Mechel FY 2008 results
Mechel Conference Call Management Speeches, 03.06.2009

Stanislav A. Ploschenko
Chief Financial Officer

Good afternoon ladies and gentlemen.

Slide 1 – Sales Overview

Despite a very challenging 4th quarter the sales of the Group for the year 2008 reached record 10 billion dollars with a gross margin of 47%. The last quarter contributed 1.37 billion dollars with a gross profit of 343 million dollars. It is notable that 1.6 bln dollars were contributed to the full result by the acquisitions in the 2nd half of 2007 and in 2008. Ductil steel and Oriel Resources, acquired in the 2nd quarter of 2008 contributed 271 mln dollars or 8% to the revenue increase, Yakutugol added 1,277 mln dollars. With content we saw the performance of HBL – a German metal trader we acquired in September 2008, which contributed significantly to support the Group's sales of steel products during the challenging last quarter of 2008 with sales of 32 million dollars, which can be compared to Mechel Service sales in Russia, Kazakhstan and Romania of 200 million dollars for the same period.

Operating profit for the full year of 2008 grew 83% to more than 2.5 bln dollars, demonstrating an operating margin of 26%. The full year result was 251 mln dollars lower than the operating result for the 9 months due to the respective loss in the 4th quarter. That was mainly due to the negative operating results of the steel and ferroalloys segments for the last quarter of the year, which together posted a USD 491 mln dollars operating loss. This was partly offset by a 240 mln dollars operating profit in the mining segment and 10 mln dollars profit in the power segment.

The negative operating result in the 4th quarter of 2008 topped up with an almost 700 mln dollars FX loss from revaluation of the balance sheet items due to a sharp ruble depreciation against the dollar lead to a 1.8 bln dollars decrease in EBITDA for the same period in comparison with the previous quarter, which resulted in the full year EBITDA of more than 2 bln dollars, showing a 23% growth year-on-year. The EBITDA margin decreased to 21%. The net income decreased from 1.64 mln dollars for the 9m2008 to 1.14 bln dollars for the full year as a result of a net loss of 497 mln dollars posted in the 4th quarter. The Net income margin for the full year also decreased to 11.5%. Despite that there was a growth in the Net income of 25% as compared with 2007.

It is worth mentioning however, that the main contributor to the net loss in the 4th quarter was a FX loss of almost 700 mln dollars as I mentioned before. Without that item the financial result for the 4th quarter would show a net income of 66 mln dollars and negative EBITDA of only 123 mln dollars. We believe it is very important to distinguish between a balance sheet FX revaluation and a real FX loss, which may be incurred when obligations in an appreciating currency have to be met by conversion of a depreciating currency. As by far the most significant dollar obligations we have represent the dollar denominated debt we adopted a policy in December 2008 to finance the operating activities in Russia only from domestic cash flow. The export cash flow in dollar and euro were saved for future debt servicing in foreign currency. This policy allowed us not only to avoid realizing the FX loss from conversion operations but also to save on a dollar appreciation which continued into the 1st quarter of 2009.

Slide 2 – Steel Sales: Structure and Prices

The steel segment was the biggest contributor to the consolidated revenue in 2008 with sales reaching 5.5 bln dollars - up 28% y-o-y. The gross margin fell to almost 27% down from 33% for the first 9 months due to a gross loss of 127 mln dollars in the 4th quarter. This resulted from a sharp decrease in sales prices and sales volumes across all our sales markets we witnessed in the last 3 months of the year. As you can see in the chart the average sales price of billet came down 62% q-o-q, rebar - 61%, wire rod - 64%, wire - 43%, construction steel - 20%. As a result, the operating loss for the 4th quarter was 363 mln dollars, EBITDA – minus 508 mln dollars and Net loss of 404 mln dollars. It is worth mentioning that most of the FX loss we reported for the consolidated figures realized precisely in the steel and ferroalloys segments, as most of the dollar-denominated debt is attributed to these segments. For the steel segment the FX loss for the 4th quarter of 2008 was 220 mln dollars.

This sharp reduction in profitability was also due to the fact that the steel segment entered into the difficult 4th quarter with significant stock of raw material and unfinished product purchased at pre-crisis prices, as we were restocking for the winter period and new contracts to be signed in January. Some of that stock was formed by raw materials purchased from the mining segment, which coking coal and iron ore. Another contributor to the negative operating result was the stock of finished products for sale at Mechel Service, recorded at the price prevailing at the time of purchase. Mechel Service entered the 4th quarter with a stock of 300 thousand tonnes of steel products with an unrealized margin related to the steel segment for an overall amount of 76 mln dollars. It is fair to say though that the cost of the unsold stock in our retail arm contributed to the operating loss, the benefits of having own retail sales operations more than compensated for that securing uninterrupted daily sales of appx 4.9 tonnes of steel during the entire 4th quarter, which helped us not to decrease production as much as our competitors. Consequently Mechel Service managed to eliminate almost all unrealized margin in stock related to the steel segment during that period. This trend continued into the 1st and the 2nd quarter of 2009: the stock of finished products at Mechel Service went down to 192 thousand tonnes by 2nd June 2009 thus bringing the stock turnover ratio to appx 50 days in May 2009, as the daily sales grew to an average of 5.4 tonnes of steel in the 1st quarter and 5.5 tonnes in the 2nd quarter so far. Overall the unrealized margin in the steel segment related to the steel segment only decreased by approx. 90%by the end of the year in comparison with the beginning of the 4th quarter. The replenishment of the old expensive stock of raw materials lead to reduction in the cash cost of production, which went down to 500 dollars for billet, 505 dollars for wire rod and 509 dollars for rebar at CMP for the 4th quarter.

While we have always positioned our steel segment as a strong regional producer it would be fair to say that our growing exposure to the international markets, taken further by acquisition of Ductil steel and HBL assisted significantly in weathering the crisis in the last 3 months of 2008. Faced with a sharp demand contraction in the domestic markets we managed to increase our exports from the average of 23% of the segment's sales in the 3rd quarter 2008 to 29% of sales in the 4th quarter 2008. Most of that increase came from export of billets, the share of which in export sales increased from 30% in the 3rd quarter 2008 to 37% in the 4th quarter 2008, and long steel products, the share of which in export sales increased from 33% in the 3rd quarter 2008 to 38% in the 4th quarter 2008. HBL sales contributed 32 mln dollars - or 21% - of our sales on the European market. Overall today CIS and European markets represent 25% of Mechel Service's sales tonnage wise.

Overall for the year the operating profit rose 43% to 770 mln dollars, whereas the FX loss resulted in a decrease in EBITDA to 630 mln dollars. The EBITDA margin went down to 11% vs 16% a year ago. The EBITDA per tonne of steel decreased by 8% to 107 dollars per tonne. The same FX loss along with increased interest expense resulted in a 39% decrease of the Net income by 145 mln dollars for the year. However, if both years results are stripped off the FX effect, the net income would increase by 166 mln dollars or by 52%, EBITDA would increase by 302 mln dollars or by 45%.

Slide 3 – Mining Sales: Structure and Prices

The mining segment demonstrated a superior performance in the 4th quarter of 2008 if compared to the other segments despite the sharp decrease in demand as a result of the steelmakers' response to market contraction by cutting capacity utilization and decreasing purchases of coal. There are several reasons for that. The coking coal business, albeit affected most seriously, was supported by the existing export contracts signed till March 2009 at the prices prevailing in spring 2008. This mostly related to the most expensive hard coking coal grades of Yakutugol. At the same time vertical integration into steel also helped us to maintain sales of coking coal. Internal sales represented 32% of total sales volumes of coking coal in the 4th quarter as compared to the average of 21% for the first 9 months. The same factor supported the production and sales of iron ore concentrate from Korshunov mining plant. Prior to the crisis the plant was selling approximately 38% of its total sales volumes to the Group, 18% to the 3rd parties in the domestic market. The rest was exported to steel mills in Northern China. Faced with domestic market contraction in the 4th quarter of 2009 we adopted a policy of covering as much as possible of our need for iron ore products from internal sources – as a result the KMP share of sales volumes to the Group companies increased to 57%. The excess over the domestic and internal demand was sold to Northern China where we have retained competitive advantage even in the environment of contracting demand and falling prices due to geographical proximity and developed clientele.

The steam coal business was affected least of all during the 4th quarter as the coming up winter season and seasonally growing demand for power generation offset the negative market trends. Internal sales volumes, including the sales volumes to Toplofikatsia Rousse, constituted 14% of the steam coal sales volumes in the 4th quarter and also supported the production. At Yakutugol we even increased the production of steam coal in the 4th quarter by 37% as compared to the 3rd quarter at Neryungri open pit by changing the mining plan and reallocating mining equipment. That made up to certain extent for the reduction of coking coal production at the same pit.

The depreciation of Ruble was more positive for the mining segment than for the steel one and although affected the bottom line negatively with a 92 mln dollars FX loss in the fourth quarter 2008, helped to support our exports by reducing the dollar denominated cost base. Our continuous efforts to cut the costs through optimization of workforce and modernization of mining equipment also contributed to that. As a result, despite decrease in production across our coal business the cash cost of production of a tonne of coking concentrate in the 4th quarter 2008 at Yakutgol fell to 20 dollars, at Southern Kuzbass to 44 dollars The cash cost of steam coal production in the 4th quarter 2008 at Yakutugol fell to 20 dollars per tonne, and at Southern Kuzbass to 16 dollars per tonne. The cash cost of a tonne of iron ore concentrate also decreased to 30 dollars.

In order to optimize the cost base we also dedicated our efforts to reduce the significant stock of coal accumulated at our mining works, largely in Southern Kuzbass**.** By reducing the coal production below the sales level and thus saving on the variable cost side we ran down the stock by 200 thousand tonnes, reducing it to 3.9 mln tonnes by the end of the reporting period across all our coal mining companies. This trend continued into the 1st quarter of 2009 bringing the stock further down to appx 2.1 mln tonnes as of today.

As a result of combination of all these factors the revenue of the segment from the 3rd parties in the 4th quarter decreased less than in steel or ferroalloy segments and posted USD 504 mln with a gross margin of hefty 79%. The segment showed an operating profit of USD 240 mln and positive EBITDA of USD 212 mln with the margin of 33%. Net Income for the 4th quarter amounted to USD 179 mln.

Overall for the year the sales of the mining segment to the 3rd parties rose almost 2.5 times to 3.3 billion dollars, Operating profit more than tripled to 1.8 bln dollars. EBITDA increased 2.7 times to 1.9 bln dollars and Net income also tripled to 1.2 bln dollars, which made it a record year for our mining business by all criteria.

Slide 4 – Ferroalloy Segment

The profitability of the Ferroalloy segment in 2008 was affected by two main factors. First of all we witnessed gradual reduction in price of nickel throughout the year which fell more than 70% to 9,560 dollars per tonne by the end of the year. The price for chrome also experienced a reversion in the 4th quarter falling from the highest level of 6,680 dollars per tonne in June 2008 to an average of 978 dollars per tonne in the 4th quarter 2008. Secondly, the benefits of vertical integration of our chrome business did not yet crystallize as Voskhod Chromite mine and the washing plant, which was officially launched in September, is still going through a ramp up phase.

The performance of the segment was also negatively affected by the combination of large raw materials stock accumulated in the 3rd quarter and contraction in production in our nickel and chrome businesses as a response to falling market demand in the 4th quarter. Average monthly production at Tikhvin plant fell to the level of 47% of the first 9 month average in the 4th quarter and then further to 38% in the 1st quarter of 2009. At South Urals nickel plant average monthly production in the 4th quarter fell to appx. 50% of the 1st 9 month average of 2008.

The stock at Tikhvin plant was largely formed by the 3rd party chrome ore, which – together with the demand slowdown - affected its economics throughout the entire 4th quarter of 2008. However, starting from February 2009 we stoped purchases of 3rd party chrome ore and from April 2009 switched to shipments from Voskhod mine, which will considerably improve the economics of our chrome business in 2009, especially when the run of mine production reaches its full capacity in July 2009. At the same time, after the launch of the 3rd furnace out four on June 1 the production at Tikhvin plant in June is expected to exceed the 9 month average for 2008.

With the recovery of the nickel prices we witnessed in the 1st and 2nd quarters of 2009 and improving demand we increased the capacity utilization in the 1st quarter 2009 which drove production up to 64% of the 1st 9 month average of 2008. After the launch of the 6th furnace in late May the plant is expected to reach the average monthly level of production of the 1st 9 months of 2008 in June.

The demand contraction affected less our ferrosilicon business: the demand and pricing level secured almost a 100% capacity utilization at Bratsk plant and kept this business profitable over the reporting period.

As a result of sharp reduction in production and sales in our nickel and chrome business, the segment revenue posted only 32 mln dollars and resulted in an operating loss of 127 mln dollars in the 4th quarter of 2008. This translated into a negative EBITDA of 498 mln dollars and Net loss of 270 mln dollars. As mentioned above, the FX loss recorded in the 4th quarter largely affected the steel and the ferroalloy segments. The latter was largely the result of the 1.5 bln dollars bridge facility for the acquisition of Oriel Resources attributed to this segment. The resulting FX effect contributed 382 mln dollars to the negative bottom line in the ferroalloy segment in the 4th quarter and 399 mln dollars for the full year, which posted a net loss of 283 mln dollars and operating loss of 51 mln dollars on the revenue from the 3rd parties of 434 mln dollars.

Power Segment

The Power segment showed a far better resilience in the changing market situation in 2008 generating a revenue of 688 mln dollars, operating result of 29 mln dollars and EBITDA of 52 mln dollars. The segment recorded a Net income for the full year for the 1st time – 3.0 mln dollars. More than 4 mln dollars thereof were recorded in the 4th quarter, when profitability improved due to lower input costs and seasonally growing demand before winter and in the 1st winter month. The decrease in coal prices helped to reduce the cash cost of generating 1MWh from 33.2 dollars in the 3rd quarter to 28.7 in the 4th quarter. At the same time ongoing gradual liberalization of power market led to the increase of electricity price per 1 kWh from 37.5 cents in 2007 to 48.5 cents in 2008.

Solid cash generation capacity

The Group has generated over USD 2.2 bln of operating cash flow in the 12 months of 2008, which exceeds the result of the year 2007 by almost 2.5 times. During the same period net income grew only 25%. The reason for such a disproportionate increase in operating cashflow is the FX loss and inventory write-offs in the 4th quarter of 2008, which together total almost 1.2 bln dollars for the full year. At the same time it is notable that despite an almost 50% increase in sales, the consumption of operating cash flow by the growth of working capital increased only by less than 6%. In fact, in the 4th quarter of 2008 the working capital released 59 mln dollars as a result of timely management efforts in response to changing market conditions.

The investment cash flow for the year 2008 rose to USD 3.3 bln, thereof almost USD 1.2 bln were spent for new property plant and equipment within the framework of our extensive investment program. Over USD 2 bln were spent on M&A transactions, which include the acquisition of Oriel Resources, Ductil Steel and advances paid for Bluestone. The investment program was largely financed by the operating cash flow whereas debt rose by almost USD 1,5 bln.

Debt profile

As of the end of 2008 the Total Debt of the Group stood at USD5.4 bln and the Group had cash of USD 255 mln in its accounts, which gave the Net Debt of USD 5.1 bln. The original structure of the debt is shown on the slides 15-16. The bulk of the debt was formed by the USD 2 bln 5 year pre-export facility, raised in 2007 to finance the acquisition of Yakutugol and Elgaugol and a USD 1,5 bln 1-year bridge facility raised in March 2008 to finance the acquisition of Oriel Resources.

In the 4th quarter of 2008 due to the fact that most of the debt and equity capital markets closed we approached the banks in the bridge facility for refinancing of the loan over a long term. At the same time due to rapidly changing situation in the debt markets we saw that the new terms of the available debt instruments required certain amendments or waivers in the existing ones. As a result, we entered into negotiations with respect to both USD 2 bln and bridge facility, as well as a number of smaller loans to amend the terms of the existing facilities and refinance the bridge facility. Due to prolonged negotiations the term of bridge facility was extended by 2 months. In late May we finally reached a principle agreement with representatives of both syndicates on the terms of restructuring of these facilities and extended the bridge facility by another 2 months till mid-July 2009 in order to document the new terms and conditions. They do not affect the tenor for the USD 2 bln syndicate and provide for a refinancing of USD 1 bln of the original bridge facility over 3.5 years with 1 year grace period. The other USD 500 mln will be prepaid out of the funds provided under the USD 1 bln 3-year loan extended to the Group by Gazprombank in 1 quarter 2009.

However, since as of today the refinancing and amendment agreements have not been signed, we decided to reclassify the loan agreements, which are subject to adopting the agreed amendments into short-term facilities according to SFAS No 78 “Classification of Obligations that are callable by creditors” and EITF No. 86-30 “Classifications of obligations when a violation is waived by the creditor”. We plan to put these amendments and refinancing to effect before the expiration of the 2 month extension.

The resulting debt profile split is shown on slide 16 and can be compared with the debt profile as of May 1 2009. We expect that after the restructuring takes place USD1 bln of current short-term debt payable in the 3rd quarter 2009 will be extended.

This restructuring will allow us to continue with our investment program and have recourse to higher variety of debt market instruments to finance both our capex and current operations. Even today with some USD 900 mln dollars in the Group’s accounts as well as some USD350 mln of undrawn available working capital and trade financing lines and USD 200 mln credit lines for capex financing we feel relatively safe in the challenging markets. This safety is also supported by a 30 bln ruble exchange bond, registered and available for issuance at any time. Another 45 bln ruble issue of up to 10 years maturity has been recently registered in order to finance the investment program at Elga deposit. We plan to place the 1st tranche of the bond within the next month.

FY2008 Results overview

To recap, the year 2008 was the most successful year in the company’s history by all the financial metrics despite the sharp reversal in the commodities and financial markets in the 4th quarter. However, we believe that the significant growth and the financial standing our company had achieved prior to the market reversal will help us not only to preserve our current business in these challenging circumstances, but to come out of them in a better shape, ready for new opportunities.

Thank you for your attention, ladies and gentlemen, and now we will be pleased to answer your questions.