control. Prices of these commodities have varied significantly in the past and could vary significantly in the future. Prolonged declines in world market prices for the commodities we sell to third parties would have a material adverse effect on our revenues. A decline in steel prices could also harm our customers for these commodities.

Mechel derives approximately ½ of its total revenues from sales to customers in Russia. The Russian economy has experienced significantly fluctuating growth rates over the past 10 years. Russian production of steel also has fluctuated a lot over the last ten years. Further, Mechel's products in Russia are mainly used in the engineering, construction and automotive industries, which are particularly vulnerable to general economic downturns. In addition to Russia, Asia and the Middle East are also large destinations for company's products, and these areas, like Russia, face greater risks of volatility. Accordingly, any significant decrease in demand for steel products or decline in the price of these products in Russia or other emerging market economies could result in significantly reduced revenues, thereby materially adversely affecting results of operations and financial condition.

In spite of all these risks related to cyclical nature of steel and mining industries we still believe that right now is still a good time to buy these stocks as we are still not on the decline part of the cycle (see "Catalysts").

- ***The steel industry is highly competitive.***

Mechel faces competition from domestic and foreign steel manufacturers, many of which have greater resources. A number of our Russian competitors are undertaking modernization and expansion plans, which may make them more efficient or allow them to develop new products.

Mechel also faces price-based competition from steel producers in emerging market countries, including, in particular, Ukraine. Recent consolidation in the steel sector globally has also led to the creation of several very large steel producers, each with greater financial resources and more extensive global operations than Mechel. Moreover, the steel industry suffers from production overcapacity. Increased competition could result in more competitive pricing and reduced profitability.

Mechel is realizing all the above threats and is investing a lot of money into modernization of its recently acquired plants and factories trying to increase productivity, profitability and be more competitive.

- ***Mechel will require a significant amount of cash to fund its capital improvements program. The ability to generate cash or obtain financing depends on many factors beyond company's control***.

The total cost of Mechel's capital improvements over the next five years is expected to be approximately $1.1 billion. Most of the current borrowing is from Russian banks. In the future, Mechel expects to rely to a greater extent than currently on foreign capital markets and other foreign financing sources for its capital needs. It is possible that these foreign sources of financing, as well as domestic sources may not be available in the future in the amounts the firm requires or at an acceptable cost. (See part about economic risks in Russia below.)

- ***Mechel's business strategy foresees additional acquisitions and continued integration, and the company may fail to identify suitable targets, acquire them on acceptable terms or successfully integrate them.***

Mechel's strategy relies on our status as an integrated steel and mining group, which allows it to benefit from economies of scale, realize synergies, better satisfy the needs of the domestic and international steel customers and compete effectively against other steel producers. Mechel also intends to enhance the profitability of our business by applying our integration strategy to a larger asset base and, towards that end, we need to identify suitable targets that would fit into our operations, acquire them on acceptable terms and successfully integrate them. The acquisition and integration of new companies pose significant risks to our existing operations, including: additional stress placed on senior management; increased complexity of the business; significant cash expenditures; incurrence of debt to finance acquisitions and strains on labor force. Moreover, the integration of new businesses may also be difficult for a variety of reasons, including differing culture or management styles, poor records or internal controls and inability to establish control over cash flows.

Despite all these facts, Mechel has so far been very successful with all its acquisitions and current management shows a great deal of experience in integrating different businesses and being able to achieve synergies between them.

- ***Mechel depends on key accounting staff for the preparation of U.S. GAAP financial information. Russia right now has shortage in such accounting personnel.***

Mechel's subsidiaries maintain their books and records in local currencies and prepare accounting reports in accordance with local accounting principles and practices. In particular, each of the Russian subsidiaries maintains its books in rubles and prepares separate unconsolidated financial statements in accordance with Russian accounting standards. For every reporting period, Mechel translates, adjusts and combines these standalone Russian statutory financial statements to prepare consolidated U.S. GAAP financial statements. This is a difficult task requiring U.S. GAAP-experienced accounting personnel at each of Mechel's subsidiaries and at Moscow corporate offices. While Mechel has hired accounting personnel who are CPAs and ACCA-qualified in the past year, Russia has available only a small number of accounting personnel with U.S. GAAP expertise. Moreover, there is an increasing demand for such personnel as more Russian companies are beginning to prepare financial statements on the basis of U.S. GAAP or other international standards. Such competition, combined with the remote locations of our subsidiaries which such personnel may not find suitable in comparison to other opportunities, makes it difficult for Mechel to hire and retain such personnel. Under these circumstances, we may have difficulty in remedying the material weaknesses identified by our independent registered public accounting firm and in the timely and accurate reporting of our financial information in accordance with U.S. GAAP.

This risk factor affects all companies operating in Russia market and reporting under GAAP. In the past though Mechel has been able to retain its key accounting personnel. It still does take a lot of time to translate the statements and at times Mechel does not report earnings until months after quarter has ended.

- ***Mechel faces numerous protective trade restrictions and duties in the export market, wile tariffs and duties that Mechel benefits from may be eliminated in the future.***

Mechel faces numerous protective tariffs, duties and quotas which reduce its competitiveness in, and limit its access to, particular markets. Several key steel importing countries currently have import restrictions in place on steel products or intend to introduce them in the future.

On the other hand, Russia has in place import tariffs with respect to certain steel products imported from outside of Russia, excluding certain other CIS countries. These tariffs and duties may be reduced or eliminated in the future, which could materially adversely affect Mechel's revenues and results of operations. But so far as described in "Catalysts" section this has not been the case and in fact a new anti-dumping duty has been introduced to the Russian market which is expected to boost Mechel's revenues.

- ***Further appreciation in real terms of the ruble against the U.S. dollar may materially adversely affect Mechel's results of operations.***

Mechel's reporting currency under GAAP is the U.S. dollar. Mechel's products are typically priced in rubles for domestic sales and in U.S. dollars (and, to a lesser extent, euros) for export sales, whereas the majority of the direct costs are incurred in rubles and, to a lesser extent, in other local currencies where the company's operations are based. Appreciation in real terms of the ruble against the U.S. dollar results in an increase in Mechel's costs relative to our revenues, adversely affecting our results of operations.

On the other hand, if US dollar depreciates that the underlying shares which are priced in Russian rubles will cost more in dollars for US investors leading to a rise in price, everything else equal. So, by looking at geographical exposure of Mechel's revenues one can clearly see that only 47% of its revenues come from outside of Russia. So, the revenues have 47% exposure to appreciating ruble, while the price of the stock has 100% exposure to this factor, making it actually a positive one for US investors in particular. We also do predict that US dollar will be further declining against Euro and Russian ruble in particular due to the growing trade deficit in US.

- ***Mechel is subject to mining risks.***

Mechel's business operations, like those of other mining companies, are subject to all of the hazards and risks normally associated with the exploration, development and production of natural resources, any of which could result in production shortfalls or damage to persons or property. In particular, hazards associated with our open-pit mining operations include:

- flooding of the open pit;
- collapses of the open-pit wall;
- accidents associated with the operation of large open-pit mining and rock transportation equipment;
- accidents associated with the preparation and ignition of large-scale open-pit blasting operations;
- production disruptions due to weather; and
- hazards associated with the disposal of mineralized waste water, such as groundwater and waterway contamination.

Hazards associated with our underground mining operations include:

- underground fires and explosions, including those caused by flammable gas;
- cave-ins or ground falls;
- discharges of gases and toxic chemicals;
- flooding;
- sinkhole formation and ground subsidence; and
- other accidents and conditions resulting from drilling, blasting and removing and processing material from an underground mine.

Even though Mechel has been very precautious and to some extent lucky in the past it is at risk of experiencing any and all of these hazards. The occurrence of any of these hazards could delay production, increase production costs and result in injury to persons and damage to property, as well as liability for the company. The liabilities resulting from any of these risks may not be adequately covered by insurance, and we may incur significant costs that could have a material adverse effect upon business, results of operations and financial condition.

RISKS RELATING TO THE POLITICAL ENVIRONMENT IN RUSSIA

- ***Political and governmental instability could adversely affect the value of Mechel's ADRs.***

Since 1991, Russia has sought to transform itself from a one-party state with a centrally-planned economy to a democracy with a market-oriented economy. As a result of the sweeping nature of the reforms, and the failure of some of them, the Russian political system remains vulnerable to popular dissatisfaction, including dissatisfaction with the results of privatizations in the 1990s, as well as to demands for autonomy from particular regional and ethnic groups. Moreover, the composition of the Russian government — the prime minister and the other heads of federal ministries — has at times been highly unstable. For example, six different prime ministers headed governments between March 1998 and May 2000. On December 31, 1999, President Yeltsin unexpectedly resigned. Vladimir Putin was subsequently elected president on March 26, 2000, and reelected for a second term on March 14, 2004. While President Putin maintained governmental stability and even accelerated the reform process during his first term, he may adopt a different approach over time. In February 2004, for example, President Putin dismissed his entire cabinet, including the prime minister. This was followed on March 12, 2004, by President Putin's announcement of a far-reaching restructuring of the Russian government, with the stated aim of making the government more transparent and efficient.

Needless to say, the biggest uncertainty right now is the fact that the country faces both parliamentary and presidential elections over the next 16 month. Russia is not one of those countries where no matter who becomes the president, economy will not be affected much (US is an example). In Russia politics and business are very much interconnected and influence each other. For While Russia is not likely to undergo the same type of crisis as occurred during the Yeltsin's years, uncertainty is never a good thing for investors and that is the direction where Russia is heading now.

Future changes in government, major policy shifts or lack of consensus between President Putin, the prime minister, Russia's parliament and powerful economic groups could disrupt or reverse economic and regulatory reforms. Any disruption or reversal of the reform policies, recurrence of political or governmental instability or occurrence of conflicts with powerful economic groups could have a material adverse effect on any company including Mechel and the value of all investments in Russia, like Mechel's ADRs.

- ***Political and other conflicts create an uncertain operating environment that hinders Mechel's long-term planning ability and could adversely affect the value of investments in Russia.***

The Russian Federation is a federation of 89 sub-federal political units, consisting of republics, territories, regions, cities of federal importance and autonomous regions and districts. The delineation of authority and jurisdiction among the members of the Russian Federation and the federal government is, in many instances, unclear and remains contested. Lack of consensus between the federal government and local or regional authorities often results in the enactment of conflicting legislation at various levels and may lead to further political instability. In particular, conflicting laws have been enacted in the areas of privatization, securities, corporate legislation and licensing. Some of these laws and governmental and administrative decisions implementing them, as well as certain transactions consummated pursuant to them, have in the past been challenged in the courts, and such challenges may occur in the future. This lack of consensus hinders companies' long-term planning efforts and creates uncertainties in the operating environment, both of which may prevent Mechel from effectively and efficiently carrying out our business strategy.

Additionally, ethnic, religious, historical and other divisions have, on occasion, given rise to tensions and, in certain cases, military conflict, such as the continuing conflict in Chechnya, which has brought normal economic activity within Chechnya to a halt and disrupted the economies of neighboring regions. Various armed groups in Chechnya have regularly engaged in guerrilla attacks in that area. Violence and attacks relating to this conflict have also spread to other parts of Russia, and a number of fatal terrorist attacks have been carried out by Chechen terrorists throughout Russia, including in Moscow. The further intensification of violence, including terrorist attacks and suicide bombings, or its continued spread to other parts of Russia, could have significant political consequences, including the imposition of a state of emergency in some or all of Russia. Moreover, any terrorist attacks and the resulting heightened security measures may cause disruptions to domestic commerce and exports from Russia, and could materially adversely affect Mechel's business and in general terms the value of all investments in Russia.

- ***Russian government has shown interest in Mechel's steel business.***

Rumors that Russian government is interested in acquiring Mechel's steel business have been spreading around since the beginning of 2006. "Rosoberonexport" – Russian state-owned defense company – has created a holding company specializing in production of special steels in Russian. The name of the new holding company is "Russpezstal". This holding company has already acquired a number of metallurgical factories around Russia and is now eyeing the steel business of Mechel and especially Chelyabinsk Metallurgical Plant – the heart of Mechel's steel segment.

The talks are in the very initial stage right now and the issues raised are that steel assets of Mechel could be exchanged for a stake in "Russpezstal". It is possible that this deal has already been discussed between Igor Zuzin and the Russian President – Vladimir Putin. Not so long ago Zuzin was meeting Putin one on one and usually after meetings like that large assets are being sold and bought in Russia. Mechel has chosen not to comment on the possible deal and the representative of "Russpezstal" stated that nothing was going on.

The main opponent of this possible deal is Zuzin himself. Stake is "Russpezstal" is not a liquid asset, in fact is will be very illiquid. If the deal goes through Mechel will loose ½ of its value and a very lucrative and profitable business that make up 60% of EBITDA. For a government entity - "Rosoberonexport " – it doesn't make sense either to buy such an expensive asset. There are plenty smaller producers of steel in Russia that are almost free. Mechel is also a public company trading on NYSE and one cannot just buy asset in this company cheap. On top of that special steels only make up about 10% of Mechel's output.

So, even though the deal is highly unlikely – the fact that Russian government is interested in Mechel's business cannot be overlooked. If the deal does go through and Zuzin is forced to spin-off steel assets into another company and sell it to "Russpezstal" – Mechel's financial future will definitely be under question.

RISKS RELATING TO THE ECONOMIC ENVIRONMENT IN RUSSIA

- ***Emerging markets such as Russia are subject to greater risks than more developed markets, and financial turmoil in any emerging market could disrupt Mechel's business, as well as cause the price of its ADRs to suffer.***

Generally, investment in emerging markets is only suitable for sophisticated investors who fully appreciate the significance of the risks involved in, and are familiar with, investing in emerging markets. Investors should also note that emerging markets such as Russia are subject to rapid change and that the information set out herein may become outdated relatively quickly. Moreover, financial turmoil in any emerging market country tends to adversely affect prices in stock markets of all emerging market countries as investors move their money to more stable, developed markets. As has happened in the past, financial problems or an increase in the perceived risks associated with investing in emerging economies could dampen foreign investment in Russia and adversely affect the Russian economy. In addition, during such times, emerging market companies can face severe liquidity constraints as foreign funding sources are withdrawn. Thus, even if the Russian economy remains relatively stable, financial turmoil in any emerging market country could seriously disrupt Mechel's business.

- ***Economic instability in Russia could adversely affect Mechel's business.***

Since the dissolution of the Soviet Union, the Russian economy has experienced at various times:

- significant declines in gross domestic product;
- hyperinflation;
- an unstable currency;
- high government debt relative to gross domestic product;
- a weak banking system providing limited liquidity to Russian enterprises;
- a large number of loss-making enterprises that continued to operate due to the lack of effective bankruptcy proceedings;
- significant use of barter transactions and illiquid promissory notes to settle commercial transactions;
- widespread tax evasion;
- the growth of black and gray market economies;
- pervasive capital flight;
- high levels of corruption and the penetration of organized crime into the economy;
- significant increases in unemployment and underemployment; and
- the impoverishment of a large portion of the Russian population.

The Russian economy has been subject to abrupt downturns. In particular, on August 17, 1998, in the face of a rapidly deteriorating economic situation, the Russian government defaulted on its ruble-denominated securities, the Central Bank of Russia stopped its support of the ruble and a temporary moratorium was imposed on certain hard currency payments. These actions resulted in an immediate and severe devaluation of the ruble, a sharp increase in the rate of inflation, a dramatic decline in the prices of Russian debt and equity securities and the inability of Russian issuers to raise funds in the international capital markets. These problems were aggravated by the near collapse of the Russian banking sector after the events of August 17, 1998. This further impaired the ability of the banking sector to act as a reliable and consistent source of liquidity to Russian companies, and resulted in the loss of bank deposits in some cases.

Russia's inexperience with a market economy also poses numerous risks. The failure to satisfy liabilities is widespread among Russian businesses and the government. Furthermore, it is difficult for Mechel to gauge the creditworthiness of some of our customers, as there are no reliable mechanisms yet, such as credit reports or credit databases, for evaluating their financial condition.

Recent trends in the Russian economy — such as the increase in the gross domestic product, a relatively stable ruble and a reduced rate of inflation — may not continue or may be abruptly reversed. Additionally, because Russia produces and exports large quantities of oil and natural gas, the Russian economy is especially vulnerable to fluctuations in the price of oil and natural gas on the world market and a decline in the price of oil or natural gas could significantly slow or disrupt the Russian economy. The key is that Russia is basically an energy and commodity producer, with some relatively uncompetitive industries attached. While prices of oil, natural gas, nickel and other stay high, the government is able to pursue a more relaxed fiscal policy and spread the wealth around, especially as both parliamentary and presidential elections are coming up. A sharp fall in oil prices would certainly hurt government finances, but in reality prices would have to slip below $38 per barrel on a sustained basis to make a difference over the medium term.

- ***The Russian banking system remains underdeveloped, and another banking crisis could place severe liquidity constraints on Mechel's business.***

Russia's banking and other financial systems are not well developed or regulated, and Russian legislation relating to banks and bank accounts is subject to varying interpretations and inconsistent applications. The August 1998 financial crisis resulted in the bankruptcy and liquidation of many Russian banks and almost entirely eliminated the developing market for commercial bank loans at that time. Although the Central Bank of Russia has the mandate and authority to suspend banking licenses of insolvent banks, many insolvent banks still operate. Most Russian banks also do not meet international banking standards, and the transparency of the Russian banking sector still lags far behind internationally accepted norms. Aided by inadequate supervision by the regulators, many banks do not follow existing Central Bank regulations with respect to lending criteria, credit quality, loan loss reserves or diversification of exposure.

Recently, there has been a rapid increase in lending by Russian banks, which many believe has been accompanied by a deterioration in the credit quality of the borrowers. The serious deficiencies in the Russian banking sector, combined with the deterioration in the credit portfolios of Russian banks, may result in the banking sector being more susceptible to market downturns or economic slowdowns, including due to Russian corporate defaults that may occur during any such market downturn or economic slowdown. If a banking crisis were to occur, Russian companies would be subject to severe liquidity constraints due to the limited supply of domestic savings and the withdrawal of foreign funding sources that would occur during such a crisis.

Mechel has tried to reduce our risk by receiving and holding funds in a number of Russian banks, including subsidiaries of foreign banks. Nonetheless, the company holds the bulk of our excess ruble and foreign currency cash in Russian banks, including subsidiaries of foreign banks, in part because it is required to do so by Central Bank regulations and because the ruble is not transferable or convertible outside of Russia. There are few, if any, safe ruble-denominated instruments in which Mechel may invest our excess ruble cash. Another banking crisis or the bankruptcy or insolvency of the banks from which Mechel receives or with which it holds its funds could result in the loss of our deposits or affect our ability to complete banking transactions in Russia, which could have a material adverse effect on its business, financial conditions and results of operations.

- ***Russia's physical infrastructure is in very poor condition, which could disrupt normal business activity.***

Russia's physical infrastructure largely dates back to Soviet times and has not been adequately funded and maintained over the past decade. Particularly affected are the rail and road networks, power generation and transmission, communication systems and building stock. Road conditions throughout Russia are poor, with many roads not meeting minimum requirements for use and safety. The federal government is actively considering plans to reorganize the nation's rail, electricity and telephone systems. Any such reorganization may result in increased charges and tariffs while failing to generate the anticipated capital investment needed to repair, maintain and improve these systems. Russia's poor physical infrastructure disrupts the transportation of goods and supplies and adds costs to doing business in Russia, and further deterioration in the physical infrastructure could have a material adverse effect on Mechel's business. In addition, there are a number of nuclear and other dangerous installations in Russia where safety systems to contain ecological risks may not be sufficiently effective. The occurrence of accidents in these installations, as well as the generally unfavorable ecological situation in Russia, may also have a material adverse effect on business.

APPENDIX 1

PROJECTION OF STEEL PRICES USING REGRESSION METHOD

1. EXCEL REGRESSION RESULTS:

Y – price index
X – time period

SUMMARY OUTPUT

Regression Statistics	
Multiple R	0.909939485
R Square	0.827989867
Adjusted R Square	0.826198094
Standard Error	21.99632023
Observations	98

ANOVA

	df	*SS*	*MS*	*F*	*Significance F*
Regression	1	223584.8073	223584.8	462.106654	1.80442E-38
Residual	96	46448.45796	483.8381		
Total	97	270033.2653			

	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*	*Lower 95.0%*	*Upper 95.0%*
Intercept	59.03261098	4.478156218	13.18235	2.9091E-23	50.14353435	67.92168762	50.14353435	67.92168762
X Variable 1	1.688477453	0.078546015	21.49667	1.8044E-38	1.532564727	1.844390179	1.532564727	1.844390179

2. REGRESSION LINE:

Y=59.03+(1.69)*(X)

or

Price Index = 59.03+(1.69)*(time period)

3. TESTING OF THE SIGNIFICANCE OF THE LINE USING t-TEST (99% CONFIDENCE):

$$H_0 : \beta = 0$$
$$H_a : \beta \neq 0$$

Reject H_0 if t-statistic < -table value, or t-statistic > table value (2-tale t-test)

Table value of t (99%, df=96=inf) = 2.57583; t-statistic from our regression = 21.49667

- ⇨ t-statistic is outside of the confidence interval (-2.57583; + 2.57583) =>we can reject H_0 with 99% confidence.
- ⇨ If H_0 can be rejected with 99% confidence – we can say with 99% confidence that our coefficient is different from 0 and the regression model is significant.

4. PERCENT CORRELATION:

Our regression equation correlation coefficient: R^2=83%, which means that 83% of the variations in prices are explained by our regression equation.

APPENDIX 2

STEEL & IRON INDUSTRY: COMPANY BROWSE

Sector: Basic Materials / Industry: Steel & Iron	Market Cap (million)	Trailing P/E	Forward P/E (1-year)	ROE, %	Div Yield, %	Long-term debt to equity	Price to Book value	Net Profit Margin, % (mrg)
	4,953,900							
	416,317	13.94	9.57	33.31	1.86	0.64	3.57	17.11
Companies								
Companhia Vale do Rio Doce (RIO)	100,200.0	15.19	8.59	42.54	1.6	1.27	5.22	20.64
Rio Tinto plc (RTP)	82,000.0	11.28	10.41	44.83	2	0.19	4.5	30.75
Arcelor Mittal (MT)	73,700.0	10.08	7.62	19.99	2.1	0.63	1.75	8.26
POSCO (PKX)	32,500.0	8.1	9.23	14.94	1.7	NA	NA	11.69
Tenaris SA (TS)	27,900.0	14.45	11.21	42.91	1.2	0.68	5.26	23.36
Nucor Corp. (NUE)	19,800.0	11.58	12.89	38.61	0.7	0.19	4.1	11.77
Gerdau S.A. (GGB)	13,300.0	9.39	8.82	32	3.3	0.91	2.72	9.93
Companhia Siderurgica Nacional (SID)	11,200.0	19.54	11.73	18.54	8.4	1.54	3.73	3.24
IPSCO Inc. (IPS)	7,100.0	11.27	12.02	32.15	0.5	0.42	3.16	14.15
Ternium S.A. (TX)	5,600.0	6.82	7.58	28.41	NA	0.28	1.49	8.84
Mechel Open Joint Stock Company (MTL)	4,500.0	10.10	7.83	18.25	4.3	0.24	1.72	15.67
Steel Dynamics Inc. (STLD)	4,300.0	11.83	11.7	37.59	*0.9*	0.36	3.51	12.51
Harsco Corp. (HSC)	4,000.0	20.55	16.43	18.36	1.5	0.93	3.5	5.75
Commercial Metals Co. (CMC)	4,000.0	11.48	10.49	29.2	1.1	0.36	2.9	3.27
Gerdau AmeriSteel Corp. (GNA)	3,500.0	9.27	8.34	22.04	0.7	0.23	1.89	*6.68*
Carpenter Technology Corp. (CRS)	3,200.0	14.43	11.7	24.57	0.7	0.32	3.11	10.9
Chaparral Steel Company (CHAP)	3,000.0	12.46	12.53	33.56	0.6	0.35	3.47	14.88
AK Steel Holding Corp. (AKS)	3,000.0	244.5	13.49	3.77	0	2.67	7.05	-3.12
Cleveland-Cliffs Inc. (CLF)	2,700.0	12.38	10.22	33.5	0.7	NA	3.62	13.44
Worthington Industries, Inc. (WOR)	1,900.0	14.44	13.81	15.22	3.1	0.41	2.08	0.81
Grupo Simec S.A.B. de C.V. (SIM)	1,800.0	8.88	N/A	24.14	NA	0	1.88	6.61
Schnitzer Steel Industries Inc (SCHN)	1,400.0	11.47	11.99	18.92	*0.1*	*0.24*	1.96	4.71
Metal Management Inc. (MM)	1,300.0	11.58	12.67	27.28	*0.6*	0	2.79	2.97
Gibraltar Industries Inc. (ROCK)	629.1	11.04	10.75	9.55	0.9	0.73	1.14	0.54
Novamerican Steel Inc. (TONS)	502.0	12.37	12.31	12.99	NA	0.01	1.51	*2.77*
Steel Technologies Inc. (STTX)	389.4	32.03	19.38	4.44	1	0.51	1.45	0.43
Claymont Steel Holdings Inc. (PLTE)	381.2	7.78	7.06	NA	NA	NA	NA	2.78
Wheeling-Pittsburgh Corp. (WPSC)	*378.4*	56.77	N/A	2.35	NA	1.44	1.32	*-5.07*
Insteel Industries Inc. (IIIN)	*328.5*	10.6	9.21	27.77	*0.7*	*NA*	2.57	8.29
Olympic Steel Inc. (ZEUS)	324.0	10.62	10.59	14.29	*0.4*	0.29	1.38	1.66
Northwest Pipe Co. (NWPX)	320.9	13.36	11.89	10.26	NA	0.44	1.38	*6.13*
Universal Stainless & Alloy Pr (USAP)	319.9	15.46	11.94	22.22	*NA*	0.22	3.03	11.52
Synalloy Corp. (SYNL)	200.3	26.57	N/A	17.61	0.5	0.39	4.22	7.5
Dayton Superior Corp. (DSUP)	*196.1*	N/A	8.07	NA	*NA*	*NA*	NA	-8.69
Great Northern Iron Ore Proper (GNI)	175.5	11.88	N/A	109.01	6.9	NA	14.34	87.76
China Precision Steel, Inc. (CPSL)	*123.3*	0.03	N/A	NA	NA	1.71	7.02	*19.24*
Metalico Inc. (MEA)	*74.2*	15.24	11.02	18.05	*NA*	*0.25*	1.79	4.41
Friedman Industries Inc. (FRD)	66.7	8.55	N/A	19.81	*3.3*	NA	1.61	2.9
Tarpon Industries Inc. (TPO)	4.0	N/A	N/A	566.25	NA	NA	NA	*-2.23*
Xpention Genetics Inc. (XPNG.OB)	3.5	N/A	N/A	NA	*NA*	NA	NA	NA
AVERAGE	**10,407.9**	**20.09**	**11.05**	**8.98**	**1.77**	**0.59**	**3.26**	**9.68**
WEIGHTED AVERAGE		**13.94**	**9.57**	**33.31**	**1.86**	**0.64**	**3.57**	**17.11**

Source: Yahoo! Finance

APPENDIX 3

INDUSTRIAL METALS & MINING INDUSTRY: COMPANY BROWSE

Sector: Basic Materials	Market Cap (million)	Trailing P/E	Forward P/E (1 year)	ROE, %	Div Yield, %	Long-term debt to equity	Price to Book value	Net Profit Margin, % (mrg)
Industry: Industrial Metals & Mining	4,953,900							
	403030.2	15.46	11.73	44.83	2.04	0.38	8.40	30.52
Companies								
BHP Billiton Ltd. (BHP)	148,400.0	12.23	11.24	49.89	2.2	0.31	5.3	33.34
BHP Billiton plc (BBL)	137,600.0	11.34	11.79	49.89	2.4	0.33	4.92	33.34
Cameco Corp. (CCJ)	16,800.0	52.68	14.28	14.72	0.4	0.26	6.91	7.58
Teck Cominco Ltd. (TCK)	16,800.0	7.83	9.38	43.82	2.2	0.25	2.89	41.48
Peabody Energy Corp. (BTU)	12,200.0	20.7	13.33	26.6	0.5	1.4	5.21	12.84
Allegheny Technologies Inc. (ATI)	11,600.0	20.43	13.96	49.89	0.5	0.37	7.74	11.96
CONSOL Energy Inc. (CNX)	7,600.0	18.89	13.86	39.1	0.6	0.52	7.13	14.11
Titanium Metals Corp. (TIE)	5,700.0	22.96	16.51	39.04	0	NA	7.06	34.65
Yanzhou Coal Mining Co. Ltd. (YZC)	5,100.0	17.73	N/A	NA	2.6	0.02	2.27	15.18
Arch Coal Inc. (ACI)	5,100.0	19.84	12.25	20.47	0.6	0.86	3.72	12.87
Mechel Open Joint Stock Company (MTL)	4,500.0	10.10	7.83	18.25	4.3	0.24	1.72	15.67
Lundin Mining Corp. (LMC)	3,800.0	13.17	8.56	12.88	NA	0.02	1.78	26.94
Fording Canadian Coal Trust (FDG)	3,500.0	7.84	N/A	138.04	11	1.02	12.73	15.74
Natural Resource Partners LP (NRP)	2,300.0	20.18	10.48	23.7	5.1	1.06	4.09	56.93
RTI International Metals Inc. (RTI)	2,200.0	29.35	16.2	17.98	0	0.03	4.79	18.63
Massey Energy Co. (MEE)	2,000.0	49.16	15.57	5.41	0.6	1.58	2.88	1.59
USEC Inc. (USU)	1,700.0	16.4	40.1	11.22	0	0.15	1.77	7.37
Foundation Coal Holdings Inc. (FCL)	1,700.0	56.35	16.42	9.86	0.5	2.1	5.76	-6.19
Walter Industries Inc. (WLT)	1,600.0	7.74	10.96	100.22	0.7	N/A	810.81	NA
Alliance Resource Partners LP (ARLP)	1,500.0	13.22	12.2	85.5	5.5	0.59	5.86	17.28
Penn Virginia Resource Partner (PVR)	1,400.0	19.15	17.31	21.55	5.3	0.54	3.43	16.71
Stillwater Mining Co. (SWC)	1,300.0	165.52	24.53	1.58	NA	0.26	2.57	1.6
Brush Engineered Materials Inc (BW)	1,200.0	23.57	18.41	19.74	0	0.17	3.99	14.59
Alpha Natural Resources Inc. (ANR)	1,200.0	8.92	13.42	46.04	NA	1.36	3.37	13.82
Penn Virginia GP Holdings LP (PVG)	1,100.0	27.55	21.42	186.57	1	2.94	14.2	6.01
Fronteer Development Group Inc (FRG)	895.5	60.41	N/A	22.91	NA	NA	9.26	NA
International Coal Group, Inc. (ICO)	876.1	NA	21.58	-1.4	NA	0.3	1.33	-0.55
Northern Orion Resources Inc. (NTO)	723.7	9.69	7.91	26.11	NA	NA	1.89	84.39
North American Palladium Ltd. (PAL)	493.1	NA	N/A	-20.85	NA	0.47	3.44	-14.57
Dynamic Materials Corp. (BOOM)	418.4	20.36	15.29	41.64	0	0.01	7.2	18.43
Anooraq Resources Corporation (ANO)	335.0	NA	N/A	-40.16	NA	1.32	41.85	NA
Uranerz Energy Corp. (URZ)	260.4	NA	N/A	-94.24	NA	NA	19.06	NA
Westmoreland Coal Co. (WLB)	204.4	NA	N/A	NA	NA	NA	NA	-8.19
James River Coal Co. (JRCC)	157.1	NA	N/A	-26.48	NA	1.94	1.82	-11.29
Nanophase Technologies Corp. (NANX)	136.2	NA	101	-33.68	NA	0.09	8.61	-72.85
US Energy Corp. (USEG)	121.3	121	N/A	3.66	NA	0.04	3.52	5463.79
Almaden Minerals Ltd. (AAU)	116.3	NA	N/A	-19.5	NA	NA	4.66	NA
National Coal Corp. (NCOC)	99.7	NA	N/A	-318.8	NA	NA	NA	-33.35
Foothills Resources Inc. (FTRS.OB)	84.4	NA	N/A	NA	NA	0.72	1.95	-56.56
Manchester, Inc. (MNCS.OB)	66.8	NA	N/A	-47.51	NA	5.07	4.51	-16.03
El Capitan Precious Metals Inc (ECPN.OB)	51.9	NA	N/A	-544.9	NA	0.44	60.91	NA
United States Antimony Corp. (UAMY.OB)	28.0	NA	N/A	NA	NA	0.85	63.64	14.05
Daybreak Oil and Gas Inc. (DBRM.OB)	26.8	NA	N/A	-82.57	NA	0.06	2.83	NA
Echo Resources Inc. (ECHR.OB)	16.6	NA	N/A	NA	NA	NA	NA	NA
Can-Cal Resources Ltd. (CCRE.OB)	12.2	NA	N/A	NA	NA	NA	NA	NA
Franklin Lake Resources Inc. (FKLR.OB)	3.4	NA	N/A	-1021.49	NA	NA	NA	NA
Consolidated Energy Inc. (CEIW.OB)	2.9	NA	N/A	NA	NA	NA	NA	-277.9
AVERAGE	**1,300.8**	**33.65**	**20.40**	**-42.40**	**2.33**	**0.87**	**33.21**	**178.63**
WEIGHTED AVERAGE		**15.46**	**11.73**	**44.83**	**2.04**	**0.38**	**8.40**	**30.52**

Source: Yahoo! Finance

APPENDIX 4

MECHEL OAO – CONSOLIDATED BALANCE SHEET

(in thousands of U.S. dollars, except share amounts)	**9M 2006**	**2005**	**2004**	**2003**
ASSETS				
Cash and cash equivalents	184,423	311,775	1,024,761	19,279
Accounts receivable, net of allowance for doubtful accounts of $20,850 in 2004 and $22,276 in 2003	207,434	140,649	135,597	85,472
Due from related parties	1,069	4,473	16,458	28,530
Inventories	538,053	496,658	568,545	348,958
Deferred cost of inventory in transit	13,608	49,893	-	29,554
Current assets of discontinued operations	-	88	1,247	18,966
Deferred income taxes	10,665	8,965	7,491	10,558
Prepayments and other current assets	336,894	346,981	349,106	170,824
Total current assets	**1,292,146**	**1,359,483**	**2,103,205**	**712,141**
Long-term investments in related parties	433,094	408,709	9,270	52,943
Other long-term investments	322,317	16,148	66,663	15,069
Non-current assets of discontinued operations	103	97	165	416
Intangible assets, net	7,713	7,590	6,379	1,936
Property, plant and equipment, net	1,847,231	1,508,984	1,274,722	881,284
Mineral licenses, net	263,866	242,006	166,483	160,106
Deferred income taxes	10,377	17,487	11,940	5,212
Goodwill	45,270	39,580	39,441	5,402
Total assets	**4,222,118**	**3,600,083**	**3,678,268**	**1,834,509**
LIABILITIES AND SHAREHOLDERS' EQUITY				
LIABILITIES				
Short-term borrowings and current portion of long-term debt	276,520	389,411	348,880	342,093
Accounts payable and accrued expenses:				
Advances received	96,238	47,367	94,964	74,414
Accrued expenses and other current liabilities	77,277	79,405	69,847	60,628
Taxes and social charges payable	148,404	144,715	145,527	149,392
Trade payable to vendors of goods and services	154,566	210,228	186,233	140,975
Due to related parties	2,313	2,937	2,048	13,887
Current liabilities of discontinued operations	487	109	30	6,923
Asset retirement obligation	4,573	4,236	8,219	1,995
Deferred income taxes	21,503	26,557	26,521	16,883
Deferred revenue	16,390	55,267	760	52,915
Pension obligations	9,093	8,189	6,261	0
Finance lease liabilities	4,078	887		
Total current liabilities	**811,442**	**969,308**	**889,290**	**860,105**
Long-term debt, net of current portion	349,964	45,615	216,113	122,311
Restructured taxes and social charges payable, net of current portion	14,374	33,866	87,364	96,879
Due to related parties	36,341	-	-	-
Asset retirement obligation, net of current portion	58,593	54,816	66,758	11,942
Pension obligations, net of current portion	49,453	43,510	40,720	-
Deferred income taxes	121,649	105,481	105,330	108,684
Other long-term liabilities	1,267	-	240	1,418
Finance lease libilities, net of current portion	37,683	9,179	-	-
Commitments and contingencies	-	-	-	-
Minority interests	136,037	127,834	214,824	184,344
Total liabilities	**1,616,803**	**1,389,609**	**1,620,639**	**1,585,683**
SHAREHOLDERS' EQUITY				
Common shares (10 Russian Rubles par value; 497,969,086 shares authorized, 416,270,745 and 382,969,086 shares issued and 403,118,680 and 366,178,815 shares outstanding as of December 31, 2004 and December 31, 2003, respectively)	133,507	133,507	133,507	121,935
Treasury shares, at cost (13,152,065 and 16,790,271 common shares at December 31, 2004 and December 31, 2003, respectively)	-	-4,187	-4,187	-5,346
Additional paid-in capital	402,636	321,864	304,404	92,659
Other comprehensive income	169,394	42,046	93,687	46,921
Retained earnings	1,899,778	1,717,244	1,530,218	192,657
Total shareholders' equity	2,605,315	2,210,474	2,057,629	448,826
Total liabilities and shareholders' equity	**4,222,118**	**3,600,083**	**3,678,268**	**1,834,509**

Source: www.mechel.com

APPENDIX 5

MECHEL OAO – CONSOLIDATED INCOME STATEMENT

(in thousands of U.S. dollars, except share amounts)	**9M 2006**	**2005**	**2004**	**2003**
Revenue, net	3,141,653	3,804,995	3,635,955	2,028,051
Cost of goods sold	-2,069,499	-2,469,134	-2,225,088	-1,422,987
Gross margin	**1,072,154**	**1,335,861**	**1,410,867**	**605,064**
Selling, distribution and operating expenses:				
Selling and distribution expenses	-321,884	-450,238	-367,514	-213,977
Taxes other than income tax	-76,850	-90,683	-69,285	-44,716
Accretion expenses	-2,247	-3,248	-2,081	-2,433
Goodwill impairment	-	-12,667	-	-
Recovery of (provision for) doubtful accounts	-395	-3,569	7,859	-9,056
General, administrative and other operating expenses	-187,801	-259,728	-229,039	-137,201
Total selling, distribution and operating expenses	-589,179	-820,133	-660,060	-407,383
Operating income	**482,975**	**515,728**	**750,807**	**197,681**
Other income and (expense):				
Income (loss) from equity investees	-3,911	12,426	4,621	1,221
Interest income	6,553	10,049	2,375	2,274
Interest expens	-33,518	-40,829	-51,409	-48,516
Other income, net	6,423	65,920	836,817	26,333
Foreign exchange gain/ (loss)	42,373	-37,435	1,884	-2,867
Total other income and (expense)	**17,920**	**10,131**	**794,288**	**-21,555**
Income before income tax, minority interest, discontinued operations, extraordinary gain and changes in accounting principles	500,895	525,859	1,545,095	176,126
Income tax expense	-122,224	-136,643	-175,776	-47,759
Minority interest in (income) loss of subsidiaries	-6,488	-6,879	-11,673	18,979
Income from continuing operations	**372,182**	**382,337**	**1,357,646**	**147,346**
Income (loss) from discontinued operations, net of tax	-66	-1,157	-15,211	-5,790
Extraordinary gain, net of tax	-	-	271	5,740
Income before cumulative effect of changes in accounting principle	372,116	381,180	1,342,706	147,296
Change in accounting principle, net of tax	-	-	-	-3,788
Net income	**372,116**	**381,180**	**1,342,706**	**143,508**
Currency translation adjustment	122,096	-53,822	49,116	46,921
Adjustment of available for sale securities	5,252	2,181	-2,350	-
Comprehensive income	**499,464**	**329,539**	**1,389,472**	**190,429**
Basic and diluted earnings per share:				
Earnings per share from continuing operations	$0.92	$0.95	$3.63	$0.39
Loss per share effect of discontinued operations	$0.00	$0.00	-$0.04	-$0.01
Earnings per share effect of extraordinary gain	$0.00	$0.00	$0.00	$0.02
Earnings per share effect of a change in accounting principle	$0.00	$0.00	$0.00	-$0.01
Net income per common share (EPS)	**$0.92**	**$0.95**	**$3.59**	**$0.39**
Weighted average number of common shares outstanding	406,522,184	403,118,680	373,971,312	366,178,815
Number of ADRs outstanding (3 common for 1 ADR)	135,507,395	134,372,893	124,657,104	122,059,605
Net income per ADR	**$2.76**	**$2.85**	**$10.89**	**$1.17**

Source: www.mechel.com

APPENDIX 6

MECHEL OAO – CONSOLIDATED STATEMENT OF CASH FLOW

(in thousands of U.S. dollars)	**9M 2006**	**2005**	**2004**	**2003**	**2002**
CASH FLOWS FROM OPERATING ACTIVITIES					
Net income	372,116	381,180	1,342,706	143,508	89,253
Adjustments to reconcile NI to net cash provided by operating activities:					
Depreciation	127,006	147,117	120,444	83,980	65,752
Depletion and amortization	13,674	20,483	17,376	17,709	13,022
Foreign exchange (gain) loss	-42,373	37,435	-1,884	2,867	-9,094
Deferred income taxes	-1,058	-12,535	-11,217	-6,905	-26,055
(Recovery of) provision for doubtful accounts	395	3,569	-7,859	10,011	3,622
Inventory write-down	-120	5,938	2,183	4,624	523
Accretion expense	2,247	3,248	2,081	2,433	–
Impairment of goodwill	-	-	–	–	7,219
Loss on write-off of property, plant and equipment	-	12,667	-	-	
Minority interest	6,488	6,879	11,673	-18,980	-10,433
Effect of change in accounting principle	-	-	–	3,788	-10,859
(Income) loss from equity investments	3,911	-12,426	-4,621	-1,221	2,675
Non-cash interest on long-term tax and pension liabilities	12,564	13,749	11,425	13,302	4,854
Loss (gain) on sale of property, plant and equipment	244	1,801	5,736	4,111	-968
(Gain) loss on sale of long-term investments	-1,223	-2,743	-803,405	-2,417	566
Loss from discontinued operations	66	1,157	15,211	5,790	1,835
Gain on accounts payable with expired legal term	-414	-23,347	-1,250	-1,400	-4,000
Gain on forgiveness of fines and penalties	-5,582	-38,383	-18,296	-9,588	-3,794
Stock-based compensation expense	209	-	1,400	2,200	–
Amortization of capitalized costs on bonds issue	668	1,553	1,525	835	–
Pension service cost and amortization of prior year service cost	2,034	2,511	2,187	–	–
Extraordinary (gain)	-	-	-271	-5,740	-1,388
Net change before changes in working capital	**490,852**	**549,853**	**685,144**	**248,907**	**122,729**
Changes in working capital items, net of effects from acquisition of new subsidiaries:					
Accounts receivable	-60,872	23,602	-2,831	-4,031	-401
Inventories	-68,884	14,614	-170,726	-97,783	6,815
Trade payable to vendors of goods and services	-59,972	60,087	-1,305	-14,468	-19,012
Advances received	43,996	-46,269	4,902	13,316	13,216
Accrued taxes and other liabilities	6,983	14,868	4,176	19,328	-27,996
Settlements with related parties	40,401	12,658	1,253	-12,815	-2,820
Current assets and liabilities of discontinued operations	-238	57	-4,134	-17,036	-1,616
Deferred revenue and cost of inventory in transit, net	-2,592	4,624	-22,607	13,949	6,907
Other current assets	35,586	-15,219	-197,734	-29,509	-16,753
Dividends received	1,994	-	-	-	
Net cash provided by operating activities	**427,254**	**618,875**	**296,137**	**119,858**	**81,069**
CASH FLOWS FROM INVESTING ACTIVITIES					
Acquisition of subsidiaries, less cash acquired	-2,153	-3,497	–	-20,919	-4,461
Acquisition of minority interest in subsidiaries	-14,898	-79,936	-37,021	-3,776	-3,487
Investment in Moscow Coke Plant	-175,465	-	-	-	
Investment in Korshunov Mining Plant	-	-	–	-82,793	-15,533
Acquizition of Yakutugol	-	-411,182	-	-	-
Acquisition of Izhstal	-	-	-22,742	–	–
Acquisition of Port Posiet	-	-	-29,966	–	–
Acquisition of Kaslinsky Architectural Casting Plan	-	-	-996	–	–
Investments in other non-marketable securities	-2,007	-7,554	-29,762	-28,525	-6,955
Proceeds from disposal of discontinued operations	-	-	–	5,162	–
Proceeds from disposal of non-marketable equity securities	3,746	19,388	875,967	33,577	1,808
Proceeds from disposals of property, plant and equipment	2,563	2,628	3,647	3,813	2,980
Purchases of property, plant and equipment	-337,894	-407,521	-303,411	-116,856	-60,985
Net cash provided from (used in) investing activities	**-532,418**	**-994,707**	**455,716**	**-210,317**	**-86,633**
CASH FLOWS FROM FINANCING ACTIVITIES					
Proceeds from short-term borrowings	854,891	1,577,984	954,733	781,525	394,388
Repayment of short-term borrowings	-982,475	-1,686,578	-941,340	-747,815	-366,675
Dividends paid	-189,582	-194,154	-5,145	-26,282	-13,425
Dividends received	-	2,000	-	-	
Proceeds from issuance of common stock	-	0	220,873	–	–
Proceeds from long-term debt	286,253	14,815	75,241	112,736	40,916
Loans and notes (issued) to/received from related parties	-	-	–	6,397	-18,373
Repayment of long-term debt	-1,766	-20,180	-52,093	-23,482	-33,409
Proceeds from disposal of treasury stock	1,248				
Repayment of obligations under finance lease	-5,784				
Net cash provided by financing activities	**-37,215**	**-306,870**	**252,269**	**103,079**	**3,422**
Effect of exchange rate changes on cash and cash equivalents	15,027	-30,284	1,360	991	-283
Net increase (decrease) in cash and cash equivalents	127,352	-712,986	1,005,482	13,611	-2,425
Cash and cash equivalents at beginning of year	311,775	1,024,761	19,279	5,668	8,093
Cash and cash equivalents at end of year	184,423	311,775	1,024,761	19,279	5,668

Source: www.mechel.com

Disclosures:

Ownership and material conflicts of interest:
The author or a member of their household, of this report does not hold a financial interest in the securities of this company. The author or a member of their household, of this report does not know of the existence of any conflicts of interest that might bias the content or publication of this report.
Receipt of compensation:
Compensation of the author(s) of this report is not based on investment banking revenue.
Position as an officer or director:
The author(s), or a member of their household, does not serve as an officer, director or advisory board member of the subject company.
Market making:
The author(s) does not act as a market maker in the subject company's securities.
Ratings key:
Banks rate companies as a STRONG BUY, BUY, HOLD or SELL. A STRONG BUY rating is given when the security is expected to deliver absolute returns of 20% or greater over the next twelve month period, while BYU rating is given when the security is expected to deliver absolute returns of 15% or greater over the next twelve month period. Both – BUY and STRONG BUY ratings – recommend that investors take a position above the security's weight in the S&P 500, or any other relevant index. A SELL rating is given when the security is expected to deliver negative returns over the next twelve months, while a HOLD rating implies returns between and 0% and 15% over the next twelve months.
Disclaimer:
The information set forth herein has been obtained or derived from sources generally available to the public and believed by the author(s) to be reliable, but the author(s) does not make any representation or warranty, express or implied, as to its accuracy or completeness. The information is not intended to be used as the basis of any investment decisions by any person or entity. This information does not constitute investment advice, nor is it an offer or a solicitation of an offer to buy or sell any security. This report should not be considered to be a recommendation by any individual affiliated with NYSSA or the NYSSA Investment Research Challenge with regard to this company's stock.