Brunswick UBS

Global Equity Research

Russia

Steel

Russian steel update

Market Comment

Momentum still positive

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- **Global and domestic fundamentals remain strong**

We believe that global and domestic fundamentals remain supportive of Russian steel equities' share price performance. Our analysis suggests that the global supply/demand balance remains favorable, with strong demand underpinned by IP growth, inventories below the historical average and no supply-side overshoot.

- **Competitive production costs and strong cash generation**

In our view, Russian steel producers continue to enjoy some of the most competitive production costs in the world due to vertical integration into raw materials and cheap labor; thus, they are less exposed to falling steel prices if the cycle turns south.

- **Corporate governance still an area of concern**

We believe recent amendments to the Law on Joint-Stock Companies - although so far approved only in their first reading - effectively allow core shareholders of all Russian steelmakers to make their companies private at the expense of minority shareholders. We believe these risks warrant lower target multiples on Russian steel equities.

- **Severstal and MMK downgraded, NLMK still our top pick**

We downgrade Severstal and MMK to Neutral 2 following strong price performance and revised multiples and earnings forecasts. We reiterate our Buy 2 rating on NLMK, which continues to be our top pick in the sector on valuations and superior cash generation. We also maintain our Buy 2 rating on NTMK.

Table 1: The Russian steel industry

	Price, $	M.Cap, $ m	Rating, old	Rating, new	Price target, $	Forecast price return	2005E EV/EBITDA	2005E P/E	2003 EV/ton, $	2004E dividend yield
Chelyabinsk Metallurgical Plant (ChMK)	129	406	Not rated	Not rated	n/a	n/a	n/a	n/a	118	n/a
Magnitogorsk Iron & Steel (MMK)	0.43	4,518	Buy 2	Neutral 2	0.43	1%	3.0	7.0	390	0.7%
Nizhny Tagil Iron & Steel (NTMK)	0.724	948	Buy 2	Buy 2	0.95	31%	2.2	5.6	194	n/a
Novolipetsk Iron & Steel (NLMK)	0.804	4,820	Buy 2	Buy 2	1.20	50%	2.1	4.6	466	7.0%
Severstal	183	4,032	Buy 2	Neutral 2	200	9%	2.8	5.6	416	5.5%

Source: RTS; Brunswick UBS estimates

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Summary and Investment Case

We remain upbeat on Russian steel equities due to our positive steel price outlook, competitive production costs, strong cash generation and attractive valuations

We believe that momentum is still supportive of steel equities globally, and Russian steel equities in particular, on the back of our positive view on the longer-term outlook for the current cycle. However, in our view, Russia's two largest steel producers—Severstal and Magnitogorsk Iron & Steel (MMK)—have already priced in most of the earnings momentum, and now appear fairly valued. Within the context of the positive momentum, we prefer equities that provide more value, and highlight Novolipetsk Iron & Steel (NLMK) as our top pick in the sector. In our view, it is not yet time to turn negative on the sector, as steel prices are likely to stay high in the short term, and we would look to review our assumptions only if more signs of downside risks to the sector appear. Below, we provide the key points supporting our near-term positive view on the Russian steel sector:

- **Positive view on the longer-term outlook for the current steel cycle** Despite a slowdown in steel demand in China, IP growth in the rest of the world in 2004–05E should support global demand for steel. Given the high probability of ongoing supply-side restraint globally—due to there being little new capacity planned to come on stream in 2005 and raw material shortages—and globally low inventories, we are positive on the longer-term prospects of the current steel cycle. Supply constraints should prolong the pricing cycle, and remove the risk of a future pricing collapse from a potential global de-stocking phase. We believe the risks to our 2005 steel price and, hence, earnings estimates are on the upside.

- **Competitive production costs** Russian steelmakers currently enjoy some of the most competitive production costs in the world, due to lower salary and energy expenses, as well proximity and control over iron ore suppliers; thus, they are less exposed to falling steel prices. For example, average Russian production costs are roughly 20% below Chinese levels.

- **Sustained competitive advantage** While in the medium-to-longer term we expect cost inflation to continue, we believe that Russian steelmakers are more hedged against rising iron ore prices and electricity costs than their international peers, with the exception of Brazilian steelmakers. Russia has the largest proven iron ore reserves in the world, and some producers—in particular NLMK and Severstal are almost self-sufficient in iron ore.

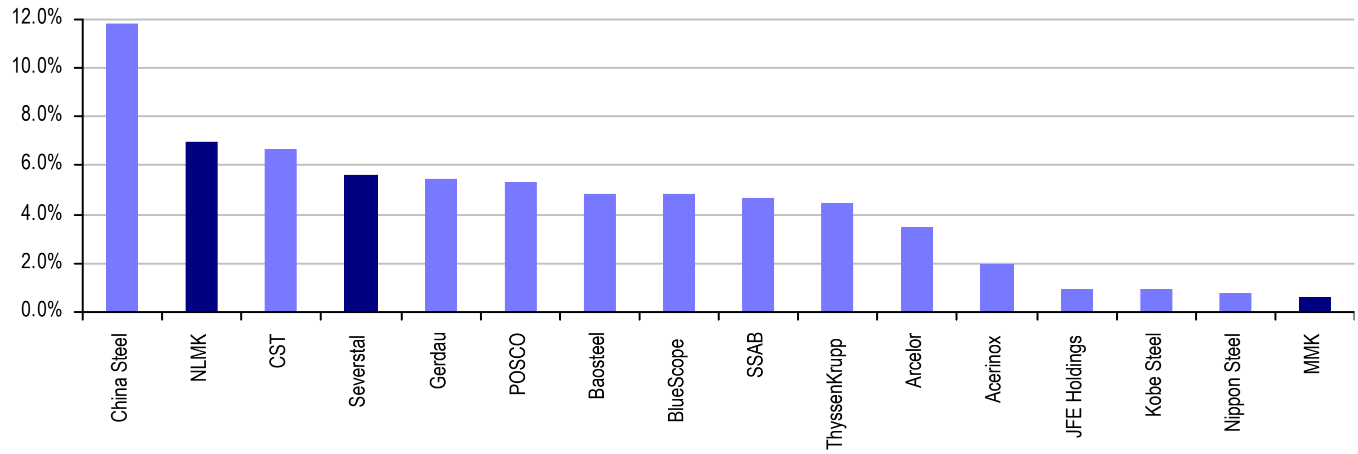
- **Robust domestic demand and pricing** Russian steel producers sell approximately 50% of their output on the domestic market, and this figure continues to rise. Consumption of rolled products in Russia rose 10% year-on-year to 25.6 m tons in 2003 and 10% year-on-year in 1H04 to 14 m tons on the back of strong industrial production growth. We anticipate a similar growth rate in 2004. Prices on the domestic market are stable and somewhat higher than export prices for some products.

- **Clean balance sheet, high profitability and cash generation** The profitability of Russian steel producers is significantly higher than that of companies operating in developed markets, and roughly comparable with the emerging market average. While Russian steelmakers are more competitive than the majority of their emerging markets peers on a production cost basis, their profitability is roughly comparable, due to higher transportation costs and somewhat lower average realized prices—a result of a relatively poorer product mix, a sizeable proportion of which is generally semi-finished products destined for export. NLMK is the most profitable producer, with a 2004E EBITDA margin of 51%, primarily due to the higher efficiency of assets and lower transportation costs, given its proximity to high-quality iron ore producers and export routes. We believe that strong cash generation should allow Russian steelmakers to pay decent dividends and play an active role in the consolidation of the global steel industry.

- **Corporate governance and low liquidity of shares still areas of concern** We are concerned about corporate governance, as Russian steel companies are effectively private companies with low share liquidity that are run in the interests of core shareholders. Recent amendments to the Law on Joint-Stock Companies approved by the Duma in their first reading in early July, effectively allow core shareholders controlling more than 90% of the company to force minority shareholders to sell them the remaining 10% at a price determined by an independent appraiser appointed by the majority shareholder. These amendments effectively allow core shareholders of Russian steelmakers to transform their companies from quasi-public to private companies at a low cost. We see higher risks of this happening at Severstal and NTMK than at NLMK, as the latter has two large shareholder groups instead of one. We believe the target multiples and equity risks premiums we use in our models to derive price targets accurately reflect these risks.

- **Cheapest steel stocks in the world** Russian steel producers also remain attractively priced relative to the global sector. Currently, they trade at large discounts on earnings-based multiples to both emerging and developed market peers. For example, NLMK trades on a 2005E EV/EBITDA multiple of 2.1—a c55% discount to the developed and emerging markets average—and a P/E of 4.6, a c45% discount. NLMK has a 2005E free cashflow yield of about 20%—one of the highest in the industry worldwide. In our view, it is hard to find a reasonable justification for such large discounts, as Russian steelmakers boast some of the highest profit margins in the sector, have strong free cashflow profiles, and, in certain cases, pay quite attractive dividends. Under our base-case assumption, according to which NLMK allocates 25% of its US GAAP net profit to dividends, the company's 2004E dividend yield is 7%.

Chart 1: 2004E dividend yields



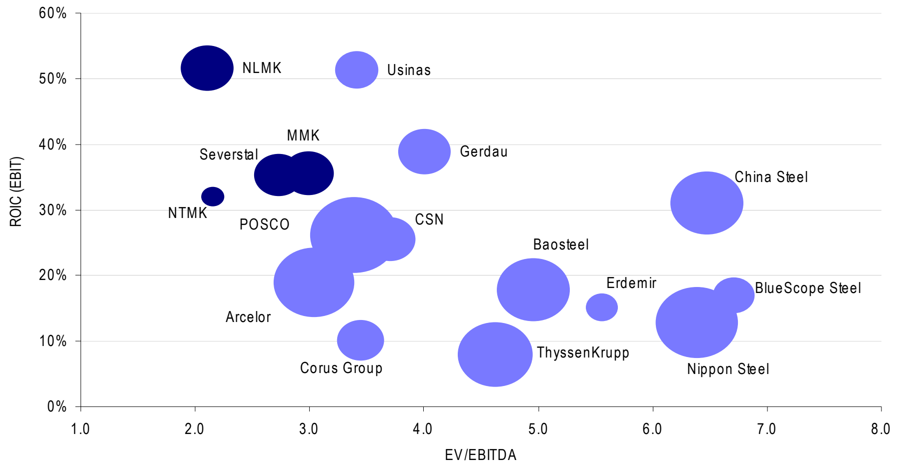
Source: UBS, Brunswick UBS estimates

We downgrade Severstal and MMK to Neutral2 and reiterate NLMK as our top pick in the sector

- **We downgrade Severstal and MMK to Neutral 2 following share price growth and revised earnings and target multiples** We marginally reduce the target multiples we use to derive price targets for steel equities to reflect the recent softening in comparable multiples of the peer group, as well as the increased perceived risks for big business in the current political environment. Based on our revised 2005E target multiples and new earnings forecasts, we reduce our price target for NLMK from $1.25 to $1.20 and maintain our **Buy 2** rating, suggesting 50% forecast price return. We also reduce our price target for Severstal from $225 to $200 per share due to higher corporate governance risks (see below), and our rating from Buy 2 to **Neutral 2**. We lower our price target for MMK from $0.55 to $0.43 per share on the back of both a multiple and an earnings downgrade, and reduce our rating from Buy 2 to **Neutral 2** implying 1% forecast price return. We downgrade our price target for NTMK from $1.05 to $0.95 and maintain our **Buy 2** rating.

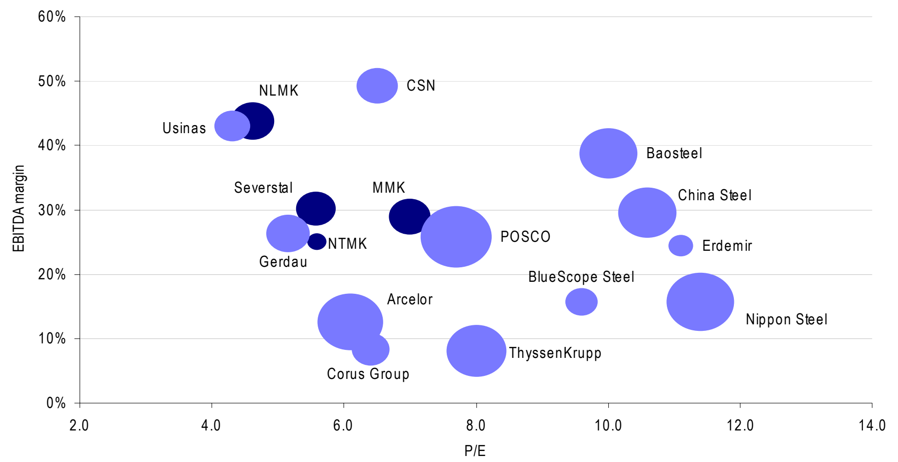
- **NLMK is our top pick** While we believe that fundamentals are still supportive of all Russian steel equities, our top pick in the sector is NLMK due to its recent underperformance relative to Severstal (and consequent attractive valuations), self-sufficiency in high-quality cheap iron ore, a clear corporate strategy and superior profitability and cash generation. Our key concern with Severstal is its non-transparent corporate strategy for minority shareholders and corporate governance concerns associated with the recent transfer of assets from Severstal-Resurs. MMK appears less attractive than NLMK and Severstal on valuations and is currently experiencing production problems due to shortages of coking coal. On top of that, MMK is not self-sufficient in iron ore—thus its earnings are more exposed to the risk of rising iron ore prices. Among smaller steel mills, we remain positive on NTMK, which showed the best financial performance in the sector in 1H04.

Chart 2: 2005E EV/EBITDA and EBIT ROIC



Source: UBS, Brunswick UBS estimates

Chart 3: 2005E P/E and EBITDA margin



Source: UBS, Brunswick UBS estimates

Update on global fundamentals

The global supply and demand situation remains supportive of steel pricing in 2H04–2005E, suggesting upside risk to our average global steel price estimates for next year. Supply-side growth appears rather limited due to a lack of new capacity expansion, raw material shortages, infrastructure capacity limitations, and better supply discipline as a result of greater industry consolidation. The latest global inventory data shows little signs of stockbuild, alleviating potential concerns over industry de-stocking. At the same time, we believe the demand outlook remains positive due to strong industrial production rates, despite the Chinese slowdown, as the rest of the world is compensating for mainland China's shortfall.

Tight global steel markets remain supportive of high steel prices in the near term

Supply

Global steel production has continued to exhibit historic highs into 2004, following the strongest year in history. In 7M04, world steel production was up 7.7% year-on-year, and is on its way to reaching the billion ton mark for the first time in history. However, excluding China, which ramped its production up 20%, the growth was a more moderate 4.1% year-on-year. We note that this increase is well below the historical rate of supply-side increases in past cycles.

World steel production was up 7.7% year-on-year in 7M04

Table 2: Steel production by major regions, m tons (daycount adjusted)

	Jul-03	Jun-04	Jul-04	% chg, m-o-m	% chg, y-o-y	7M03	7M04	% chg, y-o-y
EC 15	12,525	14,342	13,889	(6.3)	10.9	94,570	98,963	4.2
USA	7,405	8,170	7,950	(5.8)	7.4	53,786	56,388	4.3
North America	9,870	10,923	10,726	(5.0)	8.7	72,051	75,645	4.5
Australia	604	592	553	(9.6)	(8.4)	4,308	4,376	1.1
China	18,273	20,798	21,988	2.3	20.3	120,648	145,677	20.2
Japan	9,258	9,420	9,549	(1.9)	3.1	64,283	65,356	1.2
Korea	3,910	3,976	3,850	(6.3)	(1.5)	26,722	27,517	2.5
Pacific Rim	36,272	39,020	40,304	0.0	11.1	244,889	273,028	11.0
Russia	5,234	5,408	5,420	(3.0)	3.6	35,597	37,058	3.6
Ukraine	3,287	3,081	3,203	0.6	(2.6)	21,057	22,430	6.0
CIS	9,120	9,242	9,368	(1.9)	2.7	60,985	64,672	5.5
Turkey	1,556	1,717	1,757	(1.0)	12.9	10,524	11,803	11.6
Brazil	2,686	2,754	2,840	(0.2)	5.7	18,009	18,999	5.0
Rest of world	6,550	6,629	6,670	(2.6)	1.8	43,050	45,398	5.0
World total	**78,580**	**84,627**	**85,553**	**(2.2)**	**8.9**	**544,078**	**588,506**	**7.7**
World excl. China	**60,307**	**63,829**	**63,566**	**(3.6)**	**5.4**	**423,430**	**442,830**	**4.1**

Source: IISI

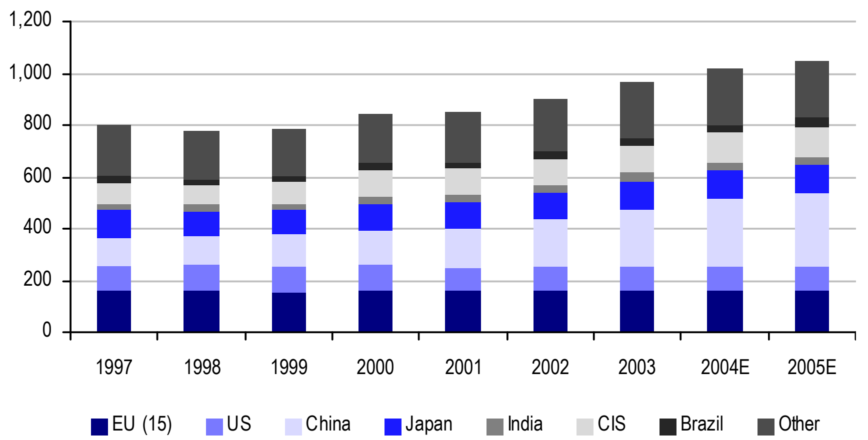
While year-on-year growth looks rather impressive, month-on-month statistics reveal somewhat different trends. July was the fifth consecutive month of broadly flat month-on-month production figures, suggesting that the industry is close to capacity. For example, compared with the previous month, both Europe and North America saw a decline in steel production in July. China was perhaps the biggest surprise, as production rebounded in July after four months of broadly stagnant month-on-month growth. However, with the Chinese month-on-month growth a modest 2%, this suggests fluctuations in utilization, not new capacity.

Month-on-month statistics suggest the industry is operating close to capacity

We see no signs of the overproduction of past cycles

We believe that this year and next year, growth in production will slow down. We are likely to see some increase in Europe and the US, as in 2H03 they were cutting production to cope with the effects of de-stocking. However, China has undergone considerable capacity expansion in 2003 and is likely to show a significant decline in production growth rates. In addition, global production growth appears limited by ongoing raw material constraints globally and seasonal maintenance shutdowns. Thus, we expect 5% growth in global steel output in 2004, followed by 3% growth in 2005. With supply growth below global demand growth, we see no signs of the traditional production overshoot of the kind that killed cycles throughout the 1990s and instigated the recession of the early 2000s.

Chart 4: Global steel production, m tons



Source: IISI, UBS

Inventories

Inventories in key regions remain below historic averages

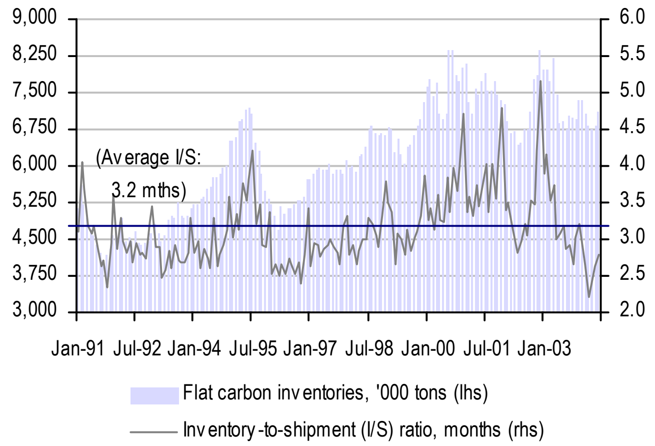
Steel inventories are another important driver of steel supply. As a rule, with inventories at below-average levels, the risk of a sudden price decrease appears lower, while above-average inventories imply a possibility of de-stocking, resulting in sudden price drops. Below, we briefly look at major steel consuming regions to determine the risk of potential de-stocking:

- **Europe and the United States.** The latest data (for May) for the US and Europe suggest that, despite a slight increase, inventories in these two key markets remain below average.

- **Asia.** Inventories in Asia also remain subdued, and close to all-time lows in certain countries.

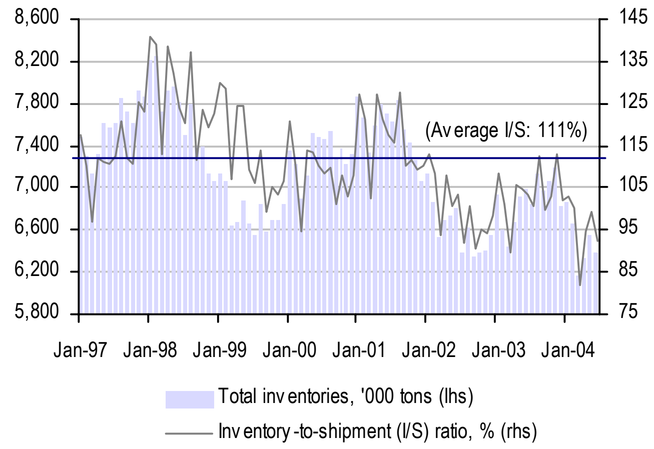
Low inventory levels across the main steel-consuming regions suggest a low risk of de-stocking, while additional re-stocking implies further demand for steel on the margin. We therefore remain broadly comfortable that there is little excess steel in the global inventory system.

Chart 5: US steel inventories (flat products)



Source: SSCI, CRU (blue line represents 13-year moving average of 3.2 months of shipments in hand)

Chart 6: Japanese steel inventories (flat and long products)



Source: Japan Iron & Steel Federation (blue line represents 7-year moving average of 111% inventory-to-shipments ratio)

Demand and pricing outlook

Steel demand remains strong, driven by healthy global IP growth

Since supply looks to remain relatively tight, as we have shown above, demand growth is crucial if the current cycle is to last. In our view, the mid-term outlook for global steel demand should remain supportive of steel pricing, due to the following:

- **Healthy global IP growth.** Industrial production growth is a good proxy for steel demand growth. Our global economics team forecasts world IP growth of 6.2% for 2004E and 5.0% for 2005E.

Table 3: UBS global industrial production (IP) forecasts

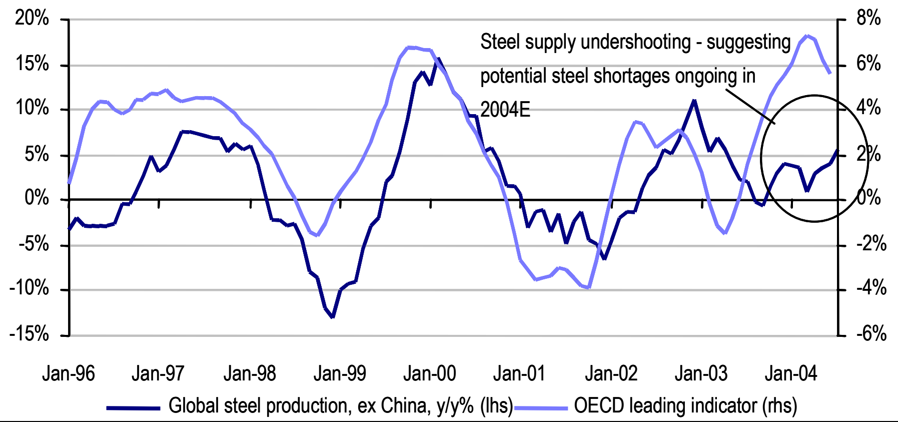
	% of global steel consumption 2003	% IP growth								
		1997	1998	1999	2000	2001	2002	2003	2004E	2005E
US	12%	7.4	5.9	4.4	4.4	(3.4)	(0.6)	0.3	5.3	5.5
Japan	8%	3.6	(7.1)	0.2	5.7	(6.8)	(1.3)	3.2	6.7	2.0
EU (12)	17%	4.2	3.8	1.8	5.3	0.4	(0.6)	0.4	2.6	2.4
S Korea	5%	4.7	(6.5)	24.2	16.8	0.7	8.1	5.1	4.8	5.1
China	26%	11.7	(1.6)	12.5	16.9	14.6	18.2	22.3	16.9	12.8
World		6.1	1.3	4.3	6.9	0.1	2.6	4.3	6.4	5.2

Source: IISI, UBS estimates

- **Asian growth.** Following the emergence of China as a major steel consumer, global steel consumption has been running at a higher level than IP growth. With China taking up a sizeable share of global IP growth, this means that should our IP growth rate forecast materialize, steel shortages may not be fully resolved by 2005E. This supports the argument against the cycle ending in the next 18 months.

- **Limited supply expansion in 2004–05E.** We believe that, globally, steel supply is likely grow at a slower rate than IP, as it is constrained by raw material bottlenecks (especially metallurgical coke) and there are few new capacity expansion plans for 2005.

Chart 7: Growth in steel production vs. OECD leading indicator

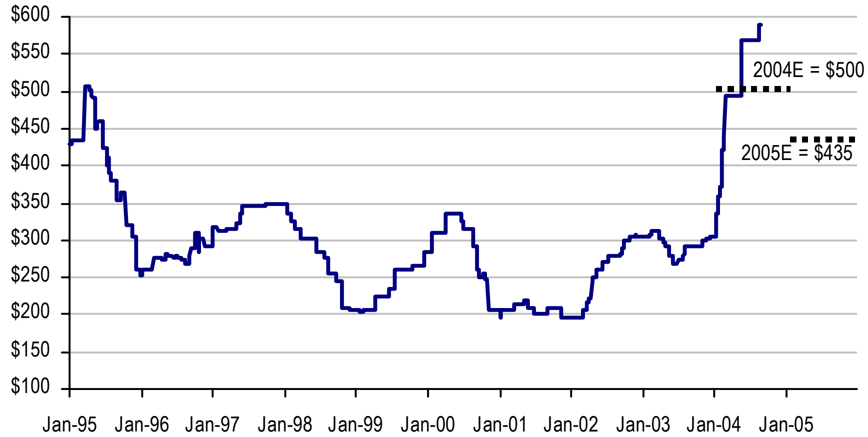


Source: IISI, Thomson Financial, Datastream

We see upside risks to our 2005 steel price estimates

Thus, robust growth in steel demand globally, coupled with below-average global inventories and visibly lower supply expansion, should provide grounds for a positive pricing outlook for 2H04–2005E. In our view, we are still not at the point where warning signs of a major threat to global steel pricing are visible. In fact, the current supply/demand outlook suggests that there may be upside risk potential to our global steel price forecasts for 2005. For example, our forecasts for hot-rolled coil (HRC) in Western Europe—a good barometer of world steel prices—are $500 per ton for this year and $435 per ton for 2005E. With the steel price currently at $590 per ton and the year-to-date average price at $500 per ton, our forecast for 2004E could already be viewed as conservative, while our forecast of a 13% decline in the average price in 2005E is based on the assumption that the supply/demand balance should loosen next year, which may not be the case.

Chart 8: West European price for hot-rolled coil (HRC), $/ton

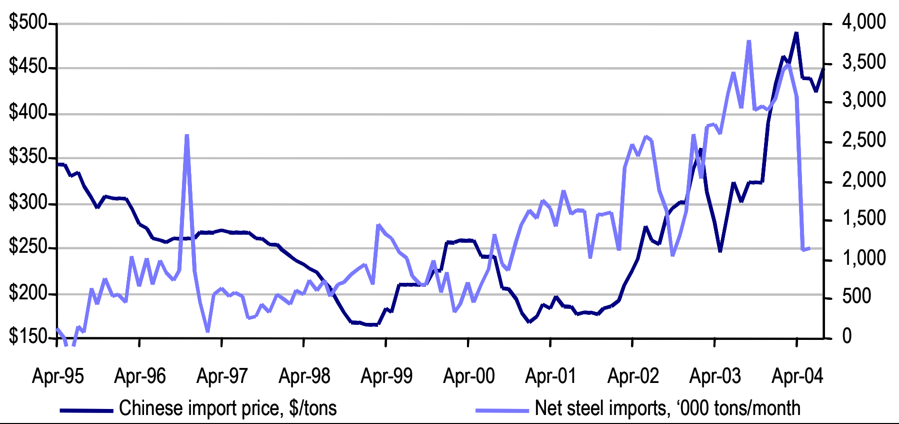


Source: Datastream, UBS

Price differences between regions have increased in recent months

With prices staying strong in the developed markets, including the EU and the US, differences in prices between regions have increased somewhat, following initiatives undertaken by the Chinese government to tighten credit policies. Since May and until recently, steel prices in China had been declining unlike in other regions, driven by softer demand. Prices bottomed out in July at $420 per ton for HRC, and have recently recovered to $450 per ton. Chinese imports declined considerably in May–July, recording double-digit year-on-year declines. Following the slowdown, with August statistics also likely to show import declines year-on-year, the supply/demand situation is now tightening, with traders starting to build up stocks and supply starting to disappear as a result of strong demand in other parts of Asia and the world. Thus, we believe that in September steel prices in China are likely to see further rises, while import growth could also be seen quite soon.

Chart 9: Chinese net imports and steel price

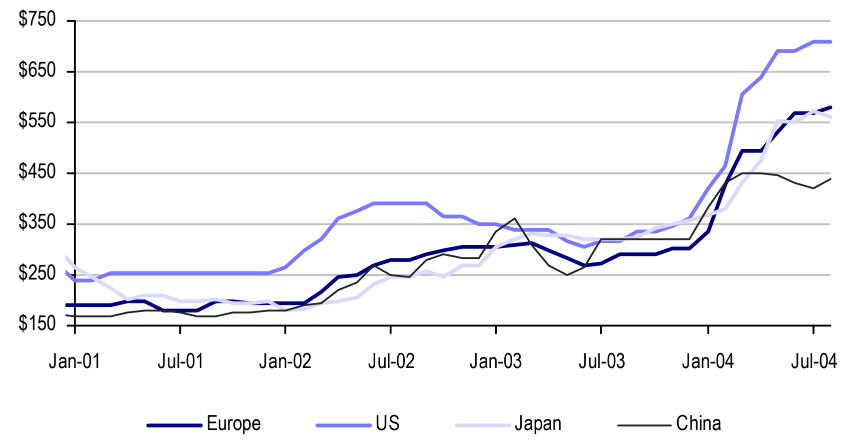


Source: Chinese customs statistics, Metal Bulletin

If Chinese steel imports do not recover from recent drops, world steel prices could be put under pressure

Importantly, the confusion in the Chinese steel market since May has been largely offset by demand expansion in other countries. Prices in other markets, including other Asian countries, have not experienced downward corrections as a result of China's lower imports, and in certain markets—such as the EU—they have seen further upward movement. Interestingly, during this period, prices for raw materials such as coke and scrap fell in the major markets, while steel product prices remained strong. Therefore, the disruption in China had no effect on other nations, while a re-acceleration of the Chinese economy, if it were to happen, would stretch the global steel market further. On the other hand, the potential risk is that the longer it takes for Chinese imports to rebound from current low levels, the more liquid the global export market could become, and this could ultimately exert pressure on global prices.

Chart 10: Steel prices by key regions



Source: MEPS, Metal Bulletin, CRU

Political factors may limit further steel price hikes in Asia

As can be observed from the above chart, price differences in various parts of the world following the Chinese slowdown have widened. This has already resulted in trade flow rebalancing, with exports going to more lucrative regions such as the US. The global rebalancing should result in lower price differences around the world, providing support to Asian prices and shaving the premium off the more expensive markets. However, taking the above—which could be a result of protective political measures undertaken in some of the Asian economies—into account, we still believe that global steel pricing is unlikely to go much higher. Currently, HRC is trading in Asian export markets at $500 per ton, and we believe that politicians in Asian emerging market countries, whose main goals include keeping inflation under control, will not allow Asian steel prices to rise much higher. Malaysia, Vietnam, Thailand and even China have all made political noises about rising steel prices this year. Therefore, a price of $500–550 per ton of HRC should look like the limit.

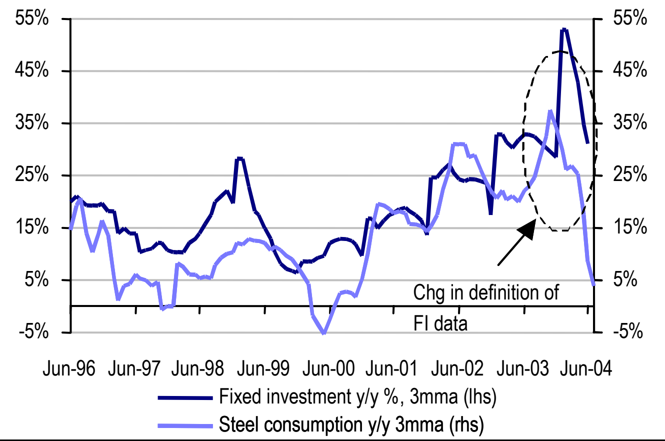
In this environment, US prices have to eventually come down, in our view, but Europe looks to have the highest likelihood of further upside risk (or less downside risk) in light of the scope for further price hikes in 4Q04 and the low likelihood of political interference.

China risk—slowdown in imports

The slowdown in China has had a negative effect on steel imports

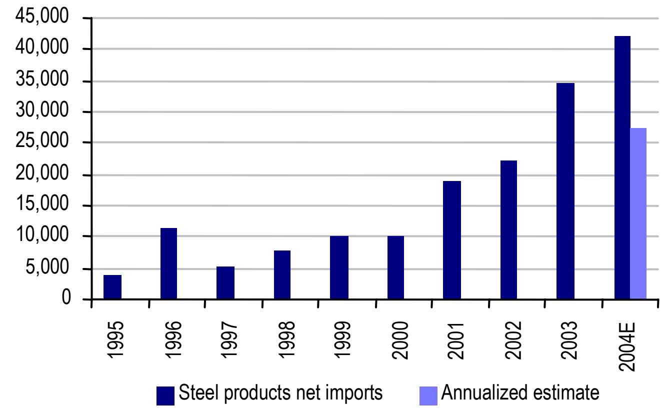
China's credit tightening in recent months has had some results, as growth in short-term loans to the construction sector has turned negative and demand for steel in the construction sector has suffered. The majority of China's steel demand comes from the construction sector. In the past three months, China's steel imports have decreased by more than 50%, from an average of 3 m tons per month to about 1 m tons. In July, net steel imports hit their lowest level since June 2000 at 750,000 tons.

Chart 11: Credit tightening, fixed investment and steel demand



Source: CEIC

Chart 12: China's net steel imports, 1995–2004E, '000 tons



Source: Chinese Customs Statistics, UBS estimates

Chinese production is growing at above the global average

China has become a significant importer of steel products, due to fast economic expansion. Its net imports have increased more than threefold, from 10 m tons in 1999 to nearly 35 m tons in 2003. At the same time, China has been the fastest-growing steel producer in the world, with steel production growing from 124 m tons to 220 m tons over the same period, making it the largest steel producer in the world. In 2004–05E, we expect it to continue growing at a rate faster than the global average. While three years ago, most of China's steel production was in long products, primarily oriented towards the construction sector, the bulk of capacity additions in recent years have been in flat products, primarily at the lower value-added end of the business. Capacity additions in higher value added products began at a later stage.

Prices in the rest of the world may come down if Chinese imports continue at current levels

Our concerns are that we may start to see import substitution in both long products and lower value-added flat products. Judging from empirical evidence, China has in the past succeeded in substituting its imports in certain cases, with aluminum industry being a good example. So far the market appears unworried by this trend, questioning how much of the steel import decline is due to price differentials between China and the US. However, if the trend were to continue, we believe it could eventually affect steel equities. In case Chinese steel product demand remains lower for the rest of this year, Chinese net steel imports could be some 15 m tons lower than expected. Redirection of this amount of steel would exert a pressure on global steel prices and is likely to truncate the current steel cycle.

Russian market fundamentals

The domestic supply and demand situation remains supportive of high steel prices in the near term. Russian steelmakers are increasing their output at a moderate rate close to the global average ex-China, running at high utilization rates, while strong exports and rapidly rising domestic steel consumption are keeping domestic supply quite tight. The domestic steel consumption outlook is underpinned by strong growth in industrial production and still low consumption per capita. Steel prices in Russia generally correlate closely with prices in Europe and Asia, although prices on certain products in deficit, including those with higher value-added, are higher.

The domestic supply and demand situation is supportive of high domestic steel prices

Supply

Russian steel output has continued to grow at healthy rates year-to-date, recording the highest production output seen in the last decade. Following year-on-year growth of 5% in 2003, rolled product output expanded another 4.8% in 1H04, and we expect that it will grow 4.5% in 2004E as companies look to meet domestic and external demand for steel.

Production continues to grow in response to high demand

Among individual companies, the three largest steelmakers reported growth rates of 2%–5%, while the subsidiaries of EvrazHolding recorded flat-to-declining production growth. In our view, the slight decline is primarily due to a different product mix, as its subsidiaries focus mainly on long products. That demand for long products in Asia—their key export market—was somewhat softer in 1H04 should explain a slight shortfall in production. That said, physical production at EvrazHolding's subsidiaries remains at one of its highest levels in the last decade, in line with the longer-term trends observed in the Russian steel industry. A number of smaller steel companies have increased their production in excess of 5%, compensating for certain shortfalls at some of the larger steelmakers.

Table 4: Production of rolled products, m tons

	July 2004	% chg. m-o-m**	1H04	% chg y-o-y	Share in total production
MMK	0.888	-1.3%	5.08	1.9%	19.4%
Severstal	0.819	-2.0%	4.56	4.5%	17.4%
NLMK	0.737	1.4%	4.32	4.8%	16.5%
ZSMK*	0.397	-2.7%	2.40	-8.0%	9.2%
NTMK*	0.385	0.7%	2.37	-0.5%	9.1%
ChMK	0.255	-8.3%	1.62	23.8%	6.2%
Uralstal	0.238	7.1%	1.27	13.7%	4.8%
NKMK*	0.191	18.9%	1.11	14.4%	4.2%
Other	0.721	5.2%	3.42	10.2%	13.1%
Russia total	**4.630**	**0.7%**	**26.15**	**4.7%**	**100%**

* Controlled by EvrazHolding
** Daycount adjusted
Source: Chermet; Company data

Continued growth in production and virtually no capacity expansion in recent years has resulted in more efficient capacity utilization at major steel companies. In general, the industry has approached close to its maximum theoretical capacity, operating at more than 90% capacity for pig iron and more than 85% for crude steel and rolled products. The high utilization of production facilities means that a production increase of more than 10%–15% is not possible without additional investment into fixed assets. The current undertakings of the main steel producers to modernize their assets should provide some additional capacity; however, we do not expect significant incremental capacity additions as a result of this.

The industry is operating close to capacity

Table 5: Capacity utilization, %

	1990	1995	2000	2001	2002	2003
Iron ore	98	84	92	93	90	96
Cast iron	94	70	86	86	88	91
Crude steel	94	67	77	77	79	83
Rolled products	92	66	72	78	79	83
Steel pipe	94	36	47	53	51	60

Source: ChermetInfo

Producers with their own raw material bases have more control over production hikes

We believe that future output increases are subject not only to excess capacity of steelmakers, but also to the availability of raw materials, in particular iron ore and coking coal. At the moment, iron ore and coal producers are working at close to capacity, and are exporting part of their output on the back of strong global fundamentals. As a result, certain steelmakers, such as MMK, are satisfying some of their ore needs by importing from CIS countries. The situation in the coal market looks similar, and steel producers with no control over coal assets are paying very high prices for coal, and sometimes face supply shortages. For example, we believe that MMK increased its steel production by only 1% in 1H04—compared to 5% increases for Severstal and NLMK—as a result of coal shortages. The option to import coal is hardly there, as CIS countries lack quality reserves of coking coal, while imports from Australia are expensive due to high transportation costs. Therefore, steel producers with their own raw material assets are more flexible in meeting future supply challenges. In this respect, we would highlight Severstal, NLMK, the subsidiaries of EvrazHolding, Chelyabinsk Metallurgical Plant (ChMK) and Oskol Steel (OEMK) as the companies that enjoy a more advantageous position than the rest of the market. The table below shows the affiliation of all major steelmakers with their raw material suppliers.

Table 6: Security of supply in raw materials

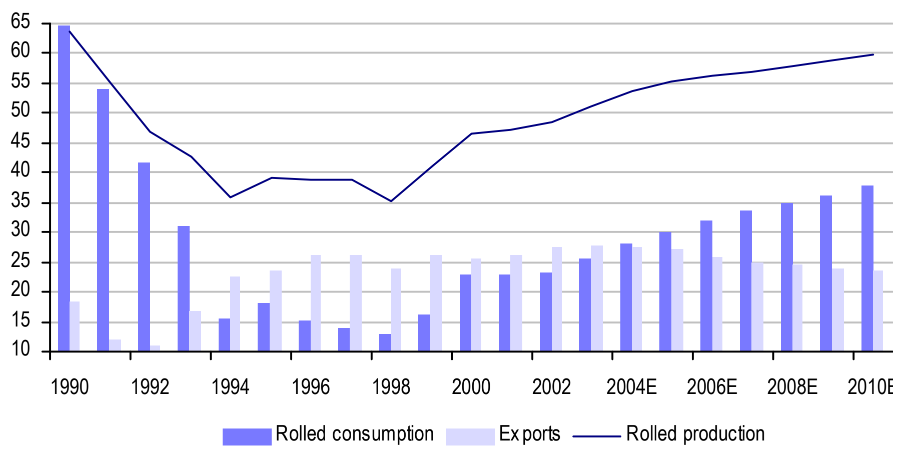
Steel producer	Controlled/affiliated iron ore producers	Self-sufficiency rate	Controlled/affiliated coking coal producers	Self-sufficiency rate
Severstal	Karelsky Okatysh, Olkon	85%	Kuzbassugol, Vorkutaugol	100%
NLMK	Stoilensky GOK, KMA-Ruda	100%	Plans a greenfield coal project to achieve 100% self-sufficiency	n/a
MMK	Own venture	10%	Uregolskaya Mine, not yet operational, seeks other projects	n/a
EvrazHolding	Kachkanarsky GOK, Vysokogorsky GOK, EvrazRuda	80%	Yuzhkuzbassugol, Raspadskaya mine	100%
ChMK	Korshunovsky GOK	65%	Yuzhny Kuzbass	100%
Oskol Steel (OEMK)	Lebedinsky GOK	100%	n/a (OEMK does not have a blast furnace plant)	n/a

Source: Company data, Brunswick UBS estimates

We do not expect Russian steelmakers to focus on new capacity additions at the top of the cycle

In our view, production of steel in Russia should continue to run at a growth rate close to the global average. In 2004, we expect an increase in steel output of 4.5%, followed by another 3.5% in 2005. Growth rates going forward should depend strongly on domestic and foreign demand, although we believe that growth will slow down as a result of falling exports, likely due to capacity expansion in key export regions such as Southeast Asia. In this base case scenario, we would not expect Russian steelmakers to undergo expensive capacity expansions, but rather to focus on modernization and diversification into value-added products.

Chart 13: Rolled steel production growth, m tons



Source: ChermetInfo, Chermet, Brunswick UBS estimates

Demand

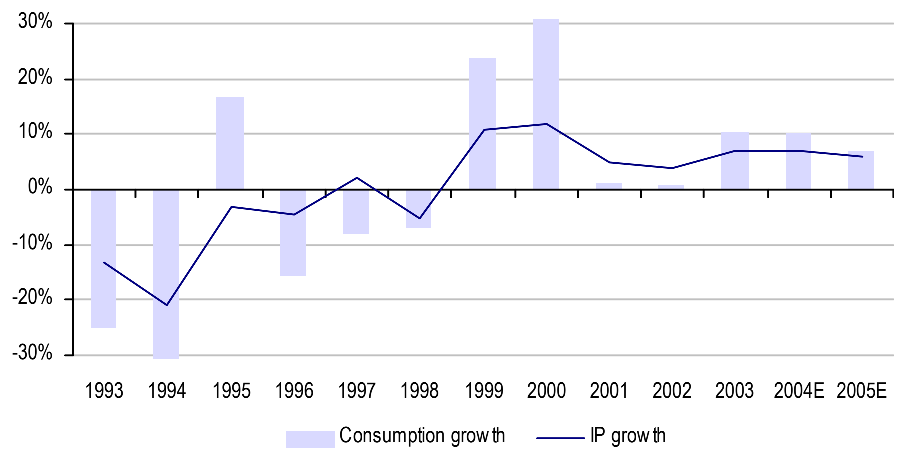
Steel consumption in Russia is expected to grow at levels above IP growth

Steel consumption in Russia has extended its growth trend into a fifth consecutive year, with growth rates not yet showing signs of saturation. In 2003, consumption of rolled products rose 10% year-on-year to 25.6 m tons, implying that more than 45% of domestically produced steel was consumed in Russia.

Growth in domestic steel consumption has been driven by rising industrial production (IP) since the 1998 crisis, with the main consumers of steel—such as the oil and gas, construction and heavy machinery sectors—increasing production and investment to keep up with growing domestic and export demand. Steel consumption has continued its growth into 2004. In 1H04, the domestic market consumed roughly 14 m tons of rolled steel, implying that 2004E consumption should be in the area of 28 m tons. This represents another 10% growth rate in 2004E.

Judging by historical trends since 1998, domestic steel consumption grows on average faster than IP growth. This also supports the argument presented earlier that domestic consumption in developing economies often grows at a rate faster than IP growth. Apart from IP growth that drives steel consumption, another positive demand shock can come from the need to replace aging assets in certain industries. In general, fixed assets in Russia are considered to be older than in developed and emerging economies due to underinvestment in the past. Thus, the need to renew assets should materialize, benefiting Russian steel producers.

Chart 14: Steel consumption vs. IP growth

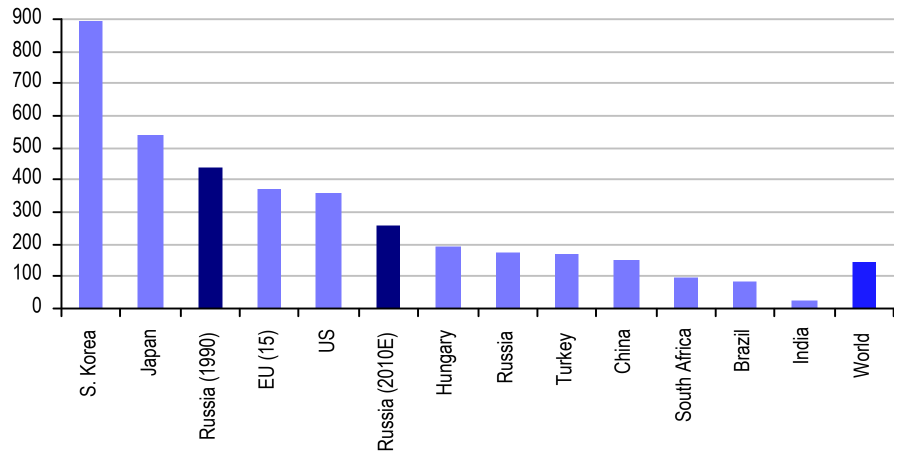


Source: Goskomstat, Brunswick UBS estimates

Consumption per capita still has room to increase

The continued strength in domestic consumption trends indicates that the market could still be quite far from saturation. One of the best indicators of this is steel consumption per capita. On a global scale, consumption per capita in Russia is significantly below that of developed markets and generally close to emerging markets. Judging from historical trends, consumption per capita rises quite fast in periods of industrial growth until GDP per capita reaches high levels and service sectors begin to play a more important role in further economic growth. As a general rule, annual consumption per capita in developed economies stabilizes at around 350–600 kg. In Russia, consumption per capita has seen strong expansion from 90 kg in 1998 to 180 kg in 2003. We believe that by 2010E it should increase to over 250 kg per capita—still a significant discount to developed markets, even based on 2003 numbers.

Chart 15: Consumption of steel per capita, kg



Source: ChermetInfo, Brunswick UBS estimates

Russia is still highly exposed to export markets

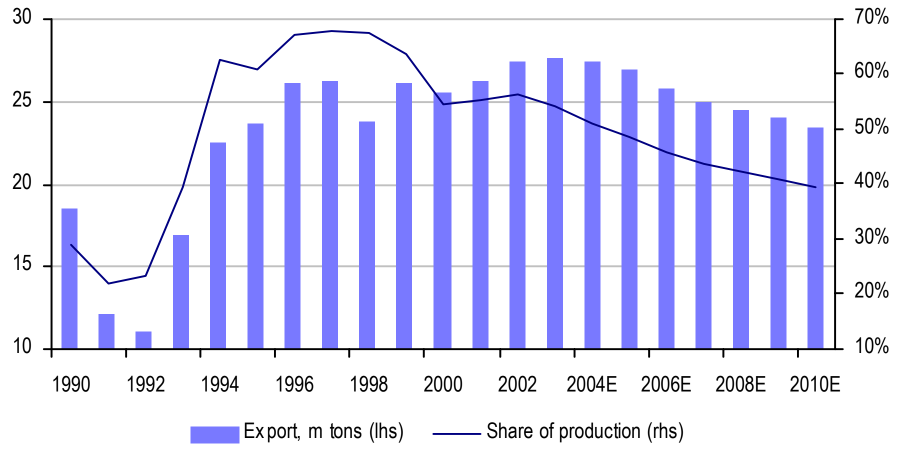
In our view, the demand outlook on export markets remains favorable for Russian steelmakers, as long as steel shortages continue to exist. Following Russia's expansion into the export market, its position has stabilized in the last few years, with exports staying in the range of 25–28 m tons of rolled products per year. This makes Russia the world's second largest steel exporter after Japan. In 2004, Russian steel exports have so far shown no signs of a slowdown, and physical export volumes are likely to stay at 2003 levels, or 27–28 m tons. However, given the high dependence of Russian producers on the strategically important export markets, the global supply/demand balance going forward is likely to be crucial.

In 2003–1H04, domestic steel producers saw some easing of trade barriers for their products, in particular in North America. We believe that lower barriers are likely to remain for as long as steel prices remain high and consumers lobby for less trade regulations to decrease their raw materials costs. However, in the longer term, the outlook for finished products remains less clear. Russia's possible accession to the WTO might provide some additional benefits to steelmakers, although the timing is still uncertain.

In the longer term we expect exports to decline due to rising domestic demand

The demand for Russian steel in export markets is driven by a favorable world economic growth outlook, especially in Asia, and tight supply. We believe that Russia is likely to keep its presence in the export markets in the near-to-medium term, given that global supply remains tight, constrained by raw material availability. In the longer term, Russia is likely to see its export volumes gradually decline as Asia—the main export route—is likely to become more self-sufficient in steel products currently in deficit. We expect that 2004 will be one of the peak years for Russian steelmakers in export markets, and expect a gradual decline in exports through 2010E to 23 m tons.

Chart 16: Export dynamics



Source: ChermetInfo, Goskomstat, Brunswick UBS estimates

Imports

Imports are unlikely to be a threat to Russian producers in the longer term

Due to its self-sufficiency, Russia is not a large importer of steel globally. Imports account for about 10% of its consumption, or roughly 2 m tons per year. Specialty products account for part of the imports, while the bulk is represented by shipments of regular products from CIS countries. The majority of imports come from Ukraine, which has a well-developed steel industry and is the world's seventh largest producer. In general, the need for imports arises from consumers seeking lower prices and, in some cases, from undersupply of rolled products. Russia hardly has any import trade barriers with the exception of galvanized sheet from Ukraine and Kazakhstan, which is subject to an import duty of 24%. In the pipe industry, Russia has set an aggregate quota of 715,000 tons for Ukrainian imports.

We believe that imports do not represent a sizeable threat to Russian steel producers. With domestic steel prices rather close to international levels, exports of steel to Russia appear unattractive economically, due to higher transportation expenses. We thus believe that exports are likely to stay at current levels in the future, while their geographical structure, as long as Ukraine remains a low-cost producer, is also unlikely to change.

Pricing environment

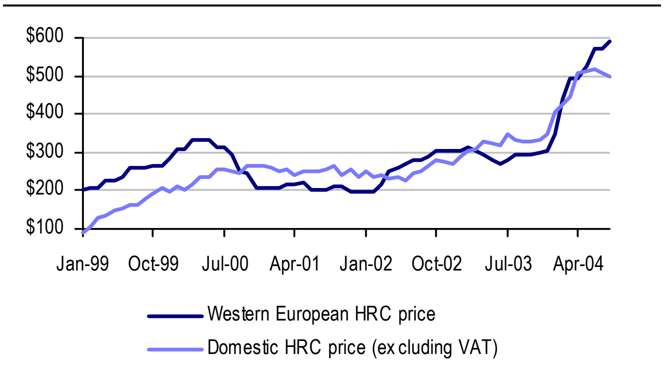
Russian steel prices continue to correlate with global prices

The pricing environment in the domestic market is dependent on the global steel cycle and macroeconomic situation. After staying virtually flat from the beginning of 2004, domestic prices caught up with export prices, while prices for certain steel products such as reinforcing bars and coated sheet currently exceed global levels. We see the main reasons for this favorable pricing environment as follows:

- Rising domestic consumption. The Russian economy is growing for its sixth consecutive year, as is domestic steel demand. In 1998, domestic consumption accounted for 35% of total production, while in 2003 it reached 50%, making the domestic market highly attractive to steelmakers. Steel products with higher value added, such as galvanized and polymer-coated sheet, are seeing even higher demand growth rates due to the low base effect.

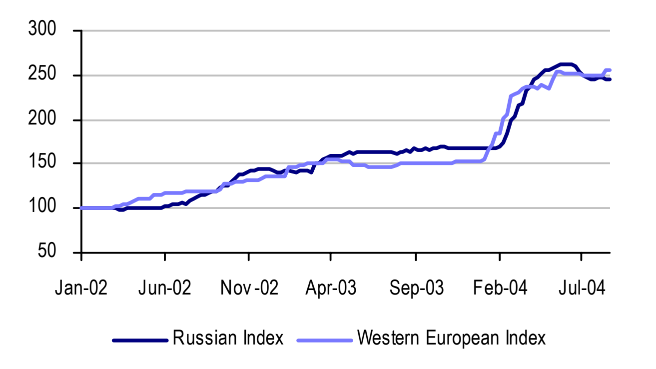
- Strong export markets. Shipments of Russian producers to export markets remain at high levels, putting an additional restraint on domestic supply, as Russian producers operate at high capacity utilization rates. We see no reason for Russian producers to leave the export markets; hence, domestic supply should remain quite tight.

Chart 17: Comparison of HRC prices in Russia and Western Europe



Source: Chermet, Company data, Datastream

Chart 18: Steel price index, Jan-02=100



Source: Datastream, Metaltorg.ru, Brunswick UBS estimates

Going forward, we believe domestic prices should more or less correlate with global prices, particularly with prices in nearby regions including Asia and Europe. Significantly higher prices cannot be sustained in our view, as Russia lacks any significant import regulations, while there is certainly a possibility that they could decrease somewhat should steel demand turn sour. The latter scenario clearly depends on the macro situation—if high commodity prices persist, there is quite a low risk of this happening. The pricing situation in 2003–04E provides good support to this argument.

Table 7: Hot-rolled coil (HRC) price forecasts, $/ton

	Current spot	2004E	2005E
Western European	590	500	435
Domestic (ex-VAT)	500	480	440

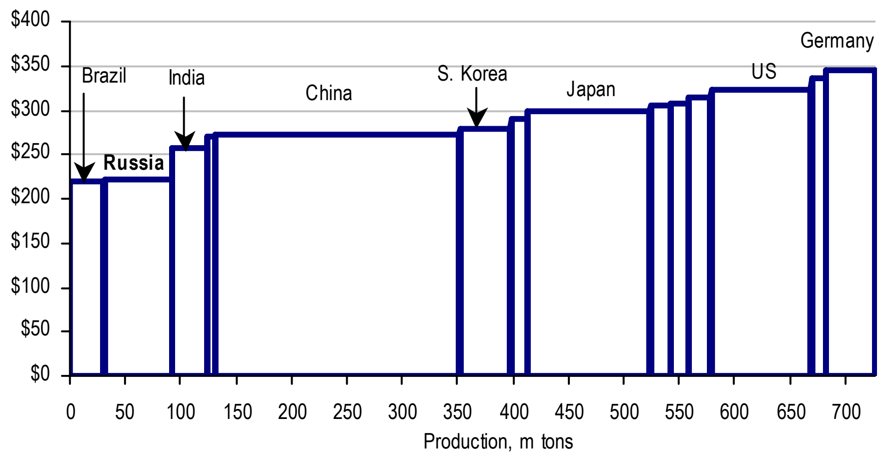
Source: Metal Bulletin, Chermet, UBS, Brunswick UBS estimates

Operating cost trends

Russian producers enjoy the benefits of low salary costs and cheaper raw materials

Major Russian steelmakers remain among the most cost competitive in the world. Russian producers' biggest comparative advantage lies in their access to cheap labor and raw materials, such as iron ore and coking coal. In addition, Russian producers benefit from cheaper energy and electricity costs. The world cost curve below represents Russia's current position among the largest steel producing nations. Currently, production unit costs in Russia are roughly in line with its Brazilian peers and about 20% lower than in India and China, which are considered to be among the most competitive steel nations. As a result, Russian producers enjoy some of the highest margins globally.

Chart 19: World HRC cost curve, $/ton



Source: World Steel Dynamics

The key operating costs for Russian steel companies in descending order of importance are:

- **Iron ore.** In general, Russian producers consume 1.65 tons of processed iron ore per ton of pig iron. This item accounts for roughly 25% of total operating cash costs.

- **Coking coal.** Russian producers consume an average of 600 kg of coking coal concentrate per ton of pig iron. As the leading Russian producers have their own coking facilities, they stand to benefit from the lack of coking facilities globally, and are hence better hedged against high prices for coke. Coking coal costs account on average for 15% of total costs.

- **Ferrous scrap.** On average, 350 kg of scrap is consumed per ton of crude steel, although this figure can be quite different for separate steelmakers depending on the availability of pig iron (and, importantly, some scrap is generated internally during the process). This cost item represents around 10%–15% of total operating costs.

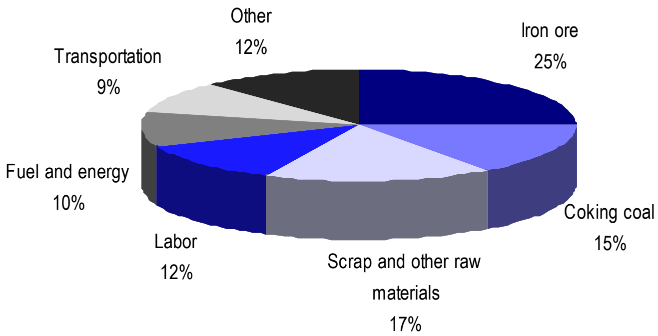
- **Labor.** Russia enjoys some of the lowest labor costs per ton in the world. Labor costs comprise around 10%–12% of total production costs.

- **Energy.** Purchases of natural gas and electricity comprise about 10% of total costs.

- **Other.** Other costs such as transportation and third-party services account for the remainder.

Below, we discuss the main trends in these cost items in greater detail, and discuss their implications for the major Russian steelmakers.

Chart 20: Typical cost structure of an integrated Russian steel producer



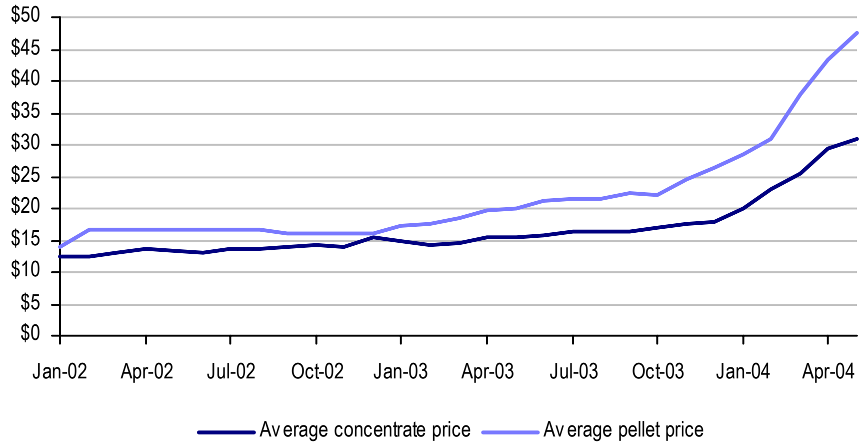
Source: Company reports, Brunswick UBS

Iron ore

Russia is self-sufficient in iron ore

Russia is a unique country, as it unites iron ore producers and steel producers in one place. Russia is fully self-sufficient in iron ore, and imports of ore from Kazakhstan and Ukraine are used to compensate for export flows. Unlike in most of the world, the majority of Russia's sizeable ore producers are controlled by steelmakers, while globally the largest ore producers tend to be independent. In Russia, the only sizeable independent iron ore company is Mikhailovsky GOK—the second largest ore producer by production and the largest by proven and probable reserves. This situation results in lower costs of iron for producers that have secured control over their ore suppliers, while steel producers without their own iron ore base have to buy ore at market prices, and can also be more susceptible to raw material shortages if and when they arise. The market price for iron ore in Russia is now rather close to the global price, as Russian raw materials producers can effectively arbitrage between export and domestic markets. Below we compare the development of ore prices in the domestic market.

Chart 21: Performance of domestic iron ore spot price, $/ton

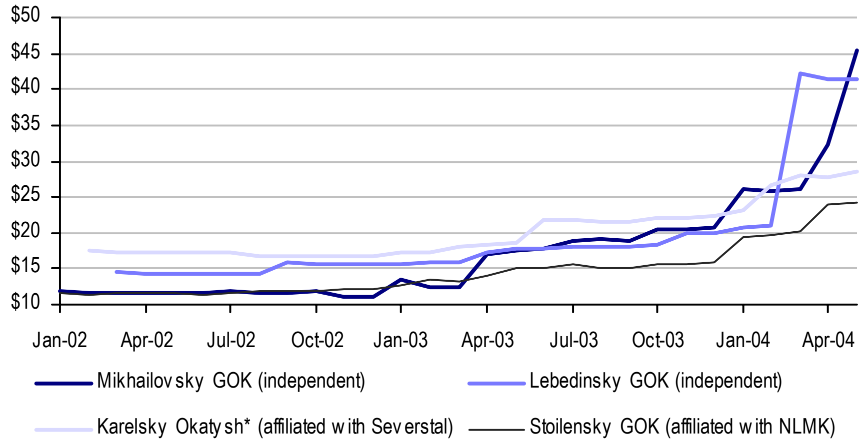


Source: Chermet

Iron ore producers affiliated with steelmakers sell products at lower prices

As the chart above shows, domestic iron ore prices peaked in early summer and have slightly come off their peak levels. We believe their behavior is a function of steel prices and ore supply. With steel prices holding up well and raw material shortages across the world, we believe domestic prices for iron ore should continue to be strong. This brings us to the argument that, with secured access to iron ore production, Russian steelmakers can substantially decrease their production costs, which positively affects the overall profitability of operations. In addition, having its own iron ore base guarantees a company's stable ore supplies, especially in a global environment of raw material shortages. Judging from pricing trends at individual ore producers, ore suppliers affiliated with steelmakers increased prices for iron ore significantly less than independent suppliers such as Mikhailovsky GOK and Lebedinsky GOK.

Chart 22: Differences in concentrate prices among iron ore producers, $/ton



* Price for pellets
Source: Chermet, Brunswick UBS

We point out that among Russia's leading steel companies, NLMK, Severstal and EvrazHolding have progressed the most on this front, having secured all or the majority of their needs in iron ore. MMK, on the other hand, contracts for 90% of its iron ore from outside suppliers, and saw its iron ore prices from Russian producers rise by 70% in 1H04, and by over 100% from its main supplier in Kazakhstan. Not surprisingly, MMK's total operating costs rose faster in 1H04 than those of its better-hedged counterparts.

Severstal, NLMK and EvrazHolding are almost self-sufficient in key raw materials

Going forward, we expect producers with their own iron ore bases to better control iron ore prices. For them, the iron ore price should simply be a function of the iron ore production cost, which we believe is likely to show moderate appreciation in the medium term due to rising electricity, gas and labor costs.

Table 8: Security of iron ore supply, 2003

Steel producer	Affiliated asset	Location	Production, m tons	Total production, m tons	Self-sufficiency rate
Severstal	Karelsky Okatysh	Northwest	7.4		
	Olenegorsky GOK (Olkon)	Northwest	3.5	11.0	85%
NLMK	Stoilensky GOK	Center	12.8		
	KMA-Ruda	Center	1.8	14.6	100%
EvrazHolding	Kachkanarsky GOK	Urals	8.6		
	EvrazRuda	Siberia	7.0		
	Vysokogorsky GOK	Urals	1.3	16.9	80%
MMK	Own mine	Urals	1.4	1.4	10%
ChMK	Korshunovsky GOK	Siberia	3.5	3.5	60%
OEMK	Lebedinsky GOK	Center	19.5	19.5	100%

Source: Company data, Brunswick UBS estimates

Coking coal

As with iron ore, Russia remains fully self-sufficient in coking coal, which is primarily produced in the Kuzbass region and the Komi Republic. Imports of coal are immaterial. As a result of coking coal shortages across the world caused by crude iron production increases and a lack of new coal projects, the price for coking coal has seen one of the highest increases among raw materials consumed by steel producers. Prices for coking coal in Russia have followed the global trend, rising from $13.5 per ton in December 2002 to over $40 per ton in June 2004, with most of the increase coming in 1H04. The spot price of coking coal concentrate (enriched raw coal), used to produce coke, was $55 per ton—rather close to the international price. At this price, the coking coal cost before it is processed into coke accounts for about $26 per ton of crude steel. We believe that the increase in price has resulted from several factors, among which we believe higher steel prices, higher exports of coking coal and growth in steel production are the most important.

As with iron ore, Russia remains fully self-sufficient in coking coal

The rising coal price and security over stable supply should raise concerns for steel producers. In table 9, we show the extent to which steel producers control coking coal supply through affiliated companies. Importantly, only Severstal, EvrazHolding's subsidiaries and ChMK are self-sufficient in coking coal (through affiliated companies), while other producers are actively seeking opportunities to achieve self-sufficiency. For example, NLMK plans to develop a greenfield coal deposit in Kuzbass, and may spend up to $100 m on the project. MMK is also actively seeking opportunities to secure coal supply, and is working on a number of options to that end. We estimate that control over coking coal supply could save steel producers around $10–15 in the cash cost per ton of crude steel in an environment of strong steel prices. As is largely the case with iron ore, the possibility of coal import from Australia—another key coking coal producer—does not appear economically feasible, as high transportation costs and high FOB prices make this option too expensive.

Only Severstal, EvrazHolding's subsidiaries and ChMK are self-sufficient in coking coal . . .

As is the case with iron ore, steel producers affiliated with coking coal suppliers should have better control over coal costs going forward. Given the shortage of metallurgical coke globally, prices for coking coal are likely to stay high for longer, at least through 2005E. Consequently, the coking coal price for producers with their own resource base should be a function of the production cost, which we believe is likely to show moderate appreciation in the medium term due to rising electricity and labor costs.

. . . and are likely to see lower price increases going forward

Table 9: Interests in coking coal producers/projects, 2003

Steel producer	Affiliated asset	Location	Production, m tons	Total production, m tons	Self-sufficiency rate
Severstal	Kuzbassugol	Kuzbass	3.7		
	Vorkutaugol	Komi Rep.	5.0	8.7	100%
NLMK	Plans a greenfield project in Kuzbass	n/a	0.0	0.0 (needs 5.5 m tons of coal concentrate)	n/a
EvrazHolding	Yuzhkuzbassugol	Kuzbass	12.9		
	Raspadskaya Mine	Kuzbass	8.5	21.0	100%
MMK	Uregolskaya Mine (not yet operational), is reviewing greenfield projects in Russia and Kazakhstan	Kuzbass	0.0	0.0 (needs 6 m tons of coal concentrate)	n/a
ChMK	Yuzhny Kuzbass	Kuzbass	12.0	12.0	100%

Source: Company data, Brunswick UBS estimates

Ferrous scrap

Ferrous scrap is the third most important raw material after iron ore and coking coal. Globally, shortages of steel scrap have caused scrap prices to rise sharply. At the moment, scrap prices are often around $200 per ton, which is far above the historic average. Scrap prices in Russia exhibit some correlation with global levels; however, we believe the Russian scrap market has somewhat different fundamentals that are beneficial to steelmakers.

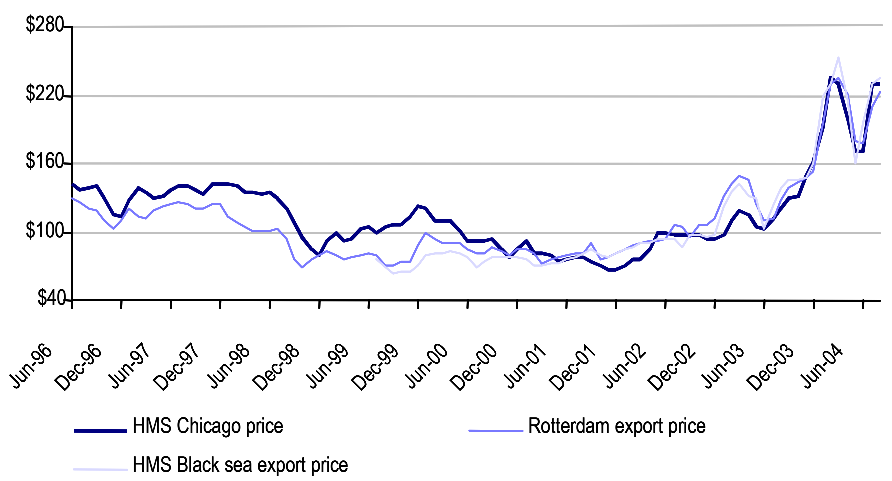
Prices for steel scrap in Russia are likely to stay below the global average in the longer term, as Russia has an excess supply

In light of global shortages of ferrous scrap, the Russian market is considered to have a surplus of steel scrap. That is, the total theoretical yearly supply in Russia is around 30 m tons, while in 2003 22.4 m tons of scrap were collected. According to our estimates, the entire industry consumed around 14 m tons of scrap in 2003. While some of the surplus is exported, the current regulatory regime and high transport rates do not make scrap exports particularly attractive. For example, the export duty is set at 15%, while transportation rates are set as if scrap were a finished product, resulting in higher transportation cost per ton compared to rates used for raw materials such as iron ore.

Scrap prices peaked in Russia in 1Q04, driven by seasonal factors (due to lower scrap collection in cold weather periods), and have since stabilized at around $120–150 per ton depending on the grade and geographical region. Prices for scrap in Russia therefore appear substantially lower than global levels, due to greater internal supply. The scrap is supplied by a number of scrap collecting companies, while the largest player in the sector is MAIR. The organizational structure of the industry therefore implies that the ferrous scrap segment operates in a rather competitive environment. There is a fairly high degree of affiliation of main steel producers with scrap collectors, although we believe they may continue to increase their interest in this segment. Currently, MMK is approximately 50% self-sufficient in scrap, while Severstal and NTMK collect about 35% of their scrap on their own. Consequently, scrap costs do not vary significantly between the major steelmakers.

In our view, prices for steel scrap in Russia are likely to stay below the global average in the longer term, as Russia has an excess supply of steel scrap. The scrap price should generally be dependent on steel prices, which we expect to come down next year.

Chart 23: Global HMS scrap prices, $/ton



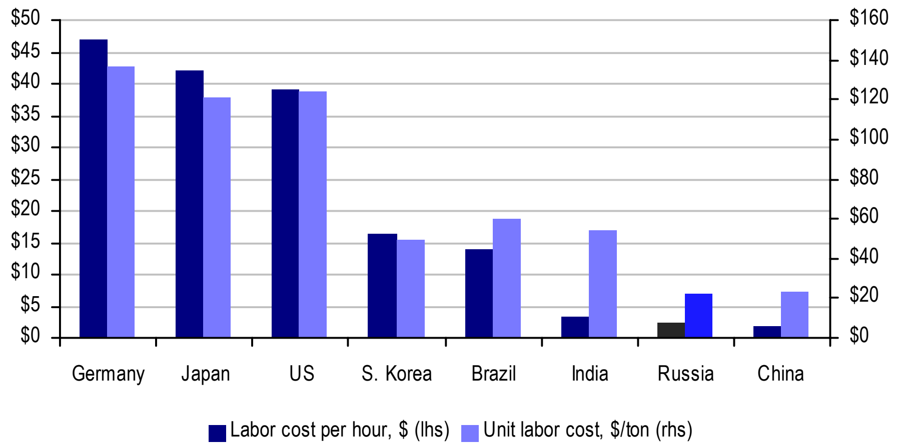
Source: CRU

Labor costs

We believe that cheaper labor should continue to be a key competitive advantage of Russian steel producers

Labor costs are probably the most predictable operating expense item for a cyclical industry such as steel. Labor costs represent a significant proportion of cash costs abroad, often taking up to 35% of total cash costs. In Russia, where wages are significantly lower than in developed markets, labor costs represent no more than 10%–12% of aggregate production costs. We believe that with GDP growth, which we expect to remain at a higher rate relative to global economic growth in the next few years, wages should also rise. On the other hand, the labor force at Russia's major steelmakers looks excessive compared to peers in developed and emerging markets, while ongoing technical improvements mean that headcount should continue to decrease. On balance, we believe that labor costs should continue rising in the foreseeable future, although they are likely to remain well below levels seen in developed markets, as wage increases should be partially compensated by labor force reductions. We therefore believe that cheaper labor should continue to be one of the key competitive advantages of Russian steel producers.

Chart 24: Comparison of labor costs and labor efficiency



Source: UBS

Energy costs

Energy costs are likely to continue rising

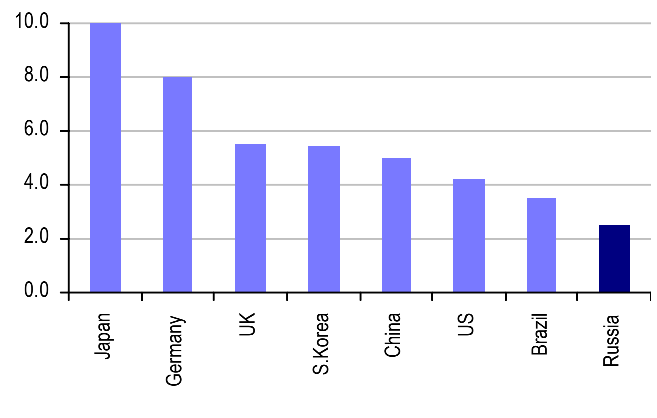
Russian steelmakers consume substantial volumes of natural gas and electricity. Electricity costs account for roughly 6.5%–7.0% of operating expenses, while natural gas constitutes around 3.0%–3.5%.

Steel companies are significant consumers of electricity, and buy electricity from UES subsidiaries. In general, tariffs for industrial consumers are set to rise 12% this year and 10% next year. Companies with their own electricity generation generally enjoy lower electricity costs as they buy it at the cost of production. Among the large producers, MMK is nearly fully self-sufficient in electricity, while NLMK, NTMK and ChMK have self-sufficiency rates ranging from 35%–85%. Taking into account cheaper in-house electricity, steel producers look keen to further increase their self-sufficiency rates.

Natural gas—another important source of energy for steel companies—is purchased from Gazprom at regulated prices. In 2004, the average wholesale tariff for industrial users was set at $27/'000 m^3$. Generally, tariffs are revised once a year, and for 2005 Gazprom expects a 23% nominal tariff increase. By 2006, we expect the gas tariff to reach $42/'000 m^3$. With tariffs rising significantly, we expect Russian producers to see their natural gas costs gradually reaching parity with their international counterparts.

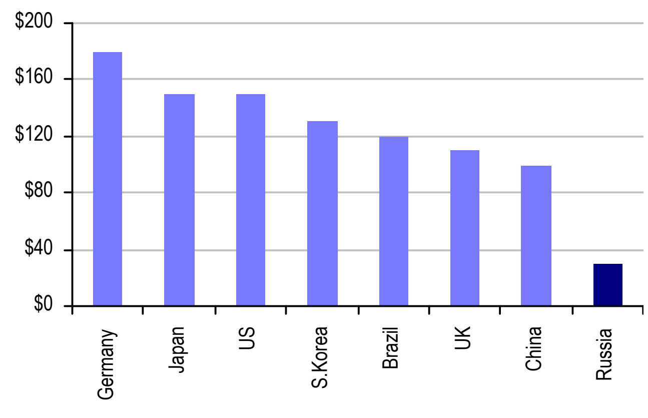
With steel prices staying at record highs on the domestic market, oil and gas companies, which are one of the major consumers of steel, have complained several times this year that high steel prices lead to capex over-budgeting. While the government has not taken any steps to contain steel prices (which had come off their highs by the end of summer), and action is unlikely given that domestic prices are driven by market mechanisms, Gazprom has warned that steel companies might not be able to buy all of their gas needs at a regulated price. In our view, this means that steel producers may buy gas at a price higher than the regulated one once when a certain quota is exceeded. However, if this materializes, we do not expect their production costs to rise significantly as a result.

Chart 25: Electricity tariffs, ¢/kWh



Source: UBS, Brunswick UBS

Chart 26: Gas prices, $/'000 bn m³



Source: UBS, Brunswick UBS

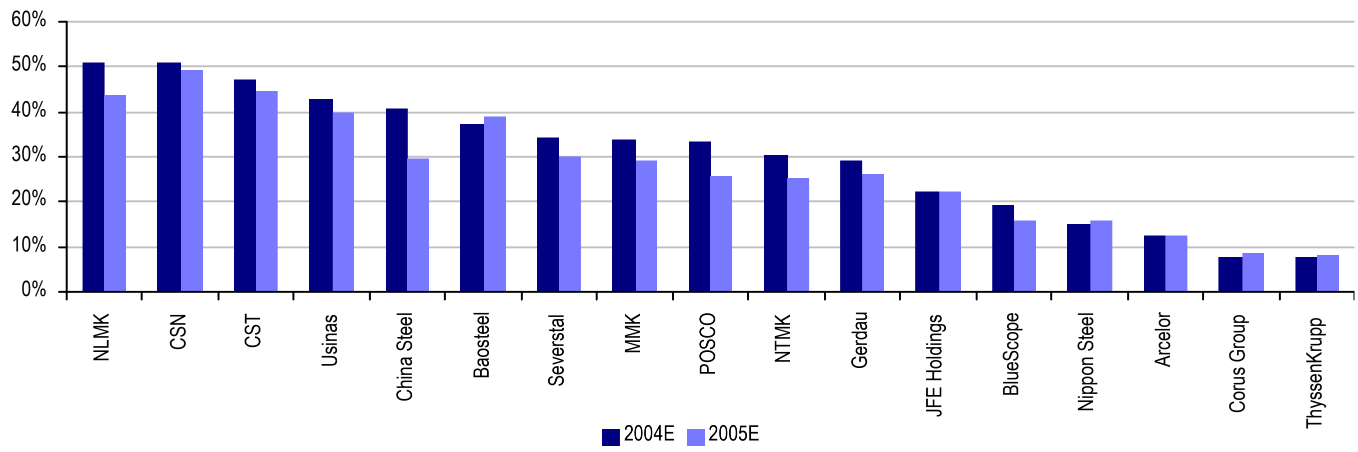
Cost and profitability comparison with peers

The profitability of Russian steelmakers is in line with their emerging market peers due to higher transportation costs

Russian producers, along with Brazil, continue to remain among the most cost competitive producers in the world on a production cost basis. We believe that the outlook for production costs for Russian producers remains more favorable for those producers with control over major cost items—namely raw materials. We therefore believe that Russian producers should keep their competitive edge over most of their major foreign competitors.

In terms of overall operating profitability, Russian producers remain in the top quartile among large steel producing nations, although their margins are generally lower than those of Brazilian peers and in line with Chinese peers due to higher transportation costs. This is explained by the less favorable geographical location of Russian steelmakers. As a rule, they incur higher transportation costs on raw materials, as well as higher transportation expenses on finished products, by either transporting them to a domestic end-user or to a seaport for export. As a result, SG&A costs, in which transportation costs are reflected, are generally higher for Russian producers than for their emerging markets peers. In addition, a relatively poorer product mix at Russian steelmakers, where a sizeable proportion of semi-finished products is destined for export, results in lower revenues per ton, putting some additional pressure on margins (although production costs are also lower for semi-finished products, but not transportation costs).

Chart 27: EBITDA margin, 2004–05E



Source: UBS, Brunswick UBS estimates

Earnings outlook

Analysis of 1H04 RSA results

In general, 1H04 RSA earnings were in line with expectations and reveal expanding profitability

Russian steelmakers' 1H04 RSA results reflected the trends described in some of the sections above quite accurately. In general, RSA results prepared for an unconsolidated parent company are a good proxy for monitoring consolidated financial performance prepared in accordance with either IAS or US GAAP. The differences are somewhat greater for Severstal and MMK, which consolidate a number of subsidiaries, and more accurate for NLMK and NTMK. Consolidation aside, the main difference between international and Russian accounts is a significantly lower depreciation charge under RSA. We also note that going forward, the differences are to widen somewhat for both NLMK, following its acquisitions of Stoilensky GOK and Tuapse Seaport, and NTMK, which recently acquired a controlling stake in Russia's fourth-largest iron ore producer—and its key ore supplier—Kachkanarsky GOK.

Table 10: 2Q04 results of the largest steel producers, $ m (RSA)

	Severstal	NLMK	MMK	NTMK
Shipments, '000 tons	2,364	2,165	2,648	1,161
% chg. q-o-q	7.9%	0.3%	8.9%	-4.0%
Average revenue per ton, $	498.6	500.4	456.1	410.6
% chg. q-o-q (	38.9%	27.2%	28.9%	28.4%
Cash costs per ton, $	263.6	243.0	286.1	259.7
% chg. q-o-q (	7.6%	17.0%	22.9%	17.6%
Revenues	1,179	1,084	1,208	477
% chg. q-o-q	50%	28%	40%	23%
COGS	616	486	717	287
% chg. q-o-q	16%	9%	36%	13%
Gross profit	563	597	490	190
% chg. q-o-q	118%	49%	48%	42%
SG&A	21	49	58	23
% chg. q-o-q	-5%	382%	6%	4%
EBITDA	556	557	450	175
% chg. q-o-q	122%	39%	53%	46%
Operating profit	542	548	433	167
% chg. q-o-q	130%	40%	56%	50%
Pretax profit	504	575	418	155
% chg. q-o-q	151%	57%	57%	50%
Net profit	380	436	319	116
% chg. q-o-q	147%	57%	57%	51%
EBITDA margin	47%	51%	37%	37%
Operating margin	46%	51%	36%	35%
Net margin	32%	40%	26%	24%
Effective tax rate	25%	24%	24%	25%

Source: Company data, Brunswick UBS estimates

Table 11: 1H04 results of the largest steel producers, $ m (RSA)

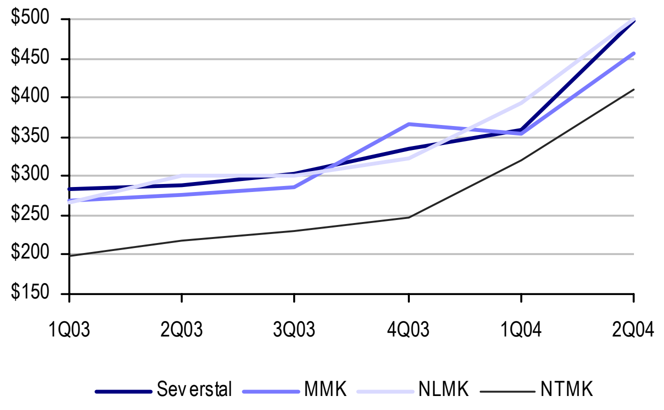
	Severstal	NLMK	MMK	NTMK
Shipments, '000's tons	4,556	4,323	5,080	2,370
% chg. y-o-y	4.5%	4.8%	1.9%	-0.5%
Average revenue per ton, $	431.9	447.2	407.4	364.5
% chg. y-o-y	50.8%	58.1%	49.3%	74.3%
Cash costs per ton, $	254.8	225.4	260.7	240.2
% chg. y-o-y	34.5%	43.4%	47.8%	52.2%
Revenues	1,968	1,934	2,070	864
% chg. y-o-y	57%	66%	52%	73%
COGS	1,146	933	1,248	541
% chg. y-o-y	38%	44%	51%	51%
Gross profit	822	1,000	822	323
% chg. y-o-y	95%	92%	54%	131%
SG&A	42	59	112	44
% chg. y-o-y	95%	251%	31%	45%
EBITDA	807	959	745	294
% chg. y-o-y	91%	85%	55%	142%
Operating profit	779	941	710	279
% chg. y-o-y	95%	87%	58%	155%
Pretax profit	708	943	686	258
% chg. y-o-y	86%	98%	67%	161%
Net profit	535	714	522	193
% chg. y-o-y	82%	96%	70%	161%
EBITDA margin	41%	50%	36%	34%
Operating margin	40%	49%	34%	32%
Net margin	27%	37%	25%	22%
Effective tax rate	24%	24%	24%	25%

Source: Company data, Brunswick UBS estimates

Severstal and NLMK recorded a significantly lower increase in the cost of goods sold due to their control over iron ore prices

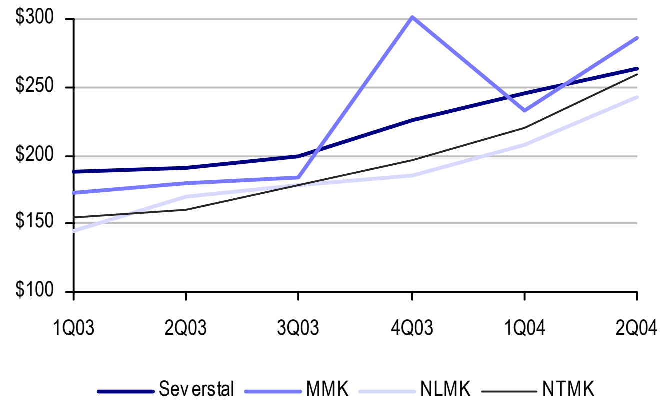
As can be seen from the table above, all Russian steelmakers recorded high increases in sales on a year-on-year basis, primarily due to significantly higher steel prices on both domestic and international markets. In our view, the greater differences occurred on the cost side. Judging from the results, Severstal and NLMK recorded a significantly lower increase in the cost of goods sold, which we believe is a result of a lower increase in raw materials prices for both steelmakers, thanks to their control over raw materials suppliers. We believe that going forward both steelmakers are unlikely to see further rises in raw materials costs, although NLMK might see a further increase in prices for coking coal should a coking coal shortage materialize. MMK and NTMK showed higher rises in the cost of goods sold, for which we believe higher raw material costs were primarily responsible. Going forward, we believe NTMK is likely to see its operating costs stabilizing following the recent acquisition of its key iron ore supplier Kachkanarsky GOK, while we find MMK the most susceptible to unpredictable iron ore and coking coal price swings. The charts below provide an illustration of the effective price per ton of rolled product and cash cost per ton of rolled output in the last six quarters for each producer.

Chart 28: Average revenue per ton, $



Source: Company data, Brunswick UBS estimates

Chart 29: Average cash cost per ton, $



Source: Company data, Brunswick UBS estimates

Forecast changes

As we keep our steel price forecasts unchanged, we do not materially change our revenue forecasts for the traded Russian steelmakers, with the exception of MMK. We lower our revenue forecast for MMK on the back of lower production growth and revised forecasts for its consolidated subsidiaries. We also consolidate NLMK's subsidiaries acquired in 2004—Stoilensky GOK and Tuapse Seaport—which results in higher revenues for the consolidated entity.

On the cost side, we decrease our raw material cost assumptions for NLMK, Severstal and NTMK, as their control over raw material suppliers should allow them to keep their raw materials costs under control. This results in greater earnings for these companies.

We materially reduce our net profit estimates for NTMK following a switch in our models from RSA to IAS accounting. The impact on the bottom line was significant due to differences in depreciation expenses, which are significantly higher under IAS. The changes to revenues and key earnings numbers are summarized below.

Table 12: Headline forecasts, $ m

	Old			New			% chg.		
	Revenues	EBITDA	Net profit	Revenues	EBITDA	Net profit	Revenues	EBITDA	Net profit
2004E									
Severstal	4,534	1,560	900	4,534	1,560	900	0%	0%	0%
MMK	4,742	1,613	947	4,399	1,485	879	-7%	-8%	-7%
NLMK	3,816	1,807	1,200	4,044	2,056	1,349	6%	14%	12%
NTMK*	1,768	517	329	1,805	551	267	2%	7%	-19%
2005E									
Severstal	4,465	1,219	656	4,422	1,335	719	-1%	10%	10%
MMK	4,454	1,264	700	4,016	1,163	647	-10%	-8%	-8%
NLMK	3,638	1,466	939	3,817	1,670	1,044	5%	14%	11%
NTMK*	1,686	415	247	1,642	412	170	-3%	-1%	-31%

*We move from RSA to IAS forecasts for NTMK
Source: Brunswick UBS estimates

Earnings outlook and sensitivity

Under our current assumptions, we believe that the Russian steelmakers' earnings will peak in 2004E, and that earnings momentum may turn negative in 2005E. We factor in steel prices falling significantly from current spot levels, with the Western European HRC price falling from $590 per ton currently to $435 per ton in 2005, which may well be conservative given currently strong fundamentals. Below we provide a table with earnings sensitivity to steel prices.

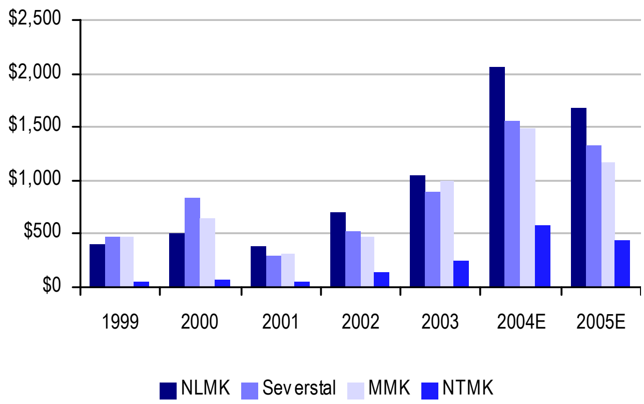
Table 13: 2005E earnings sensitivity to steel prices

	HRC price, $/ton	300	350	360	370	380	390	400	410	420	430	440	450	460	470	480	490	500	550
Severstal	Net profit, $ m	352	486	513	540	567	594	621	648	674	701	728	755	782	809	836	863	890	1,024
	% chg	-51%	-32%	-28%	-24%	-21%	-17%	-13%	-9%	-6%	-2%	2%	6%	9%	13%	17%	21%	24%	43%
NLMK	Net profit, $ m	400	639	687	734	782	830	878	925	973	1,021	1,068	1,116	1,164	1,212	1,259	1,307	1,355	1,593
	% chg	-62%	-39%	-34%	-30%	-25%	-21%	-16%	-11%	-7%	-2%	2%	7%	11%	16%	20%	25%	30%	52%
MMK	Net profit, $ m	(192)	119	181	243	305	367	429	491	553	616	678	740	802	864	926	988	1,050	1,361
	% chg	n/m	-82%	-72%	-62%	-53%	-43%	-34%	-24%	-14%	-5%	5%	14%	24%	34%	43%	53%	62%	110%
NTMK	Net profit, $ m	n/m	(48)	(22)	4	29	55	81	106	132	158	183	209	235	260	286	312	337	465
	% chg	n/m	n/m	n/m	-98%	-83%	-68%	-52%	-38%	-23%	-7%	7%	23%	38%	53%	68%	83%	98%	173%

Source: Brunswick UBS estimates

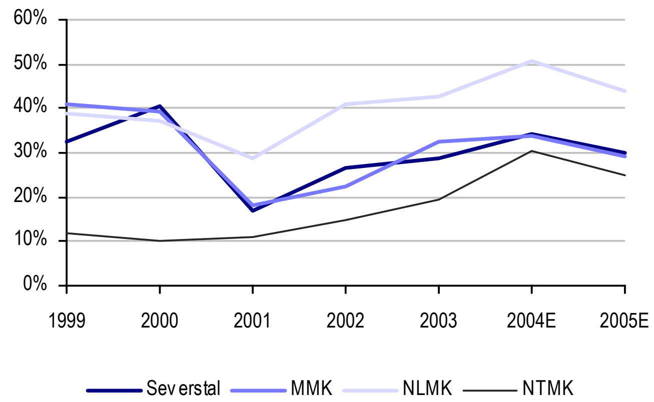
At our price forecasts, Russian steelmakers should remain free cashflow positive in 2005E, driven by earnings above historical levels. We also note that the earnings of Russian steelmakers are better hedged than most of their foreign peers in the current environment of raw material shortages and consequently high input prices, thanks to their control over Russian-based raw material suppliers.

Chart 30: EBITDA dynamics, $ m



Source: Company data, Brunswick UBS estimates

Chart 31: EBITDA margins



Source: Company data, Brunswick UBS estimates

Analysis of cash use

Among Russian steelmakers, NLMK has the strongest cashflow generation and cleanest balance sheet

At currently high steel prices, Russian steel producers generate substantial operating cashflow, which allows them to fully cover their rather aggressive capex needs and generate significant free cashflow. It is therefore important to analyze how this excess cash is used by different companies.

Among the Russian steelmakers, we believe NLMK has the strongest cashflow generation and cleanest balance sheet. The other companies carry a certain amount of debt on their balance sheets, but are still net cashflow positive, which is in contrast to the majority of their developed and emerging market peers. We thus believe that while other companies are likely to use their free cash to reduce their debt burden at the peak of the cycle and pay dividends, Russian steelmakers are likely to use their cash for further acquisitions in addition to dividends.

We have questions over Severstal's acquisition strategy going forward

Among the big three, Severstal has had the most aggressive acquisition strategy, starting with its integration into raw materials (iron ore and coal), acquisitions of its largest customers (carmakers), and subsequently moving internationally into the US (Rouge Industries). In addition, the company has participated in a number of privatization auctions in Ukraine and Eastern Europe. We estimate the company's cash position as of July at roughly $1.4 bn (which roughly equals the company's financial debt, implying zero net cash). We believe the company may use this cash for further acquisitions in the sector. Severstal may potentially bid for Krivorozhstal—the largest Ukrainian steel producer with capacity of 7 m tons—which was privatized earlier this year, or may use this cash to buy out shares in subsidiaries of EvrazHolding, in case the potential merger between the companies goes ahead. In our view, the company's track record has not yet shown significant value creation as a result of the corporate transactions. For example, its raw material subsidiaries were spun off into a separate entity in the form of dividends, and subsequently sold back to the company at an undisclosed price. Separately, we believe the company is likely to continue paying at least 25% of its IAS net profit as dividends to shareholders in accordance with its dividend policy (for dividend yields, see chart 1).

NLMK acquired a controlling stake in its largest iron ore producer in early 2004

NLMK had not been aggressive in terms of acquisitions prior to 2004. However, in 1H04, it made a strategically important move into the raw materials sector, acquiring a 60% stake in its largest iron ore supplier Stoilensky GOK (Russia's third largest ore producer with annual output of about 13 m tons) for $510 m. As a result, NLMK secured an in-house supply of iron ore, covering 100% of its needs in this raw material. The acquisition allowed NLMK to hedge against rising iron ore prices, which now are roughly half of the market price. At a later stage, it was reported that the company increased its stake to 93%, acquiring management's stake. Subsequently, NLMK acquired Russia's third largest seaport—Tuapse—for $100 m, securing its own export hub.

NLMK is likely to use its free cash on new acquisitions and dividends

We estimate that NLMK's cash position as of July is $700 m, and that it has no financial debt. We believe that part of this balance could be used to acquire additional shares in Stoilensky GOK (see above), as well as a controlling stake in Russia's second-largest seaport—St. Petersburg. Going forward, we believe that the company is likely to continue vertical integration opportunities, in particular in the coking coal area. While this has not been an official strategy, we believe that, in the longer term, the company may consider horizontal integration, both domestically and internationally. Separately, we believe the company is likely to continue paying at least 20%–25% of its US GAAP net profit as dividends to shareholders in accordance with its dividend policy (for dividend yields, see chart 1).

We believe that MMK's acquisition strategy is constrained by the upcoming privatization of the government's stake

MMK has not made any significant acquisitions in the past, but has instead concentrated on modernization of its fixed assets. As a result, the company had accumulated over $900 m in cash on its balance sheet by July (its net cash position was close to $400 m). Following the recent price hikes for iron ore and coal, MMK has become more active in screening for acquisition opportunities in the raw materials sector, in particular in the coking coal segment. However, we believe that the company's strategy is constrained by the upcoming privatization of the government's stake. Separately, MMK continues to lack a defined dividend policy, and pays much smaller dividends than NLMK and Severstal.

Investment strategy

We reiterate our positive stance on the Russian steel sector and NLMK as our top pick

UBS continues to be Neutral on the steel sector globally, as steel prices on the spot markets have already peaked in many regions and valuations are close to reaching previous peak-cycle levels. However, regionally we prefer Europe and Latin America due to their recent underperformance and attractive valuations.

We keep our positive stance on the Russian steel sector due to a combination of competitive production costs, robust earnings and cashflow generation and attractive valuations. However, we believe that Russia's two largest steel producers—Severstal and MMK—have already priced in most of the earnings momentum, and now appear fairly valued. Within the context of the positive momentum, we prefer equities that provide more value, and highlight NLMK as our top pick in the sector. Among the smaller producers we continue to remain positive on NTMK.

In our view, it is not yet time to turn negative on the sector, as steel prices are likely to stay high in the next few months, and we would look to review our assumptions if more signs of downside risks to the sector appear. Among the sector-specific issues we highlight that corporate governance and low liquidity remain key areas of concern for Russian steel companies.

As Russian steel producers are highly exposed to export markets and spot pricing, we estimate that earnings momentum is likely to turn negative for the majority of Russian steel companies in 2005. However, we note that earnings visibility still remains low for 2005 due to low predictability of the steel price, and our current models may prove to be conservative given current strong fundamentals—we assume a drop in the Western European HRC price to \$430 per ton in 2005, whereas the spot price is \$590 per ton. We prefer producers that are self-sufficient in key raw materials, including NLMK and Severstal, since they should be able to better control costs in an environment of falling steel prices. We believe that a potential decline in earnings is already reflected in the share prices of Russian steelmakers, as they look cheap and trade at substantial discounts to their peers even on 2005E earnings multiples.

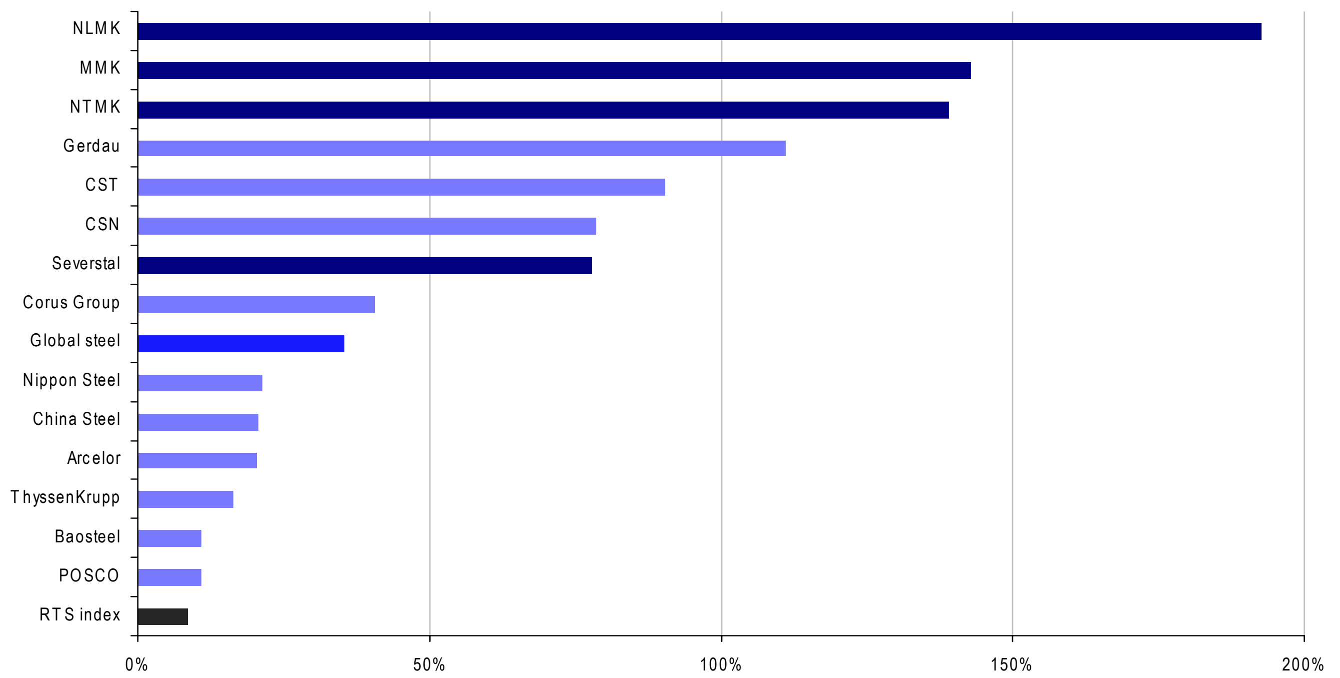
We downgrade Severstal and MMK to Neutral 2 and maintain Buy 2 rating on NLMK and NTMK

We marginally reduce the target multiples we use to derive price targets for steel equities to reflect the recent softening in comparable multiples of the peer group as well as the increased perceived risks for big business in the current political environment. Based on our revised 2005E target multiples and new earnings forecasts, we reduce our price target for NLMK from \$1.25 to \$1.20 and maintain our **Buy 2** rating, implying 50% forecast price return. We also reduce our price target for Severstal from \$225 to \$200 per share on lower multiples due to higher corporate governance risks (see below), and our rating from Buy 2 to **Neutral 2** following recent share price appreciation. We lower our price target for MMK from \$0.55 to \$0.43 per share on the back of both a multiple and an earnings downgrade, and reduce our rating from Buy 2 to **Neutral 2,** suggesting 1% forecast price return. We downgrade our price target for NTMK from \$1.05 to \$0.95 and maintain our **Buy 2** rating.

While we believe the fundamentals are still supportive of the performance of all Russian steel equities, our top pick in the sector is NLMK due to its recent underperformance relative to Severstal (and consequent attractive valuations), its self-sufficiency in high-quality cheap iron ore, clear corporate strategy and superior profitability and cash generation. Our key concern with Severstal is its non-transparent corporate strategy for minority shareholders and corporate governance concerns associated with the recent transfer of assets from Severstal-Resurs. MMK appears less attractive than NLMK and Severstal on valuations and is currently experiencing production problems due to shortages of coking coal. On top of that, MMK is not self-sufficient in iron ore and its earnings are thus more exposed to the risk of rising iron ore prices. Among smaller steel mills, we keep our positive stance on NTMK, which exhibited the best financial performance in the sector in 1H04.

Despite the strong share price performance of Russian steel producers and outperformance compared to international peers over the last 12 months, they remain attractively priced in the global universe.

Chart 32: 12-Absolute share price performance, last 12 months



Source: UBS, Brunswick UBS

Russian producers remain attractively valued in the global universe . . .

At the moment, Russian steel companies trade at deep discounts on earnings based multiples to both emerging and developed market peers. For example, NLMK trades on a 2005E EV/EBITDA of 2.1—a c55% discount to the developed and emerging market average—and a P/E of 4.6, a c45% discount. NLMK has a 2005E free cashflow yield of about 20%—one of the highest in the industry worldwide. In our view, it is hard to find a reasonable justification for such large discounts, as Russian steelmakers boast some of the highest profit margins in the sector, have strong free cashflow profiles, and, in certain cases, pay quite attractive dividends. In addition, we would like to once again mention that NLMK and Severstal are in general significantly better hedged against both high prices for raw materials and shortages, which are currently a major concern for most international steel producers.

Table 14: International valuation comparison

	Rating	Price	Curr.	M.Cap,	EV/S			EV/EBITDA			P/E			EV/prod, $/ton
		8-Sep		$ m	03	04E	05E	03	04E	05E	03	04E	05E	03
Severstal	Neutral2	183	USD	4,032	1.32	0.90	0.83	4.6	2.6	2.8	9.3	4.5	5.6	416
MMK	Neutral2	0.43	USD	4,518	1.47	0.91	0.87	4.5	2.7	3.0	7.2	5.1	7.0	390
NLMK	Buy2	0.804	USD	4,820	1.67	0.94	0.92	3.9	1.9	2.1	7.3	3.6	4.6	466
NTMK	Buy2	0.72	USD	948	1.02	0.57	0.54	5.3	1.9	2.2	14.5	3.6	5.6	194
Russian steel average					**1.37**	**0.83**	**0.79**	**4.6**	**2.3**	**2.5**	**9.6**	**4.2**	**5.7**	**367**
Russian steel premium/(discount) to emerging markets					**2%**	**-46%**	**-49%**	**24%**	**-44%**	**-46%**	**75%**	**-38%**	**-32%**	**-51%**
International	**Country**													
Nippon Steel	Japan	258	JPY	11,727	1.13	1.03	1.02	9.1	7.4	6.8	neg.	31.5	13.2	855
Corus Group	UK	49	GBX	3,854	0.21	0.33	0.29	10.6	4.2	3.5	neg.	8.2	6.6	290
ThyssenKrupp	Germany	16	EUR	9,730	0.37	0.40	0.37	5.4	5.3	4.6	10.5	10.4	8.0	n/a
Arcelor	France	15	EUR	11,297	0.41	0.41	0.38	4.7	3.3	3.1	40.1	5.4	6.1	338
SSAB	Sweden	133	SEK	1,773	0.70	0.72	0.72	5.4	4.2	4.9	12.5	7.8	10.4	537
Rautaruuki	Finland	7.29	EUR	1,234	0.52	0.53	0.51	4.1	3.6	4.1	7.5	5.1	7.2	468
BlueScope Steel	Australia	8.20	AUD	2,908	0.54	0.77	0.89	3.67	4.4	6.7	5.81	7.6	10.0	483
Developed markets- ferrous average					0.55	0.60	0.60	6.2	4.6	4.8	15.3	10.9	8.8	495
POSCO	Korea	174,500	KRW	13,779	0.96	0.97	0.91	3.1	2.9	3.5	5.6	4.9	7.6	516
Erdemir	Turkey	5,450	TRL	1,779	0.76	1.28	1.37	3.1	5.2	5.6	2.8	8.8	11.2	412
Usinas Siderurgicas De MG SA	Brazil	44.4	BRL	3,287	1.29	1.43	1.34	3.6	3.3	3.4	2.6	4.4	4.3	1,175
China Steel	Taiwan	33	TWD	9,476	1.78	1.88	1.98	4.5	4.6	6.7	6.1	6.7	10.5	820
Cia. Siderurgica Nacional	Brazil	45	BRL	4,423	1.60	1.83	1.80	3.4	3.6	3.6	5.8	6.5	6.4	1,055
Baosteel	China	6.1	CNY	9,191	1.70	1.77	1.92	4.5	4.7	4.9	9.9	9.2	10.0	511
Emerging markets - ferrous average					1.35	1.53	1.55	3.7	4.1	4.6	5.5	6.8	8.3	748

Source: UBS, Brunswick UBS

. . . but face specific risks such as low liquidity and corporate governance issues

Our main concerns specific to Russian steelmakers remain their low stock liquidity and corporate governance issues. In 1H04, Severstal Group—Severstal's core shareholder—decided to restructure its raw materials arm Severstal-Resurs, with the aim of transferring Severstal-Resurs' stakes in raw material producers to Severstal. Following that, the group transferred Severstal-Resurs' entire stake in Karelsky Okatysh to its affiliated company for an undisclosed price, which resulted in disagreement from Severstal-Resurs' minority shareholders. The group has since largely resolved the conflict with minorities, although the offer price of $8 per share was significantly below the all-time high of $15. In our view, while the deal itself may prolong concerns over Severstal's corporate governance for some time, we believe the deal is positive for Severstal's shareholders in purely economic terms, as Severstal would directly consolidate its stakes in raw materials producers on its balance sheet.

NLMK has the highest chances of improving corporate governance, in our view

We believe that the corporate governance profile of NLMK—which we have found to be strong, with the company publishing audited US GAAP accounts since 2000—improved even further following the emergence of a significant minority shareholder, Metalloinvest. Metalloinvest became the owner of a 15.5% stake in NLMK after its sale of a controlling 60% stake in Russia's largest iron ore producer Stoilensky GOK, which was structured as a share swap. Following the completion of the deal, Metalloinvest gained two seats on NLMK's Board of Directors, and we believe that Metalloinvest would be interested in maximizing the value of its stake. In addition, the core shareholders of NLMK have announced a strategy to increase the stock's liquidity, and we believe they may launch a liquidity program once conditions in the Russian equity market improve.

We are also concerned by the recent amendments to the Law on Joint-Stock Companies approved by the Duma in their first reading in early July, which effectively allow core shareholders controlling more than 90% of a company to force minority shareholders to sell them the remaining 10% at a price determined by an independent appraiser appointed by the majority shareholder. These amendments effectively allow core shareholders of Russian steelmakers to transform their companies from quasi-public to private companies at a low cost. We see higher risks of this happening at Severstal and NTMK than at NLMK, as the latter has two large shareholder groups instead of one. We believe the target multiples and equity risk premiums we use in our models to derive price targets accurately reflect these risks.

Valuation methodology

We continue to set price targets based on target EV/EBITDA multiples

We continue to use an earnings multiple approach to set price targets for Russian steel equities, which we believe is consistent with the cycle valuation (the implied valuations at the top and the bottom of the cycle) of these stocks. As a crosscheck, we also compare the result derived using the target multiples with their DCF valuations.

In the past we used target EV/EBITDA multiples of 3.25–4.0 for Russian steel equities. We reduce our target multiples to reflect the higher equity risk premium and corporate governance risks for minority shareholders in private companies due to the potential adoption of the new Law on Joint-Stock Companies.

Table 15: Calculation of price targets for Russian steel producers

Company	Price, $ (8-Sep)	M.Cap, $ m	Estimated freefloat	2005E revenues, $ m	2005E EBITDA, $ m	Target EV/EBITDA multiple	2005E average net debt, $ m	2005E M.Cap., $ m	12-month price target, $	Forecast price return, %	Rating
Steel											
Severstal	182.7	4,032	9.0%	4,422	1,335	3.0	(347)	4,406	200	9%	Neutral 2
NLMK	0.80	4,820	5.0%	3,817	1,670	3.5	(1,309)	7,154	1.20	50%	Buy 2
MMK	0.43	4,518	2.0%	4,016	1,163	3.0	(1,041)	4,577	0.43	1%	Neutral 2
NTMK	0.72	948	9.3%	1,642	412	2.8	(55)	1,226	0.95	31%	Buy 2

Source: Brunswick UBS estimates

In general, we believe Russian steel companies, despite competitive production costs and strong cash generation, deserve lower target EV/EBITDA multiples than their emerging and developed market peers (our colleagues use multiples ranging from 3.5–7.5) due to the following:

- **Higher country risk and equity risk premiums.** We use a long-term risk free rate of 7.5%, based on the expected 2030 sovereign Eurobond yield, and an equity risk premium of 6.0%.

- **Higher share liquidity premium.** All Russian steel companies have limited freefloats—ranging from 2%–10%—creating liquidity problems for investors.

- **Premium for corporate governance.** All Russian steelmakers effectively continue to be privately owned companies, which presents a risk that they may be run in the interests of core, but not all, shareholders.

- **Large cash balances discounted by the market.** Russian steelmakers have significant net cash positions that reduce future enterprise value. However, given that these companies are privately held and minorities have virtually no influence over cash management, the market appears to be discounting the cash on their balance sheet. Conversely, on forward-looking P/E multiples, the discounts to peers do not appear that significant.

Table 16: Current and implied target EV/EBITDA and P/E for steel companies

	Country	Rating	M.Cap.	2005E EV/EBITDA		2005E P/E	
			8-Sep	Current	Implied target	Current	Implied target
Severstal	Russia	Neutral 2	4,032	2.8	3.0	5.6	6.1
NLMK	Russia	Buy 2	4,820	2.1	3.5	4.6	6.9
MMK	Russia	Neutral 2	4,518	3.0	3.0	7.0	7.1
NTMK	Russia	Buy 2	948	2.2	2.8	5.6	7.2
CSN	Brazil	Buy 2	4,423	3.6	4.5	6.4	9.2
Usiminas	Brazil	Buy 2	3,287	3.4	4.0	4.3	5.7
Gerdau	Brazil	Buy 2	4,855	3.8	4.0	5.2	6.7
Arcelor	Luxembourg	Buy 2	11,297	3.1	4.0	6.1	7.6
Corus	UK	Buy 2	3,854	3.5	4.0	6.6	6.7
POSCO	S.Korea	Neutral 2	13,779	3.5	3.5	7.6	7.3
Baosteel	China	Buy 2	9,191	4.9	6.2	10.0	12.6
Nippon Steel	Japan	Buy 2	11,727	6.8	7.5	13.2	13.2

Source: UBS, Brunswick UBS estimates

Risks

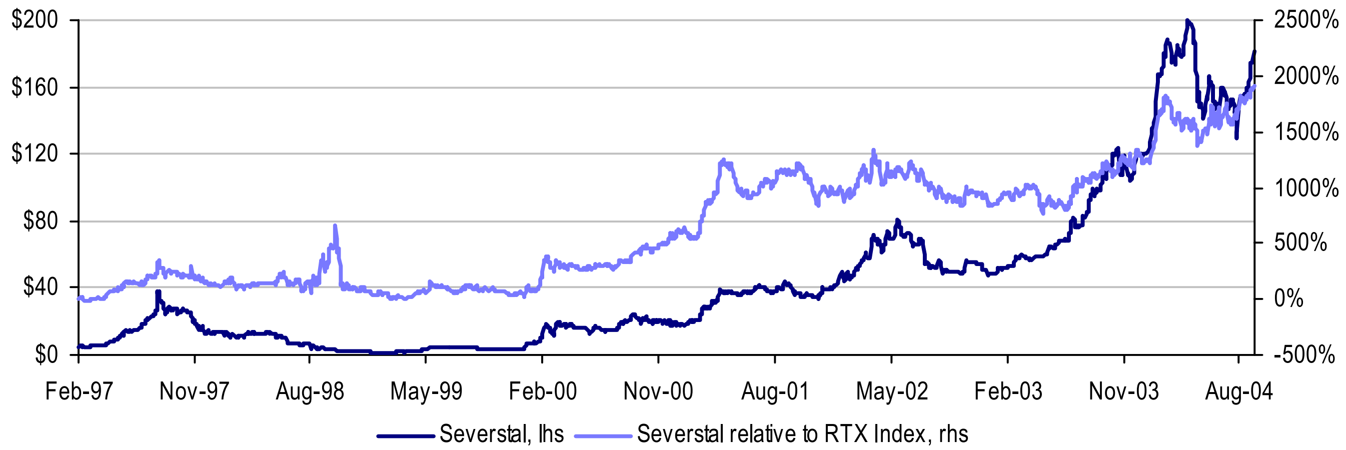
We believe that all Russian steelmakers potentially face similar risks to those surrounding Yukos, in particular the risk of back taxes due to the wide use of transfer pricing in the past. The probability of a broader review of privatization is still only remote, in our view. However, the risk of something similar to the Yukos case happening, in particular potential changes in ownership, cannot be fully discounted given the political reality surrounding the ownership of such assets.

We are also concerned by recent amendments to the Law on Joint-Stock Companies approved by the Duma in their first reading in early July, which effectively allow core shareholders controlling more than 90% of a company to force minority shareholders to sell them the remaining 10% at a price determined by an independent appraiser appointed by a majority shareholder. These amendments effectively allow core shareholders of Russian steelmakers to transform their companies from quasi-public to private companies at a low cost. We see higher risks of this happening at Severstal and NTMK than at NLMK, as the latter has two large shareholder groups instead of one. We believe the target multiples and equity risks premiums we use in our models to derive price targets accurately reflect these risks.

We see several risks inherent in the steel sector, including the volatile nature of steel prices and global trade restrictions. The sector remains highly cyclical; thus, should global oversupply resume prematurely, our steel price assumptions may not be met, posing risks to our earnings projections and, hence, our valuations. The sector is also exposed to other political, financial and operational risks, which we believe have the potential to significantly impact company and industry performance.

Appendix 1: Company profiles

Severstal [Neutral2, PT $200]



Source: RTS

Capital structure		Ownership structure	
Ordinary share price, $	183	Management	84.2%
High/Low 1997-2004, $	200 / 1.3	Portfolio investors	6.5%
M.Cap, $ m	4,032	Employees	9.3%
No. of shares, m	22.1		
Par value, Rb	0.25		
Ordinary/Preferred, %	100 / 0		
		Freefloat estimate	**10.0%**

Source: RTS; Skrin; Brunswick UBS estimates

Company overview

Severstal (Cherepovets Metallurgical Plant) is one of Russia's top three integrated steel producers, with over 10 m tons of steel-making capacity, consisting of oxygen converters (8.0 m tons), open-hearth (1.0 m tons) and electric arc furnaces (1.1 m tons). Severstal is generally considered technically on par with major Western producers. The acquisition of America's fifth-largest steel producer Rouge Industries in early 2004 brought Severstal's steel-making capacity to almost 15 tons, making it the largest Russian producer on a consolidated basis and the world's 15th-largest steel producer. Severstal mostly produces flat products, and is the leading producer of value-added products such as strip, cold-rolled sheet, and galvanized sheet. Through common owners, it is affiliated with Karelsky Okatysh and Olenegorsk GOK, which provide 70% of its iron ore needs. Domestic sales account for approximately 50% of Severstal's output, with the pipe industry its leading customer (21%), closely followed by the automotive sector (16%) and metalware (10%). Asia accounted for 32% of export sales in 2003, followed by Europe (30%), the Middle East (10%), the US (10%), Africa (9%) and Latin America (9%).

Plans/prospects

Severstal's AGM of June 2002 approved a spin-off, in the form of non-cash dividends, of the company's non-core businesses—SeverstalAuto (an automotive holding consisting of UAZ and ZMZ) and Severstal-Resurs (a mining holding uniting Karelsky Okatysh, Olenegorsk GOK and Kuzbassugol). In July 2004, Severstal Group announced plans to integrate Severstal-Resurs back into Severstal. In late 2003 the company obtained permission to float up to 19.9% of its shares in the form of GDRs, with portfolio investors receiving an option to convert their shares into GDRs, which are traded OTC. Severstal's dividend policy envisages allocating 25% of its IAS net profit on dividends. Its investment program focuses on downstream operations. Under the auspices of Severgal, Severstal (75%) and Arcelor (25%) have invested $180 m in a galvanized steel line with annual capacity of 400,000 tons of Extragal™, an Arcelor proprietary product, to be completed at Severstal in 2004. Severstal is also constructing a 200,000 ton polymer coating line, expected to be completed by 2005. The total investment cost of the new line is €50 m. In June 2003, Severstal and NTMK (controlled by EvrazHolding) reached an agreement on uniting their large-diameter pipe projects on the basis of Izhora Pipe's Mill 5000, located in the Leningrad region and owned by Severstal. The total required investments are expected to be around $130 m, which encompasses upgrading the mill and installing an electrowelding line to produce steel pipe with a diameter of up to 1,420 mm and length up to 18 m. All pipe is to be protected with triple corrosion-resistant coating. The parties target initial annual capacity of 450,000 tons. The project is expected to come on-line by the end of 2005. NTMK and Severstal view Gazprom as their primary Russian consumer, they expect to market their product to other Russian consumers in the oil and gas industry, and to export a substantial part. Severstal also plans to continue modernizing its steel-making facilities and further expand its generating capacity (it is currently 40% self-sufficient in energy). Severstal has started constructing a second EAF and a continuous caster to replace the remaining three open-hearth furnaces with outdated ingot casting. The company's development program envisages capex of $1.5 bn over 2004–12, heavily skewed towards the first few years.

In February Severstal completed the acquisition of the assets of the US' fifth-largest steel producer Rouge Industries (which concentrates on flat products including hot- and cold-rolled sheet and galvanized sheet, with yearly output of about 2.5 m tons) for $286 m in cash under bankruptcy proceedings. We view Severstal's strategy for its US operations as very reasonable, and believe that the company will be able to turn a profit from Rouge's operations in 2004. Finally, we note that the acquisition is strategically important for Severstal, allowing it to gain exposure to the US steel market, which is characterized by higher prices and strong protective measures.

Valuation/rating

Severstal trades on a 2005E EV/EBITDA multiple of 2.8—a 30% premium to NLMK—and a P/E of 5.6—roughly in line with Brazilian peers. We believe Severstal has already priced in most of the positive earnings momentum and appears fairly valued. We set our 12-month price target of $200 per share based on a target 2005E EV/EBITDA multiple of 3.0, down from 3.5 previously to reflect the higher equity risk premium and heightened concerns over corporate governance following the Severstal-Resurs transaction. Following the company's strong share price performance over the last month, we downgrade our rating from Buy 2 to **Neutral 2**. We note that Severstal's earnings should be less susceptible to commodity price changes than other Russian steel producers, as it relies more on long-term contracts, and has a diversified product mix.

Catalysts

We believe that the following possible catalysts could influence the share price in the near term:

- Newsflow on the details of a potential merger with Russia's largest producer of long products and largest steel company on a consolidated basis— EvrazHolding.
- Steel prices continuing to perform ahead of our forecasts
- Good operational performance, meeting production targets and keeping costs under control
- Better than expected dividends
- Clarity on synergies with the recently acquired assets of Rouge Industries
- Consolidation of Severstal-Resurs assets on Severstal's balance sheet

Risks

Operating in a cyclical sector, Severstal is exposed to the volatile nature of steel prices. Therefore, if spot steel prices differ greatly from our estimates, our earnings assumptions—and hence valuations—may not be met. Further, the company is exposed to risks emanating from the new rules-of-the-game between the state and big business. In addition, we believe investors in Severstal should be aware of corporate governance risks related to transactions that may not be in the interests of minority shareholders.

Severstal financials (IAS)

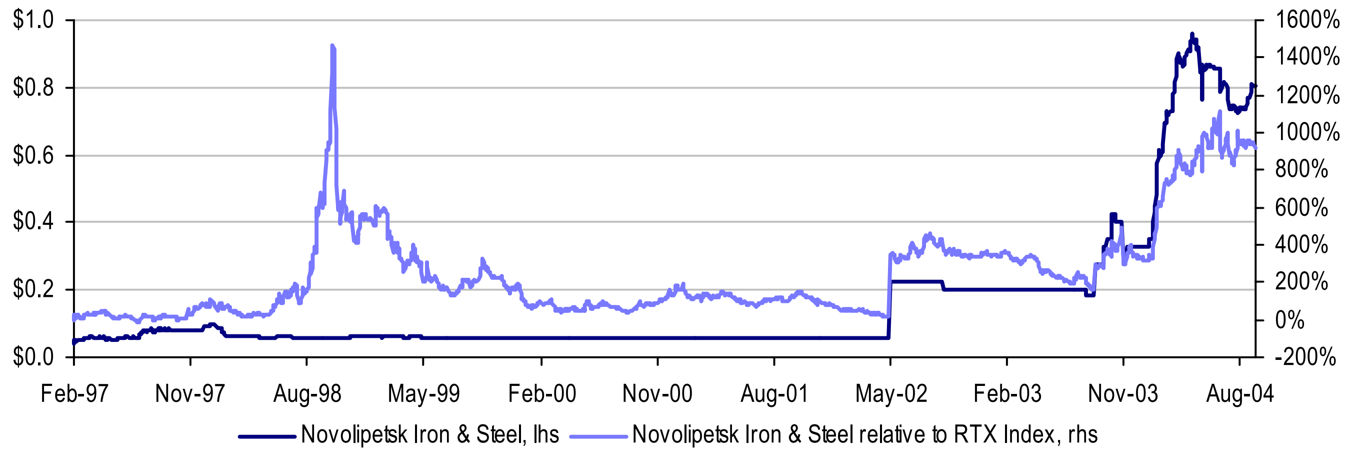
Income statement, $ m	2001	2002	2003E	2004E	2005E
Revenues	**1,789.1**	**1,965.2**	**3,121.7**	**4,533.7**	**4,422.3**
Depreciation	191.6	196.7	206.8	230.8	262.2
Other operating expenses	1,505.4	1,478.3	2,260.2	3,003.2	3,107.3
Operating profit	**92.1**	**290.2**	**654.8**	**1,299.7**	**1,052.7**
Interest expense	12.2	24.7	(26.9)	10.4	11.8
Other non-operating expenses/(gains)	639.9	19.6	15.0	15.0	15.0
Pretax profit	**(560.1)**	**245.9**	**666.7**	**1,274.3**	**1,025.9**
Taxation	(93.2)	67.9	233.3	374.3	307.1
Minority expense/(interest)	0.0	0.0	0.0	0.0	0.0
Net profit	**(466.9)**	**178.0**	**433.4**	**900.0**	**718.8**
EBITDA	**301.1**	**525.4**	**891.6**	**1,560.5**	**1,335.0**
Net debt, year-end	75.7	16.8	133.9	(78.0)	(616.6)
Cashflow statement, $ m	**2001**	**2002**	**2003E**	**2004E**	**2005E**
Operating cashflow	**80.2**	**418.5**	**798.0**	**1,092.3**	**1,018.3**
Net profit	(466.9)	178.0	433.4	900.0	718.8
Depreciation	191.6	196.7	206.8	230.8	262.2
Provisions and write-offs	595.3	38.5	30.0	30.0	20.0
Net change in working capital	(18.6)	22.8	(80.2)	(168.5)	12.3
Other	(221.2)	(17.4)	208.0	100.0	5.0
Investing cashflow	**(378.5)**	**(344.7)**	**(601.2)**	**(655.5)**	**(300.0)**
Capital (expenditures)	(79.2)	(184.4)	(358.2)	(370.0)	(300.0)
Disposals/(acquisitions)	(299.3)	(160.3)	(243.0)	(285.5)	0.0
Financing cashflow	**46.4**	**(0.5)**	**(213.8)**	**575.0**	**(179.7)**
Equity	(25.0)	(18.8)	(313.8)	(225.0)	(179.7)
Debt	71.3	18.3	100.0	800.0	0.0
Effect of exchange rate on cash	(0.3)	1.4	0.0	0.0	0.0
Net change in cash	**(252.2)**	**74.8**	**(17.0)**	**1,011.8**	**538.6**
Balance sheet, $ m	**2001**	**2002**	**2003E**	**2004E**	**2005E**
Cash and marketable securities	57.1	131.9	114.8	1,126.7	1,665.3
Accounts receivable	189.6	203.8	312.2	453.4	442.2
Inventory	150.5	146.3	232.4	362.7	353.8
Other current assets	273.8	418.1	286.0	271.6	264.9
Fixed assets	1,924.6	1,844.4	1,995.8	2,135.0	2,172.8
Other non-current assets	190.9	194.8	437.8	723.3	723.3
Total assets	**2,786.5**	**2,939.2**	**3,379.0**	**5,072.6**	**5,622.3**
Accounts payable	96.2	123.5	249.7	362.7	353.8
Short-term financial debt	70.5	66.3	66.3	66.3	66.3
Other current liabilities	95.9	97.1	156.1	226.7	221.1
Long-term financial debt	62.3	82.4	182.4	982.4	982.4
Other long-term liabilities	351.4	302.8	337.8	372.8	397.8
Shareholders' funds	**2,110.3**	**2,267.2**	**2,386.7**	**3,061.7**	**3,600.9**
Total liabilities and equity	**2,786.5**	**2,939.2**	**3,379.0**	**5,072.6**	**5,622.3**

Source: Company data; Brunswick UBS estimates

Dividends	2001	2002	2003E	2004E	2005E
Ordinary share, $	0	2.34	14.4	9.09	7.39
Ordinary share yield, %	0.0%	1.3%	7.9%	5.0%	4.0%
Earnings	**2001**	**2002**	**2003E**	**2004E**	**2005E**
EPS, $	n/m	8.1	19.6	40.8	32.6
CEPS, $	14.5	18.7	30.4	52.6	45.4
Profitability	**2001**	**2002**	**2003E**	**2004E**	**2005E**
EBITDA margin	17%	27%	29%	34%	30%
Operating margin	5%	15%	21%	29%	24%
Pretax margin	n/m	13%	21%	28%	23%
Net margin	n/m	9%	14%	20%	16%
Growth	**2001**	**2002**	**2003E**	**2004E**	**2005E**
Revenues	-14%	10%	59%	45%	-2%
Operating profit	-87%	215%	126%	98%	-19%
EBITDA	-64%	74%	70%	75%	-14%
Net profit	n/m	n/m	144%	108%	-20%
Value	**2001**	**2002**	**2003E**	**2004E**	**2005E**
EV	3,946	4,078	4,107	4,060	3,685
EV/S	2.21	2.08	1.32	0.90	0.83
EV/EBITDA	13.11	7.76	4.61	2.60	2.76
P/BV	1.91	1.78	1.69	1.32	1.12
P/S	2.25	2.05	1.29	0.89	0.91
P/E	neg.	22.7	9.3	4.5	5.6

Source: Company data; Brunswick UBS estimates

Novolipetsk Iron & Steel (NLMK) [Buy 2, PT $1.20]



Source: RTS

Capital structure		Ownership structure	
Ordinary share price, $	0.80	Core shareholders	80.0%
High/Low 1997-2004, $	0.96 / 0.042	Metalloinvest	15.5%
M.Cap, $ m	4,820	Other	4.5%
No. of shares, m	5,993		
Par value, Rb	1		
Ordinary/Preferred, %	100 / 0	**Freefloat estimate**	**4.5%**

Source: RTS; Skrin; Brunswick UBS estimates

Company overview

Novolipetsk Iron and Steel (NLMK) is one of Russia's top three integrated steel producers, with over 9 m tons of steel-making capacity, and is generally considered technically on par with major Western producers. NLMK's product range includes hot- and cold-rolled steel sheet, coated sheet and slab. Exports account for 60% of the company's sales and are skewed towards slab (about 50% of exports) rather than hot-rolled (25%) and cold-rolled coil (15%). Domestically, the automotive sector is the main customer—NLMK is the major supplier to Avtovaz—followed by the construction and pipe industries. The company is conveniently located on the edge of the Kursk Magnetic Anomaly with its high-grade iron ore, and in 1Q04 acquired a 60% stake in its largest iron ore supplier Stoilensky GOK for $510 m, which puts NLMK in a unique position in the industry, as it now controls two ore suppliers (the other one is KMA-Ruda) which fully cover its needs in this raw material, and now appears hedged against the risk of rising iron ore prices. It also owns 12% of its iron ore supplier Lebedinsky GOK (controlled by Gazmetall), 69.4% of Russia's third largest Tuapse seaport and 12% of Lipetskenergo. NLMK enjoys the most competitive production costs in the industry, and as a result has one of the highest EBITDA margins globally. As part of the transaction to acquire 60% of Stoilensky GOK, NLMK core shareholders transferred 15.5% of NLMK shares to Metalloinvest—a private holding company that controlled Stoilensky GOK—which elected two representatives to NLMK's Board. To improve the attractiveness of its shares traded on the RTS-Board, NLMK in 1H04 performed a 1:1,001 share split.

Plans/prospects

NLMK's development program for 2000–05 focuses on upgrading its steel-making facilities, increasing the production of high value-added products, and further shifting to the domestic market. The program envisages total investment of $1.2 bn, primarily financed from operating cashflow. During 2000–1H04 the company completed upgrading its blast furnace and oxygen converter facilities, commissioned two color-coating lines with 400,000 ton capacity, replaced three outdated continuous casting machines with a new €43 m unit (June 2002), modernized coking batteries, and installed a new refining unit. Priority projects for 2004–05 include completing the modernization of coking facilities and blast furnaces, installing a third polymer coating line, further increasing color-coated steel capacity to 600,000 tons by 2005, and increasing the output of the hot-dip galvanizing line to 1 m tons. As a result, NLMK hopes to be able to fully satisfy growing domestic demand for coated steel products by 2005. NLMK also plans to develop its own coalfields in the Kuzbass region over the next three years, investing up to $100 m in the project, which should allow it to meet internal demand for coking coal. In 2001 NLMK launched a 50-MW turbo generator at its power plant, reaching 40% self-sufficiency in electricity, and further generating capacity is planned.

While NLMK's liquidity is still low, it has improved significantly in 1H04 due to several small placements, and average daily volumes have picked up. With the emergence of a minority shareholder with a 15.5% stake, we believe that corporate governance and liquidity should improve further. The company's disclosure standards are already at high levels, with several years of audited US GAAP statements. In 2004, the company has implemented a consistent dividend policy, according to which NLMK is to distribute at least 15% of US GAAP net profit as dividends. NLMK's strategic goal going forward is to distribute at least 25% of net profit as dividends to its shareholders.

Valuation/rating

NLMK trades on a 2005E EV/EBITDA multiple of 2.1 and a P/E multiple of 4.6—55% and 45% discounts to emerging market averages respectively. We set our 12-month price target of $1.20 per share based on a target 2005E EV/EBITDA multiple of 3.5, down from 4.0 previously to reflect the higher equity risk premium associated with a change in the rules of the game between the state and big business. We continue to rate it **Buy 2**, and maintain NLMK as our top pick in the Russian steel sector. We note that while NLMK appears to have a reasonably hedged cost base following its acquisition of Stoilensky GOK, its earnings could be quite sensitive to commodity price changes. This is explained by NLMK's high exposure to spot contracts and export markets, as well as to semi-finished products.

Catalysts

We believe that the following possible catalysts could influence the share price in the near term:

- Steel prices continuing to perform ahead of our forecasts
- Good operational performance, meeting production targets and keeping costs under control
- Better than expected dividends
- Continued newsflow on further corporate activity, including mergers and acquisitions in the sector
- Possible improvements in share liquidity
- Consolidation of minority shareholders' stake in Stoilensky GOK

Risks

Operating in a cyclical sector, NLMK is exposed to the volatile nature of steel prices. Therefore, if spot steel prices differ greatly from our estimates, our earnings assumptions—and hence valuations—may not be met. Further, the company is exposed to risks emanating from the new rules-of-the-game between the state and big business. In addition, we believe investors in NLMK should be aware of corporate governance risks related to transactions that may not be in the interests of minority shareholders; however, we believe this risk is lower at NLMK than at other Russian steelmakers, as the company has two shareholders with significant stakes.

Novolipetsk Iron & Steel financials, US GAAP

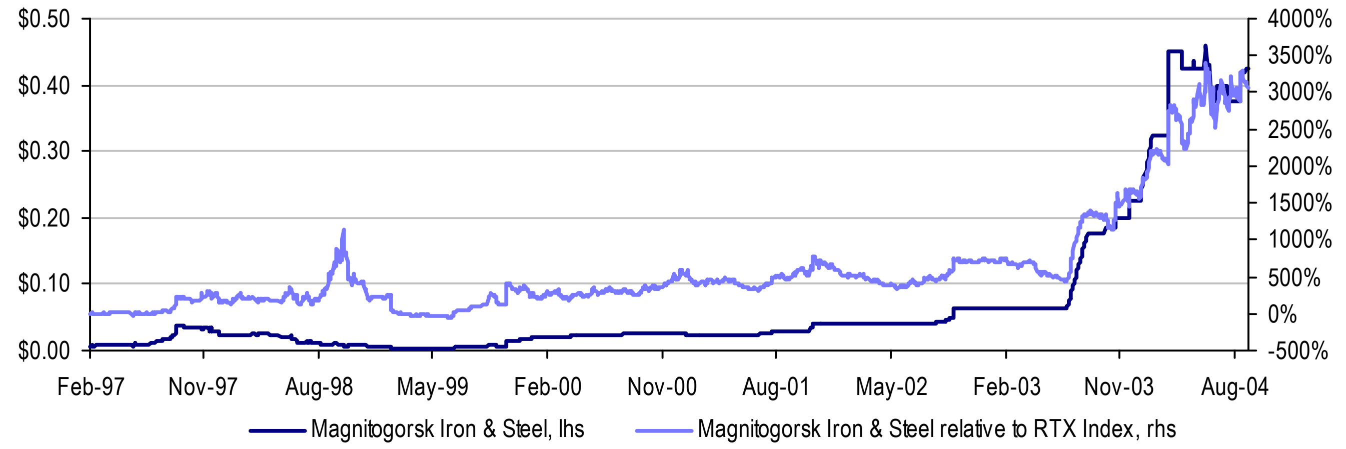
Income statement, $ m	2001	2002	2003	2004E	2005E
Revenues	**1,322.4**	**1,711.7**	**2,468.0**	**4,043.7**	**3,816.9**
Depreciation	159.7	146.3	157.8	173.1	193.5
Other operating expenses	957.4	1,053.4	1,419.0	1,988.2	2,147.0
Operating profit	**205.4**	**511.9**	**891.2**	**1,882.4**	**1,476.3**
Interest expense	(6.3)	(18.9)	(26.3)	(37.9)	(42.4)
Other non-operating expenses/(gains)	49.1	64.0	35.7	62.7	62.7
Pretax profit	**162.6**	**466.9**	**881.7**	**1,857.5**	**1,456.0**
Taxation	75.5	129.7	223.0	501.5	407.7
Minority expense/(interest)	(0.5)	(1.2)	2.2	7.2	4.8
Net profit	**87.5**	**338.4**	**656.5**	**1,348.8**	**1,043.5**
EBITDA	**380.1**	**698.5**	**1,049.0**	**2,055.5**	**1,669.8**
Net debt, year-end	(94.5)	(427.4)	(954.2)	(1,045.8)	(1,572.8)
Cashflow statement, $ m	**2001**	**2002**	**2003**	**2004E**	**2005E**
Operating cashflow	**214.8**	**497.4**	**668.3**	**1,432.8**	**1,264.3**
Net profit	87.5	338.4	656.5	1,348.8	1,043.5
Depreciation	159.7	146.3	157.8	173.1	193.5
Provisions and write-offs	0.0	0.0	0.0	0.0	0.0
Net change in working capital	(39.0)	(24.1)	(111.2)	(89.1)	27.2
Other	6.5	36.8	(34.8)	0.0	(0.0)
Investing cashflow	**(190.3)**	**(215.8)**	**(247.3)**	**(1,214.0)**	**(400.0)**
Capital (expenditures)	(140.6)	(153.6)	(187.5)	(324.0)	(400.0)
Disposals/(acquisitions)	(49.7)	(62.2)	(59.7)	(890.0)	0.0
Financing cashflow	**6.4**	**(81.2)**	**(68.4)**	**(127.2)**	**(337.2)**
Equity	0.0	0.0	(61.7)	(127.2)	(337.2)
Debt	6.4	(81.2)	(6.7)	0.0	0.0
Effect of exchange rate on cash	0.0	0.0	46.4	0.0	0.0
Net change in cash	**30.8**	**200.4**	**399.0**	**91.6**	**527.1**
Balance sheet, $ m	**2001**	**2002**	**2003**	**2004E**	**2005E**
Cash and marketable securities	190.0	390.5	789.5	881.1	1,408.1
Accounts receivable	241.1	305.0	377.7	485.2	458.0
Inventory	180.0	199.0	301.3	404.4	381.7
Other current assets	5.5	52.9	244.1	244.1	244.1
Fixed assets	1,174.7	1,167.7	1,280.8	1,431.7	1,638.2
Other non-current assets	104.9	94.7	91.8	981.8	981.8
Total assets	**1,896.2**	**2,209.7**	**3,085.3**	**4,428.3**	**5,112.0**
Accounts payable	118.5	181.3	282.9	404.4	381.7
Short-term financial debt	92.4	3.3	2.8	2.8	2.8
Other current liabilities	0.0	0.0	0.0	0.0	0.0
Long-term financial debt	3.2	3.0	13.3	13.3	13.3
Other long-term liabilities	30.2	30.9	176.4	176.4	176.4
Shareholders' funds	**1,652.0**	**1,991.2**	**2,609.9**	**3,831.5**	**4,537.8**
Total liabilities and equity	**1,896.2**	**2,209.7**	**3,085.3**	**4,428.3**	**5,112.0**

Source: Company data; Brunswick UBS estimates

Dividends	2001	2002	2003	2004E	2005E
Ordinary share, $	0	0.0102	0.0204	0.051	0.032
Ordinary share yield, %	0.0%	1.3%	2.5%	6.3%	4.0%
Earnings	**2001**	**2002**	**2003**	**2004E**	**2005E**
EPS, $	0.015	0.056	0.110	0.225	0.174
CEPS, $	0.041	0.081	0.136	0.254	0.206
Profitability	**2001**	**2002**	**2003**	**2004E**	**2005E**
EBITDA margin	29%	41%	43%	51%	44%
Operating margin	16%	30%	36%	47%	39%
Pretax margin	12%	27%	36%	46%	38%
Net margin	7%	20%	27%	33%	27%
Growth	**2001**	**2002**	**2003**	**2004E**	**2005E**
Revenues	-4%	29%	44%	64%	-6%
Operating profit	-43%	149%	74%	111%	-22%
EBITDA	-25%	84%	50%	96%	-19%
Net profit	-46%	287%	94%	105%	-23%
Value	**2001**	**2002**	**2003**	**2004E**	**2005E**
EV	4,739	4,559	4,129	3,820	3,511
EV/S	3.58	2.66	1.67	0.94	0.92
EV/EBITDA	12.47	6.53	3.94	1.86	2.10
P/BV	2.92	2.42	1.85	1.26	1.06
P/S	3.64	2.82	1.95	1.19	1.26
P/E	55.1	14.2	7.3	3.6	4.6

Source: Company data; Brunswick UBS estimates

Magnitogorsk Iron & Steel (MMK) [Neutral 2, PT $0.43]



Source: RTS

Capital structure		Ownership structure	
Ordinary share price, $	0.43		
High/Low 1997-2004, $	0.45 / 0.002	Management/MMK	62.0%
M.Cap, $ m	4,518	Federal government	18.0%
No. of shares, m	10,630	Mechel Steel Group	12.0%
Par value, Rb	1	Other	8.0%
Ordinary/Preferred, %	75 / 25		
Preferred share price, $	0.31	**Freefloat estimate**	**2.0%**

Source: RTS; Skrin; Brunswick UBS estimates

Company overview

Magnitogorsk Iron & Steel (MMK) is one of Russia's top three integrated steel producers, with 12 m tons of steel-making capacity (down from 16 m tons in the Soviet era), of which oxygen converters account for 85% and aged open-hearth furnaces for the remainder. In 2003 MMK accounted for 19% of Russian crude steel production. The company's location in the Urals leads to high transportation costs, both for supplies and shipments. The product mix mostly favors flat products (over 75% of output), and MMK is Russia's largest producer and exporter of plate and hot-rolled coil. Domestically, the company competes directly with Severstal and Novolipetsk Iron & Steel (NLMK) for orders from the oil and gas and machine-building sectors (MMK's leading customers). MMK exports 49% of its output, with Asia and the Far East accounting for 51% of exports and the Middle East for 29%. It is almost self-sufficient in electricity generation, operating three cogeneration power plants, but imports over 70% of its iron ore from Kazakhstan's Sokolovo-Sarbaisky GOK under long-term contract arrangements.

Plans/prospects

The key issue with MMK is uncertainty over its ownership structure. The company is effectively controlled by management, which has control over 60% of the company's shares. Almost half of the stake is held in the form of treasury shares, and the remaining half—while held on the company's balance sheet—was transferred to companies affiliated with management under trust agreements. As 60% of the shares are thus held as treasury, we believe this makes MMK vulnerable to M&A, in particular given the upcoming privatization of the government's 18% stake (24% voting) and the fact that 12% (16% voting) is already held by a strategic investor—Mechel Steel Group. We believe the government's stake will most likely be acquired by management, which may then streamline MMK's ownership structure. If management then decides to cancel the treasury stock, we believe this represents possible upside for minority shareholders; however, this may only happen if management buys out Mechel Steel Group's stake. At this stage we do not treat the stock held by MMK as treasury and calculate its market capitalization based on the total number of shares.

MMK's strategic development plan focuses on revamping its steel-making facilities by shutting down its remaining open-hearth furnaces by 2005–06E, increasing production of high value-added products, and further shifting towards the domestic market—the company is seeking to increase the share of domestic sales to 60%–70% in the medium term. Having essentially completed the upgrade of its continuous casting facilities in 2001, MMK commissioned an 800,000-ton cold-rolling machine shop from Germany's SMS Demag, a 500,000-ton continuous galvanizing line from Italy's Danieli in 2002, and a 200,000-ton polymer coating line from VAI. Total capex over 1992–2002 was $1.6 bn. In the next two years MMK plans to invest around $700 m, focusing on the installation of two new continuous billet casters by VAI, replacing its remaining open hearth furnaces with two new EAFs, modernizing rolling mills and a sinter plant, installing three new long-product rolling mills, and constructing a new oxygen-generation plant. To finance its working capital needs and capex requirements, MMK completed a $100 m Eurobond placement in January 2002 and a $300 m Eurobond in October 2003. MMK also announced that it was seeking RTS and Micex listings and might launch a Level 1 ADR for up to 10% of charter capital in the medium term. However, these plans await the results of the privatization of the government's 18% stake, scheduled for 2H04.

We believe MMK is well positioned to take advantage of growing domestic consumption and strong export markets. However, the company is exposed to some operational and strategic risks—as it lacks its own raw materials resource base, it is more exposed to the bargaining power of raw materials suppliers, which may result in higher production costs, raw materials shortages and a deteriorating competitive position. In our view, future strategic plans are dependent on the outcome of the upcoming privatization of the government's stake, with the possibility of management changes. The stock's liquidity is low, as the company does not have a listing on the RTS.

Valuation/rating

MMK's stock trades at a 2005E IAS EV/EBITDA of 3.0 and a P/E of 7.0—discounts of 35% and 16% to emerging market peers respectively. We set our 12-month price target of $0.43 per share based on a target 2005E EV/EBITDA multiple of 3.0, down from 3.5 previously to reflect the higher equity risk premium associated with a change in the rules of the game between the state and big business. Following its strong share price performance over the last 12 months period, and an earnings reduction on the back of costs rising ahead of expectations, we downgrade our rating from Buy 2 to **Neutral 2**. We note that MMK should have high earnings sensitivity to commodity prices and Chinese steel demand, due to not having its own raw materials resource base and high exposure to the Asian market.

Catalysts

We believe that the following possible catalysts could influence the share price in the near term:

- Privatization of the government's stake in the company and possible improvements in share liquidity thereafter
- Steel prices continuing to perform ahead of our forecasts
- Good operational performance, meeting production targets and keeping costs under control
- Continued newsflow on further corporate activity, including mergers and acquisitions in the sector
- Better than expected dividends

Risks

Operating in a cyclical sector, MMK is exposed to the volatile nature of steel prices. Therefore, if spot steel prices differ greatly from our estimates, our earnings assumptions—and hence valuations—may not be met. The company also lacks its own resource base, which makes its earnings less predictable than other Russian steelmakers. Further, the company is exposed to risks emanating from the new rules-of-the-game between the state and big business. In addition, we believe investors in MMK should be aware of corporate governance risks related to transactions that may not be in the interests of minority shareholders.

Magnitogorsk Iron & Steel financials (IAS)

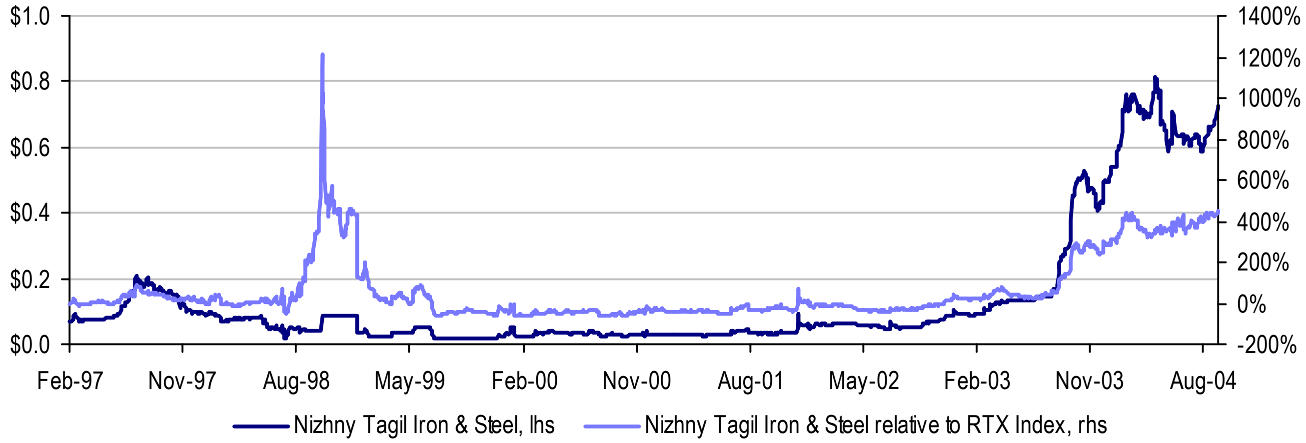
Income statement, $ m	2001	2002	2003	2004E	2005E
Revenues	**1,733.0**	**2,065.0**	**3,047.0**	**4,399.4**	**4,015.7**
Depreciation	206.0	220.0	212.0	209.2	219.6
Other operating expenses	1,421.0	1,600.0	2,056.0	2,914.4	2,852.4
Operating profit	**106.0**	**245.0**	**779.0**	**1,275.8**	**943.7**
Interest expense	12.0	43.0	18.0	20.0	20.0
Other non-operating expenses/(gains)	11.0	0.0	0.0	0.0	0.0
Pretax profit	**83.0**	**202.0**	**761.0**	**1,255.8**	**923.7**
Taxation	(58.0)	86.0	141.0	376.7	277.1
Minority expense/(interest)	(3.0)	1.0	(10.0)	0.0	0.0
Net profit	**144.0**	**115.0**	**630.0**	**879.1**	**646.6**
EBITDA	**312.0**	**465.0**	**991.0**	**1,485.0**	**1,163.3**
Net debt, year-end	199.0	133.0	(225.0)	(805.7)	(1,275.6)
Cashflow statement, $ m	**2001**	**2002**	**2003**	**2004E**	**2005E**
Operating cashflow	**267.0**	**212.0**	**588.0**	**995.3**	**863.9**
Net profit	144.0	115.0	630.0	879.1	646.6
Depreciation	206.0	220.0	212.0	209.2	219.6
Provisions and write-offs	(23.0)	(62.0)	11.0	0.0	0.0
Net change in working capital	36.0	(124.0)	(193.0)	(92.9)	(2.3)
Other	(96.0)	63.0	(72.0)	0.0	0.0
Investing cashflow	**(360.0)**	**(137.0)**	**(249.0)**	**(400.0)**	**(350.0)**
Capital (expenditures)	(301.0)	(204.0)	(202.0)	(400.0)	(350.0)
Disposals/(acquisitions)	(59.0)	67.0	(47.0)	0.0	0.0
Financing cashflow	**96.0**	**70.0**	**222.0**	**(148.6)**	**(264.4)**
Equity	(10.0)	(18.0)	(13.0)	(14.6)	(44.0)
Debt	106.0	88.0	235.0	(134.0)	(220.4)
Effect of exchange rate on cash	0.0	0.0	0.0	0.0	0.0
Net change in cash	**3.0**	**145.0**	**561.0**	**446.7**	**249.5**
Balance sheet, $ m	**2001**	**2002**	**2003**	**2004E**	**2005E**
Cash and marketable securities	77.0	222.0	824.0	1,270.7	1,520.2
Accounts receivable	267.0	266.0	384.0	483.9	481.9
Inventory	233.0	231.0	308.0	439.9	405.9
Other current assets	3.0	11.0	50.0	50.0	50.0
Fixed assets	1,853.0	2,125.0	2,071.0	2,261.8	2,392.2
Other non-current assets	91.0	3.0	13.0	13.0	13.0
Total assets	**2,524.0**	**2,858.0**	**3,650.0**	**4,519.4**	**4,863.2**
Accounts payable	409.0	292.0	301.0	439.9	401.6
Short-term financial debt	195.0	137.0	134.0	196.6	64.6
Other current liabilities	0.0	0.0	0.0	0.0	0.0
Long-term financial debt	81.0	218.0	465.0	268.4	180.0
Other long-term liabilities	293.0	404.0	292.0	292.0	292.0
Shareholders' funds	**1,546.0**	**1,807.0**	**2,458.0**	**3,322.4**	**3,925.0**
Total liabilities and equity	**2,524.0**	**2,858.0**	**3,650.0**	**4,519.4**	**4,863.2**

Source: Company data; Brunswick UBS estimates

Dividends	2001	2002	2003	2004E	2005E
Ordinary share, $	0.0003	0.0004	0.0009	0.0026	0.0018
Preferred share, $	0.0003	0.0011	0.0027	0.0077	0.0054
Ordinary share yield, %	0.1%	0.1%	0.2%	0.6%	0.4%
Preferred share, %	0.1%	0.4%	0.9%	2.5%	1.8%
Earnings	**2001**	**2002**	**2003**	**2004E**	**2005E**
EPS, $	0.014	0.011	0.059	0.083	0.061
CEPS, $	0.031	0.026	0.080	0.102	0.081
Profitability	**2001**	**2002**	**2003**	**2004E**	**2005E**
EBITDA margin	18%	23%	33%	34%	29%
Operating margin	6%	12%	26%	29%	24%
Pretax margin	5%	10%	25%	29%	23%
Net margin	8%	6%	21%	20%	16%
Growth	**2001**	**2002**	**2003**	**2004E**	**2005E**
Revenues	n/a	19%	48%	44%	-9%
Operating profit	n/a	131%	218%	64%	-26%
EBITDA	n/a	49%	113%	50%	-22%
Net profit	n/a	-20%	n/m	40%	-26%
Value	**2001**	**2002**	**2003**	**2004E**	**2005E**
EV	4,717	4,684	4,472	4,002	3,477
EV/S	2.72	2.27	1.47	0.91	0.87
EV/EBITDA	15.12	10.07	4.51	2.70	2.99
P/BV	2.92	2.50	1.84	1.36	1.15
P/S	2.61	2.19	1.48	1.03	1.13
P/E	31.4	39.3	7.2	5.1	7.0

Source: Company data; Brunswick UBS estimates

Nizhny Tagil Iron & Steel (NTMK) [Buy2, PT $0.95]



Source: RTS

Capital structure		Ownership structure	
Ordinary share price, $	0.72	EvrazHolding	80.1%
High/Low 1997-2004, $	0.81 / 0.02	General Refractories Ltd.	10.7%
M.Cap, $ m	948	Other	9.3%
No. of shares, m	1,310		
Par value, Rb	1		
Ordinary/Preferred, %	100 / 0	**Freefloat estimate**	**9.3%**

Source: RTS; Skrin; Brunswick UBS estimates

Company overview

Nizhny Tagil Iron & Steel (NTMK) is a Russia's fifth-largest integrated steel producer with over 5.5 m tons of installed capacity, of which oxygen converters account for 65% and open-hearth furnaces 35%. In 2003 capacity utilization was close to full for steel and around 90% for rolled products. Contrary to the three leading Russian steel mills, NTMK focuses on long products, essentially monopolizing Russian production of H-beams, and is the second-largest producer of rails after NKMK, with a 31% market share. With its 42% domestic market share, NTMK is one of Russia's two producers of railway wheels, after Vyksunsky Pipe. NTMK also sells billets, a semi-product used for re-rolling into long products. Raw materials are sourced from other companies controlled by NTMK's largest shareholder, EvrazHolding—Vysokogorsky GOK (iron ore), and Yuzhkuzbassugol (coal). In 1H04, NTMK has acquired a controlling stake in its key iron ore supplier Kachkanarsky GOK, making it self-sufficient in this raw material. NTMK is located close to its iron ore suppliers but incurs higher transportation costs on coal from Western Siberia. During 1999 the company refocused its business towards the domestic market, and exports accounted for 50% of physical output in 2003, primarily comprised of semi-finished. In 2003, EvrazHolding completed streamlining its organizational structure, but has no plans at the moment to transfer to a single share. Since 2001, NTMK has reported IAS financials.

Plans/prospects

During 1999 NTMK was under threat of bankruptcy due to its heavy indebtedness to the administration of the Sverdlovsk region, trading companies and other related parties. In December 1999 an amicable agreement was signed with creditors, restructuring the company's Rb 4.5 bn debt over 2001–08E, with 60% of the total to be repaid in the last three years. NTMK's development plans focus on general reconstruction and participation in a large-diameter pipe project. The reconstruction and modernization program envisages investing $400 m over 2004–08 in blast furnaces reconstruction to increase their useful life and production efficiency, refurbishment of coke oven batteries, modernizing its oxygen furnace shop to increase its capacity with an aim to replace outdated open-hearth furnaces, modernizing its wheel rolling mill to improve quality and capacity, and construction of a fourth continuous slab caster (launched in 3Q04). In addition, NTMK plans to install additional power generators to increase its self-sufficiency to 65%. In June 2003, NTMK and Severstal reached an agreement on creating a 50/50 joint venture to produce large-diameter pipe on the basis of Izhora Pipe's Mill 5000, located in the Leningrad region and owned by Severstal. The total initial investment is expected to run to $130 m. Slabs are to be supplied by NTMK, and targeted production capacity is 450,000 tons per year. While NTMK and Severstal view Gazprom as their primary Russian consumer, they expect to export a substantial part of the output.

In our view, NTMK is among the better Russian steel companies, although lagging the three majors in terms of production efficiency and product range. We believe management's efforts to improve efficiency and introduce new products should positively reflect on the company's competitive position and profitability. From a strategic viewpoint, we believe a merger risk exists should EvrazHolding decide to transfer its subsidiaries to a single share.

Valuation/rating

NTMK trades at a 2005E EV/EBITDA multiple of 2.2 and a P/E multiple of 5.6—a discount of more than 50% to its emerging market peers on EV/EBITDA and more than 30% on P/E. We derive our 12-month price target of $0.95 based on a target 2005E EV/EBIDTA multiple of 2.8, down from 3.25 previously, to reflect the higher equity risk premium associated with the changes in the rules of the game between the state and big business. We continue to rate NTMK **Buy 2**.

Catalysts

We believe that the following possible catalysts could influence the share price in the near term:

- Steel prices continuing to perform ahead of our forecasts
- Good operational performance, meeting production targets and keeping costs under control
- Continued newsflow on further corporate activity, including mergers and acquisitions in the sector

Risks

Operating in a cyclical sector, NTMK is exposed to the volatile nature of steel prices. Therefore, if spot steel prices differ greatly from our estimates, our earnings assumptions—and hence valuations—may not be met. Further, the company is exposed to risks emanating from the new rules-of-the-game between the state and big business. In addition, we believe investors in NTMK should be aware of corporate governance risks related to transactions that may not be in the interests of minority shareholders.

Nizhny Tagil Iron & Steel financials (IAS)

Income statement, $ m	2001	2002	2003	2004E	2005E
Revenues	**838.1**	**810.4**	**1,039.8**	**1,804.7**	**1,641.6**
Depreciation	66.5	80.2	83.4	91.0	92.2
Other operating expenses	747.3	691.7	837.9	1,253.5	1,229.2
Operating profit	**24.3**	**38.5**	**118.5**	**460.2**	**320.1**
Interest expense	22.9	27.5	23.5	26.3	29.6
Other non-operating expenses/(gains)	(26.2)	(12.5)	(0.6)	50.0	40.0
Pretax profit	**27.7**	**23.4**	**95.6**	**383.9**	**250.5**
Taxation	(32.0)	11.4	30.2	117.1	80.2
Minority expense/(interest)	0.0	0.0	0.0	0.0	0.0
Net profit	**59.6**	**12.0**	**65.4**	**266.8**	**170.4**
EBITDA	**90.8**	**118.7**	**201.9**	**551.2**	**412.3**
Net debt, year-end	153.8	116.2	116.4	50.3	(160.4)
Cashflow statement, $ m	**2001**	**2002**	**2003**	**2004E**	**2005E**
Operating cashflow	**22.6**	**92.3**	**140.2**	**368.1**	**310.8**
Net profit	59.6	12.0	65.4	266.8	170.4
Depreciation	66.5	80.2	83.4	91.0	92.2
Provisions and write-offs	(103.3)	(17.9)	0.1	50.0	40.0
Net change in working capital	(23.1)	(9.6)	(32.1)	(39.7)	8.2
Other	22.9	27.5	23.5	0.0	(0.0)
Investing cashflow	**(37.6)**	**(28.4)**	**(106.6)**	**(302.0)**	**(100.0)**
Capital (expenditures)	(15.8)	(38.3)	(99.6)	(140.0)	(100.0)
Disposals/(acquisitions)	(21.8)	9.9	(7.1)	(162.0)	0.0
Financing cashflow	**11.6**	**(52.3)**	**22.3**	**25.0**	**25.0**
Equity	0.0	0.0	0.0	0.0	0.0
Debt	11.6	(52.3)	22.3	25.0	25.0
Effect of exchange rate on cash	(0.8)	(1.5)	0.0	0.0	0.0
Net change in cash	**(4.2)**	**10.0**	**59.6**	**91.1**	**235.8**
Balance sheet, $ m	**2001**	**2002**	**2003**	**2004E**	**2005E**
Cash and marketable securities	15.8	13.9	73.5	164.5	400.3
Accounts receivable	55.6	54.8	89.8	135.4	123.1
Inventory	55.3	45.5	74.2	117.3	106.7
Other current assets	4.9	10.1	7.8	7.8	7.8
Fixed assets	638.1	586.6	623.2	672.2	679.9
Other non-current assets	18.3	16.8	21.2	133.2	93.2
Total assets	**787.9**	**727.6**	**889.7**	**1,230.4**	**1,411.1**
Accounts payable	113.3	85.9	113.6	162.4	147.7
Short-term financial debt	81.9	26.4	23.3	35.8	48.3
Other current liabilities	2.1	11.1	1.1	1.1	1.1
Long-term financial debt	87.8	103.7	166.5	179.0	191.5
Other long-term liabilities	117.8	103.4	88.1	88.1	88.1
Shareholders' funds	**385.1**	**397.1**	**497.2**	**764.0**	**934.4**
Total liabilities and equity	**787.9**	**727.6**	**889.7**	**1,230.4**	**1,411.1**

Source: Company data; Brunswick UBS estimates

Dividends	2001	2002	2003	2004E	2005E
Ordinary share, $	0	0	0	0	0
Ordinary share yield, %	0.0%	0.0%	0.0%	0.0%	0.0%
Earnings	**2001**	**2002**	**2003**	**2004E**	**2005E**
EPS, $	0.046	0.009	0.050	0.204	0.130
CEPS, $	0.017	0.057	0.114	0.311	0.231
Profitability	**2001**	**2002**	**2003**	**2004E**	**2005E**
EBITDA margin	11%	15%	19%	31%	25%
Operating margin	3%	5%	11%	26%	20%
Pretax margin	3%	3%	9%	21%	15%
Net margin	7%	1%	6%	15%	10%
Growth	**2001**	**2002**	**2003**	**2004E**	**2005E**
Revenues	29%	-3%	28%	74%	-9%
Operating profit	-35%	58%	208%	288%	-30%
EBITDA	40%	31%	70%	173%	-25%
Net profit	216%	-80%	n/m	308%	-36%
Value	**2001**	**2002**	**2003**	**2004E**	**2005E**
EV	1,134	1,083	1,065	1,032	893
EV/S	1.35	1.34	1.02	0.57	0.54
EV/EBITDA	12.48	9.13	5.27	1.87	2.17
P/BV	2.46	2.39	1.91	1.24	1.02
P/S	1.13	1.17	0.91	0.53	0.58
P/E	15.9	79.0	14.5	3.6	5.6

Source: Company data; Brunswick UBS estimates

notes

■ Analyst Certification

Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

Required Disclosures

This report has been prepared by Brunswick UBS, an affiliate of UBS AG (UBS).

UBS Investment Research: Global Equity Ratings Definitions and Allocations

UBS rating	Definition	UBS rating	Definition	Rating category	Coverage[1]	IB services[2]
Buy 1	FSR is > 10% above the MRA, higher degree of predictability	**Buy 2**	FSR is > 10% above the MRA, lower degree of predictability	**Buy**	44%	33%
Neutral 1	FSR is between -10% and 10% of the MRA, higher degree of predictability	**Neutral 2**	FSR is between -10% and 10% of the MRA, lower degree of predictability	**Hold/Neutral**	48%	31%
Reduce 1	FSR is > 10% below the MRA, higher degree of predictability	**Reduce 2**	FSR is > 10% below the MRA, lower degree of predictability	**Sell**	7%	28%

1: Percentage of companies under coverage globally within this rating category.
2: Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS; as of 30 June 2004.

KEY DEFINITIONS

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.
Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (an approximation of the equity risk premium).
Predictability Level The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities.
Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.
Rating/Return Divergence (RRD) This qualifier is automatically appended to the rating when stock price movement has caused the prevailing rating to differ from that which would be assigned according to the rating system and will be removed when there is no longer a divergence, either through market movement or analyst intervention.

EXCEPTIONS AND SPECIAL CASES

US Closed-End Fund ratings and definitions are: Buy: Higher stability of principal and higher stability of dividends; Neutral: Potential loss of principal, stability of dividend; Reduce: High potential for loss of principal and dividend risk.
UK and European Investment Fund ratings and definitions are: Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Reduce: Negative on factors such as structure, management, performance record, discount.
Core Banding Exceptions (CBE): Exceptions to the standard +/-10% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Companies Mentioned table in the relevant research piece.

Companies mentioned

Company Name	Reuters	Rating	Price
Avtovaz	AVAZ.RTS	Reduce 2	US$24.18
ChMK	MECH.RTS	Not rated	US$129.00
Gazprom[2a,4,16]	GAZPq.L	Buy 2	US$34.50
Magnitogorsk[2a]	MAGNI.RTS	Neutral 2	US$0.31
Nizhny Tagil	NTMK.RTS	Buy 2	US$0.72
Novolipetsk	NLMKI.RTS	Buy 2	US$0.81
Severstal[5]	CHMF.RTS	Neutral 2	US$182.65
UES	EESR.RTS	Buy 2 (RRD)	US$0.28
Yukos[2b,4,16]	YUKO.RTS	Buy 2	US$3.89

Price(s) as of 8 September 2004. Source: UBS.

2a. UBS AG, its affiliates or subsidiaries has acted as manager/co-manager in the underwriting or placement of securities of this company or one of its affiliates within the past 12 months.

2b. UBS AG, its affiliates or subsidiaries has acted as manager/co-manager in the underwriting or placement of securities of this company or one of its affiliates within the past three years.

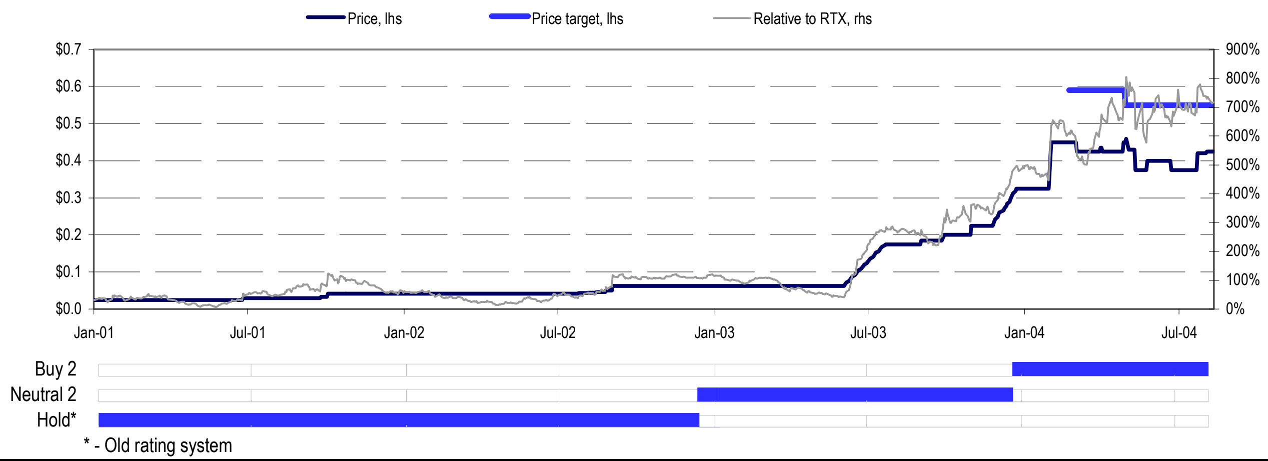
4. Within the past 12 months, UBS AG, its affiliates or subsidiaries has received compensation for investment banking services from this company.

5. UBS AG, its affiliates or subsidiaries expect to receive or intend to seek compensation for investment banking services from this company within the next three months.

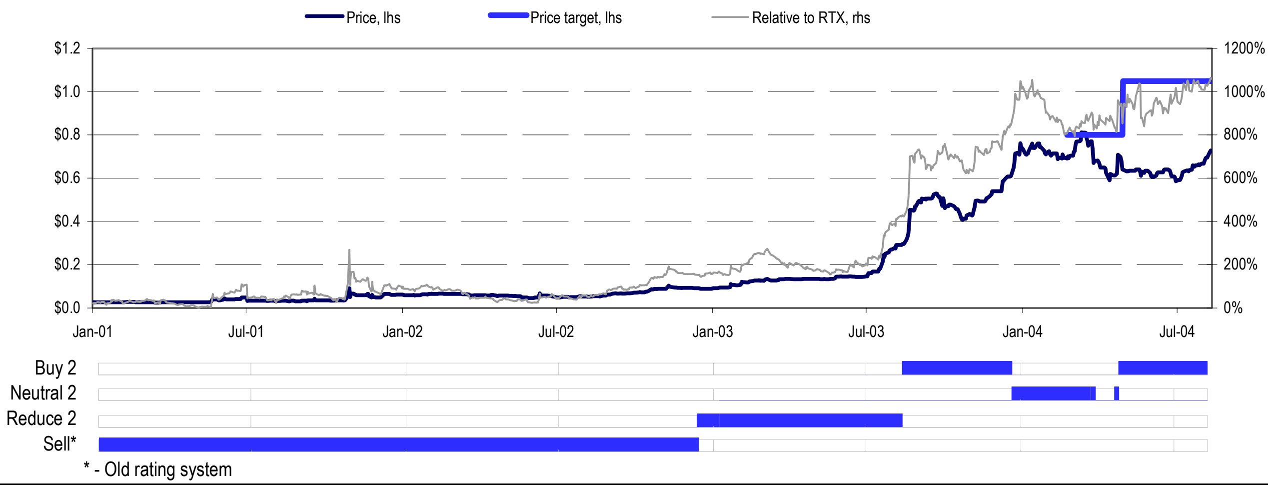
16. UBS Securities LLC makes a market in the securities and/or ADRs of this company.

Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

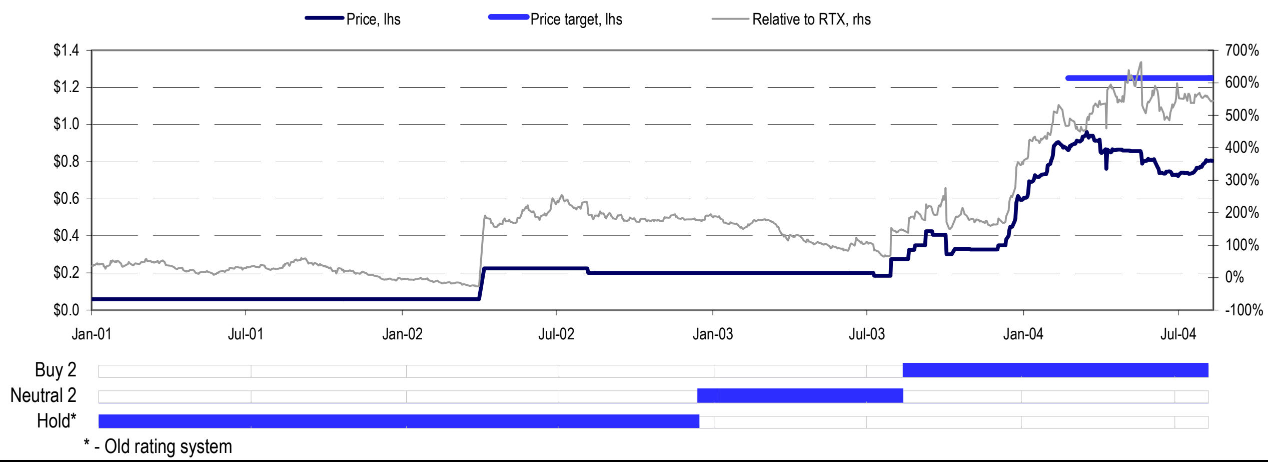
Magnitogorsky Iron & Steel (US$)



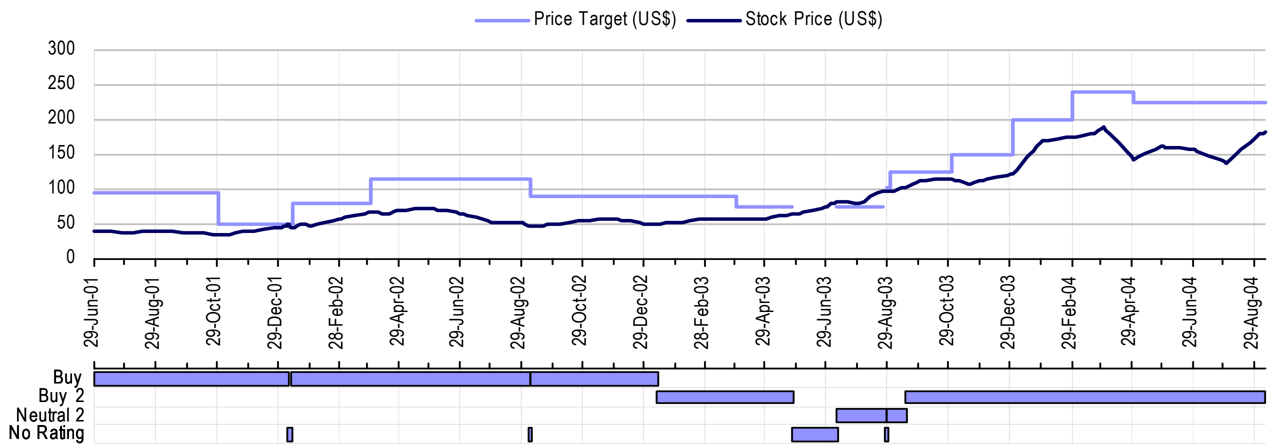
Nizhny Tagil Iron & Steel (US$)



Novolipetsk Iron & Steel (US$)



Severstal (US$)



Source: UBS; as of 8 September 2004.

Note: On October 13, 2003, UBS adopted new definition criteria for its rating system. (See 'UBS Investment Research: Global Equity Ratings Definitions and Allocations' table for details.) Between January 11 and October 12, 2003, the UBS ratings and their definitions were: Buy 1: Excess return potential > 15%, smaller range around price target; Buy 2: Excess return potential > 15%, larger range around price target; Neutral 1: Excess return potential between -15% and 15%, smaller range around price target; Neutral 2: Excess return potential between -15% and 15%, larger range around price target; Reduce 1: Excess return potential < -15%, smaller range around price target; Reduce 2: Excess return potential < -15%, larger range around price target.

Prior to January 11, 2003, the UBS ratings and definitions were: Strong Buy: Greater than 20% excess return potential, high degree of confidence; Buy: Positive excess return potential; Hold: Low excess return potential, low degree of confidence; Reduce: Negative excess return potential; Sell: Greater than 20% negative excess return potential, high degree of confidence. Under both ratings systems, excess return is defined as the difference between the FSR and the one-year local market interest rate.

Global Disclaimer

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