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## Severstal: Vertical Integration Brings Its Pluses

**BUY**

Ticker MICEX	CHMF
Мcap, USD mn	14814
EV, USD mn	19 113
Number of common shares, mn.	1008
Free float	18%

<b>Common shares</b>		<b>Buy</b>
Target price by the end of 2011, USD	18.9	
Current price, USD	14.7	
Upside	28%	

<b>Financials, USD mn</b>			
	2010A	2011E	2012E
Revenue	13573	16337	19068
EBITDA	3263	4217	4295
Net Income	-577	1825	2288

<b>Margins, %</b>			
	2010A	2011E	2012E
EBITDA margin	24%	26%	23%
Net Income margin	-4%	11%	12%

<b>Multiples</b>			
	2010A	2011E	2012E
EV/S	1.4	1.2	1.0
EV/EBITDA	5.9	4.5	4.4
P/E	-25.7	8.1	6.5

<b>Dividends, USD per share</b>			
for the year	2010A	2011E	2012E
Common shares	0.14	0.45	0.57

**Balanced organic growth and vertical integration - the main competitive advantage.** The basis of Severstal's strategy is an improvement in the efficiency of existing assets and a gradual increase in the output capacity of high value added products. The company does not focus on single multibillion development projects, rather it distributes its CAPEX across the entire production chain (from raw materials to finished products) with a balanced approach. This minimizes the risks of possible financial losses and increases the competitiveness of the finished products on the market.

**High value added products sales to grow significantly.** According to our estimates, sales of high value added products and long products will grow by 48% and 80% respectively by 2015 relative to the current levels.

**The current year to be successful for the company.** We believe that the growth in the finished products prices and a high degree of vertical integration will significantly improve Severstal's financials this year. We expect total revenue in 2011 to grow by 20% y-o-y, EBITDA to increase by 29% y-o-y to USD4.2 bn, and net income to be USD 1.8 bn (positive for the first time in two years).

**Gold segment (Nordgold) IPO - mid-term growth driver.** Severstal has succeeded in the development of its gold business, showing q-o-q an increasing pace of gold production. The successful holding of a Nordgold IPO (the current gold prices are very favorable) could add at least USD2 to the price of Severstal common stocks.

**Instability in the financial markets could harm the overall economy.** The current instability in the financial markets could harm the overall economy and lead to a new recession. Another recession would mean a significant decline in finished steel products prices and sales volumes at the end of this year and the first half of 2012. In the case of another recession, our target price for Severstal stocks, by the end of 2011, is USD13.1 per share.

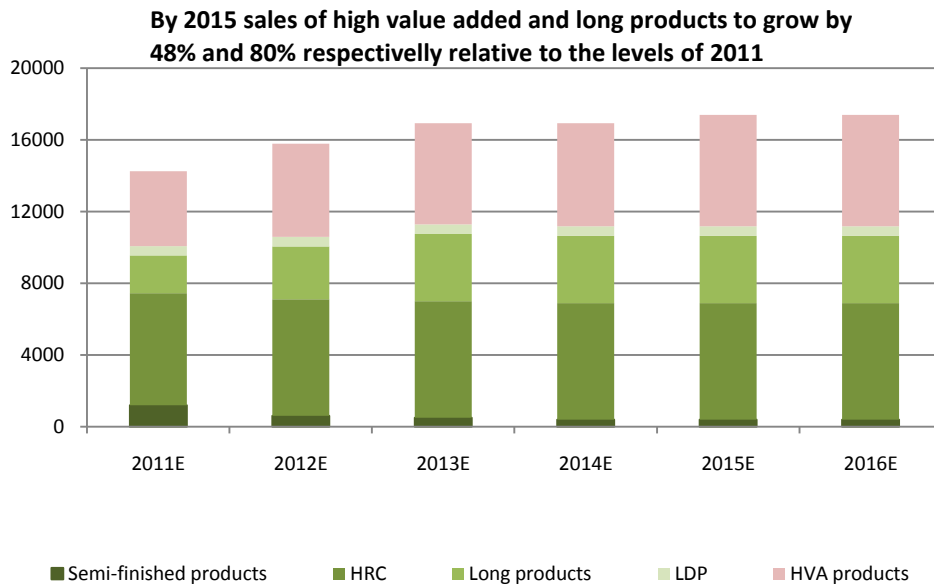
However, in our view, there is little likelihood of new recession.

*We are initiating our coverage of Severstal with a Buy recommendation and a target price of USD 18.9 by the end of 2011. Our target price is derived from an average of estimates made using DCF and the multiples methods.*



- Severstal has good prospects for organic growth

### Severstal: finished products output estimates, th.tonnes



Source: Company data, Grandis Capital estimates

Severstal plans to increase its output of high value products by 2015. By the end of this year the company, at its Cherepovetsk site, plans to put into operation a new color coating line with a capacity of 200 tpa and, by 2015, to commission color coating and galvanized lines with capacities of 200 and 450 tpa respectively. Currently the company is building a mini-mill in the Saratov region with a capacity of 1 mn tpa of long products. The plant will be commissioned in 2013. At Severstal North America galvanized products capacities will grow by 1 mn tpa by the end of 2011. We also expect an increase in sales of cold rolled products by 150 mn tpa in 2012 due to expansion of cold rolling mill capacity.

Considering the completion of the program to update existing assets we expect sales of high value added and long products to grow by 48% and 80% respectively relative to the current levels. This growth will allow Severstal to maintain its operational margin in an environment with a more rapid growth rate of variable costs relative to the growth rate of finished products prices (the main scenario).

- In our financial model we assume costs will rise faster than sales prices (main scenario).

In our financial model of the company we make a fairly conservative assumption; after quite strong growth in finished products prices in 2011 we expect the mid-term growth rate to be 2-3% per year and the long term growth rate to be 1%.

In the Russian steel segment we expect the growth rate of cash costs per tonne to be twice as high as the growth rate of finished products prices. In the Severstal North America segment we assume the growth rate of cash costs per tonne and finished product prices to be equal.



## Severstal: main assumptions

		2009A	2010A	2011E	2012E	2013E	2014E	2015E	2016E
<b>Russian steel</b>									
HRC	\$/tonne	453	582	690	744	768	787	806	816
	change y-o-y		28%	19%	8%	3%	2%	2%	1%
CRC	\$/tonne	504	656	825	891	920	943	966	978
	change y-o-y		30%	26%	8%	3%	2%	2%	1%
Galvanized products	\$/tonne	719	839	998	1152	1176	1196	1215	1225
	change y-o-y		17%	19%	15%	2%	2%	2%	1%
Cash costs of final products	\$/tonne	537	658	773	880	943	985	995	1021
	change y-o-y		23%	17%	14%	7%	4%	1%	3%
<b>North America</b>									
HRC	\$/tonne			825	853	880	902	924	935
	change y-o-y				3%	3%	2%	2%	1%
CRC	\$/tonne			938	969	1000	1025	1050	1063
	change y-o-y				3%	3%	2%	2%	1%
Galvanized products	\$/tonne			1013	1046	1080	1107	1134	1148
	change y-o-y				3%	3%	2%	2%	1%
Cash costs of final products	\$/tonne			859	893	918	941	963	979
	change y-o-y				4%	3%	2%	2%	2%

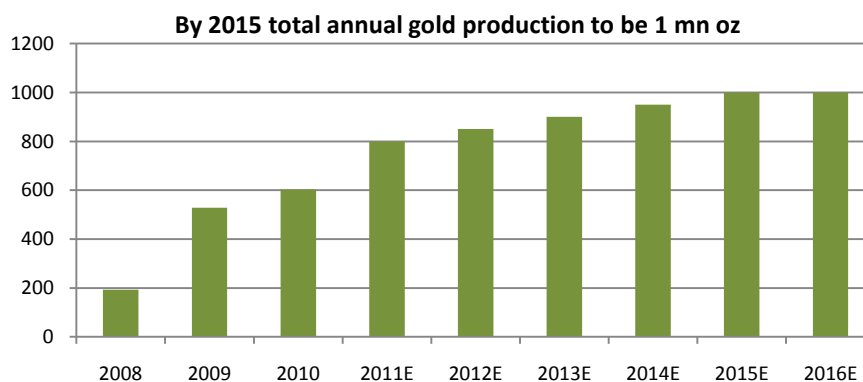
Source: Company data, Grandis Capital estimates

- Gold mining segment – a safe haven in case of global instability in the financial markets

Severstal has succeeded in building its gold business in recent years. The company has consolidated 8 mining assets of High River Gold, Celtic and Semgeo, Neryungri-Metallik and Aprelkovo, Crew Gold located in Kazakhstan, Russia, Burkina Faso and Guinea. These deposits are consolidated in Nordgold which is a subsidiary of Severstal.

Thanks to organic growth and acquisitions of gold mining assets, total gold production increased from 193 koz in 2008 to 603 koz in 2010. We expect the company's gold production will increase by 33% y-o-y to 800 koz in 2011 and the level of production will reach 1 mn ounces per year by 2015.

## Severstal: gold production, koz

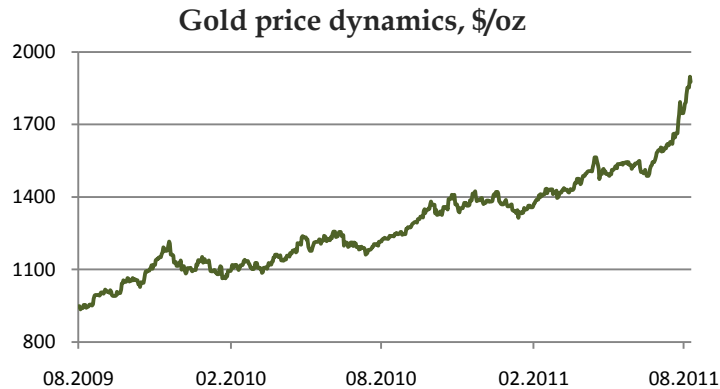


Source: Company data, Grandis Capital estimates



Over the last two years gold prices have almost doubled – from a price of USD900 per ounce the price of gold has reached USD1910 per ounce. Recent growth in gold prices has been triggered by the soft monetary policies of central banks worldwide in recent years, the debt crisis in the European Union, and concerns about the level of government debt in the U.S.

Historically gold has been perceived by investors as a safe haven and the increased volatility in financial markets has only contributed to the increase in demand for the precious metal.



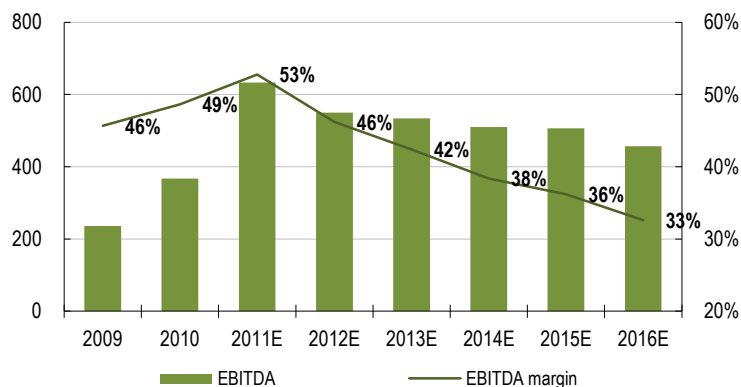
Source: Bloomberg

We believe that the price of gold by the end of this year will be in the range of \$ 1600-1700 an ounce. This corresponds to an average price of USD1500 per ounce in 2011, which is 22% y-o-y higher.

Nevertheless, the level of \$ 1600-1700, in our opinion, is overpriced, so we expect a lower price in 2012. We forecast that the average price of gold will be USD1400 per ounce that is 15-20% lower of the current quotes. We also consider USD1400 per ounce as a long term target for gold.

This year we expect that EBITDA of the Severstal gold segment will grow by 72% y-o-y to USD633 mn. The main contribution to this growth will be the high level of gold prices (relative to previous years) and an increased volume of gold mined. In the period of 2012-2016 EBITDA profitability margins will gradually decrease due to growing in cash costs and the lack of increase in the gold prices in the foreseeable future.

**Nordgold: financials and forecasts, USD mn**



Source: Company data, Grandis Capital estimates



## Nordgold: main assumptions

Nordgold		2009A	2010A	2011E	2012E	2013E	2014E	2015E	2016E
Gold price	\$/ounce	982	1226	1500	1400	1400	1400	1400	1400
change	y-o-y		25%	22%	-7%	0%	0%	0%	0%
Cash costs of gold production	\$/ounce	532	643	709	753	807	863	894	944
change	y-o-y		21%	10%	6%	7%	7%	4%	6%

Source: Company data, Grandis Capital estimates

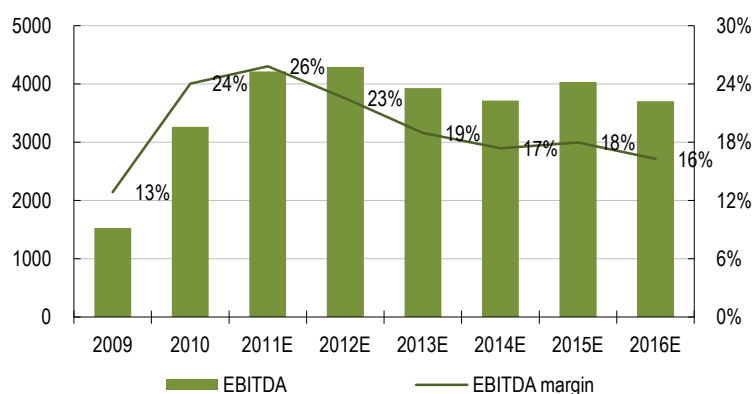
- We expect strong growth in Severstal financials in 2011

We expect that this year will be successful for Severstal due to the growth in final products prices and a high degree of vertical integration (helping curb soaring raw materials costs).

Severstal revenue will grow by 20% y-o-y in 2011, EBITDA will increase by 29% y-o-y to USD 4.2 bn, and net income will be USD 1.8 bn (positive for the first time in 2 years).

We also note that Severstal has completed the restructuring of its North America assets and, by the end of this year, will complete an extensive investment program aimed at improving the operating efficiency of the Columbus and Dearborn plans. These steps will allow the North American assets to show positive EBITDA both this year as well as in the period of 2012-2016.

## Severstal: financials and forecasts, USD mn



Source: Company data, Grandis Capital estimates

In the medium term we expect a gradual decrease in the company's profitability due to more rapid growth in cash costs compared with an increase in finished product prices.



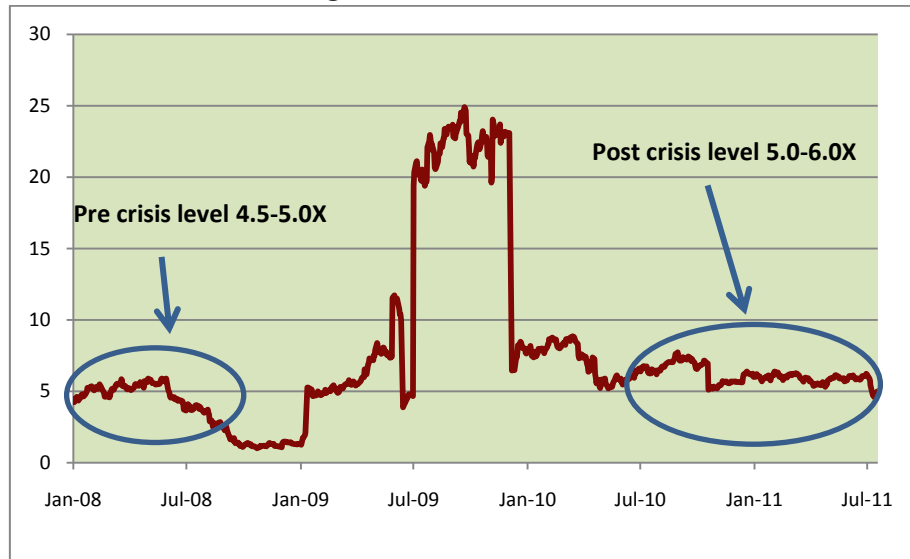
- Our target price - an average of estimates made by DCF and multiples methods

We estimate the fair value of Severstal stocks using an average of the estimates made by the discounted cash flows (DCF) and multiples methods.

As a basic multiplier, we propose using the leading EV/EBITDA. (EBITDA is a Bloomberg consensus for first estimated fiscal year.)

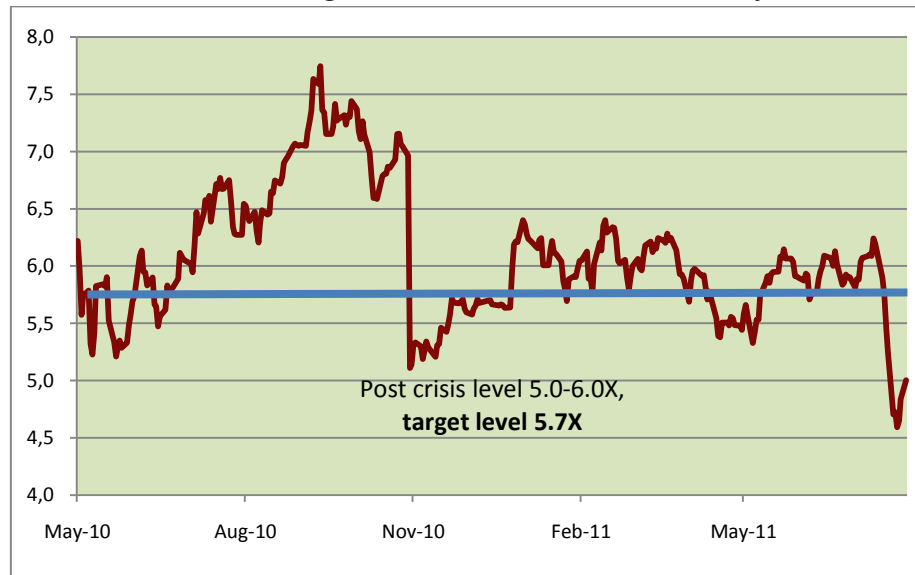
- We target leading EV/EBITDA at 5.7X.

**Severstal: leading EV/EBITDA estimate from Jan 2008**



Source: Bloomberg, Grandis Capital estimates

**Severstal: leading EV/EBITDA estimate from May 2010**



Source: Bloomberg, Grandis Capital estimates



Historically, the market priced Severstal stocks in terms of leading EV/EBITDA in the range of 5.0-6.0X. As the target level for this multiplier, we propose to take the value of 5.7X.

We construct our DCF model to include 2016. We assume the terminal growth rate to be 3.5% and the discount rate WACC to be 11.2%.

### Severstal: discounted cash flow model (DCF)

USD mn		2009A	2010A	2011E	2012E	2013E	2014E	2015E	2016E
Revenue		11872	13573	16337	19068	20705	21357	22467	22715
EBITDA		1529	3263	4217	4295	3930	3715	4037	3702
margin %		13%	24%	26%	23%	19%	17%	18%	16%
EBIT		577	2498	3388	3425	3018	2781	3078	2745
Taxes		115	500	678	685	604	556	616	549
NOPAT		461	1999	2710	2740	2414	2225	2462	2196
+ Depreciation		952	765	829	870	912	934	959	957
- CAPEX		-1073	-1366	-2042	-2096	-1952	-1355	-1429	-917
Change in working capital		1622	631	-833	-638	-443	-186	-217	-108
FCF		1963	2028	664	876	931	1618	1775	2128

WACC Calculation	
Terminal growth rate	3.5%
Cost of Equity	12.4%
After tax cost of debt	6.4%
Debt/(Debt+Equity)	20%
<b>WACC</b>	<b>11.2%</b>
DCF	5789
Terminal value	28465
Discounted terminal value	16714
Total DCF	22502
Net Debt of 31/12/10	4259
Equity value (common shares)	18244
Number of common shares, mn	1007.7
<b>Target price by the end of 2011, \$</b>	<b>18.1</b>

Sensitivity analysis								
		Discount rate (WACC)						
		9.7%	10.2%	10.7%	11.2%	11.7%	12.2%	12.7%
Terminal growth rate (%)	5.0%	31.2	27.7	24.8	22.4	20.3	18.6	17.0
	4.5%	28.2	25.3	22.8	20.8	19.0	17.4	16.0
	4.0%	25.8	23.3	21.2	19.3	17.7	16.3	15.1
	3.5%	23.8	21.6	19.7	18.1	16.7	15.4	14.3
	3.0%	22.0	20.1	18.5	17.0	15.7	14.6	13.6
	2.5%	20.5	18.9	17.4	16.1	14.9	13.9	12.9
	2.0%	19.2	17.7	16.4	15.2	14.1	13.2	12.3

Source: Company data, Grandis Capital estimates

- The fair value of Severstal stocks by the end of 2011r. is USD18.9 per share

Taking into account our estimates of the Severstal fair value made by the multiples and DCF methods our target price for the company's stock at the end of 2011 is USD18.9 per share - that implies a 28% upside potential to the current price.

Multiples valuation, EV/EBITDA 5.7X, USD/share	Weight 0.5	19.7
DCF valuation, USD/share	Weight 0.5	18.1
<b>Fair value by the end of 2011, USD/share</b>		<b>18.9</b>
<b>Upside</b>		<b>28%</b>

Source: Grandis Capital estimates



## Severstal: financial performance under IFRS and forecasts, USD mn

P&L	2007A	2008A	2009A	2010A	2011E	2012E	2013E	2014E	2015E	2016E
<b>Sales</b>	<b>15245</b>	<b>23211</b>	<b>11872</b>	<b>13573</b>	<b>16337</b>	<b>19068</b>	<b>20705</b>	<b>21357</b>	<b>22467</b>	<b>22715</b>
Operational expenses	11600	17632	10343	10310	12121	14773	16776	17641	18430	19013
Depreciation & Amortization	803	1103	957	786	829	870	912	934	959	957
Operating profit	2807	4476	571	2477	3388	3425	3018	2781	3078	2745
<b>EBITDA</b>	<b>3645</b>	<b>5579</b>	<b>1529</b>	<b>3263</b>	<b>4217</b>	<b>4295</b>	<b>3930</b>	<b>3715</b>	<b>4037</b>	<b>3702</b>
Net interest expenses	159	350	497	527	466	435	411	389	340	304
Other expenses (income)	73	1538	1175	262	100	0	0	0	0	0
Profit before taxes	2576	2588	-1101	1914	2822	2990	2607	2393	2738	2441
Profit tax	700	520	18	487	706	598	521	479	548	488
Minority interest	27	34	-82	62	92	104	91	83	95	85
<b>Net profit</b>	<b>1849</b>	<b>2034</b>	<b>-1037</b>	<b>-577</b>	<b>1825</b>	<b>2288</b>	<b>1995</b>	<b>1831</b>	<b>2095</b>	<b>1868</b>
<b>BS</b>	<b>2007A</b>	<b>2008A</b>	<b>2009A</b>	<b>2010A</b>	<b>2011E</b>	<b>2012E</b>	<b>2013E</b>	<b>2014E</b>	<b>2015E</b>	<b>2016E</b>
Cash and cash equivalents	2289	3472	2949	2025	1652	1324	955	1362	2408	3769
Accounts receivable	1816	2006	1484	980	1483	1731	1880	1939	2040	2062
Inventories	2721	4279	2974	2367	3140	3827	4345	4570	4774	4925
Other current assets	1366	936	777	4195	887	1067	1195	1249	1308	1341
Property, plant and equipment	8289	9868	9485	7352	8565	9791	10831	11252	11722	11683
Other non-current assets	1120	1919	1974	2409	2984	3411	3774	3920	4084	4070
<b>Total assets</b>	<b>17601</b>	<b>22480</b>	<b>19644</b>	<b>19329</b>	<b>18711</b>	<b>21151</b>	<b>22979</b>	<b>24292</b>	<b>26336</b>	<b>27849</b>
Accounts payable	1303	1599	1395	914	1357	1654	1879	1976	2064	2129
Short-term debt	1129	1978	1478	1422	1222	1142	1062	982	982	982
Other current liabilities	1060	1192	955	4019	1191	1515	1780	1910	2055	2102
Long-term debt	2813	6278	5749	4720	4420	4100	3780	3460	3460	3460
Other non-current liabilities	1221	1880	1691	934	1420	1807	2123	2277	2450	2507
Equity	10074	9554	8376	7320	9100	10932	12355	13687	15325	16669
<b>Total liabilities and equity</b>	<b>17601</b>	<b>22480</b>	<b>19644</b>	<b>19329</b>	<b>18711</b>	<b>21151</b>	<b>22979</b>	<b>24292</b>	<b>26336</b>	<b>27849</b>
<b>Cash flow statement</b>	<b>2007A</b>	<b>2008A</b>	<b>2009A</b>	<b>2010A</b>	<b>2011E</b>	<b>2012E</b>	<b>2013E</b>	<b>2014E</b>	<b>2015E</b>	<b>2016E</b>
Operating profit	2807	4476	571	2477	3388	3425	3018	2781	3078	2745
Income tax expense	700	520	18	487	706	598	521	479	548	488
Depreciation and amortization	803	1103	957	786	829	870	912	934	959	957
Change NWC	-726	-1452	1622	631	-833	-638	-443	-186	-217	-108
Other operating expenses	-211	-177	1025	1620	0	0	0	0	0	0
<b>Operating CF</b>	<b>2236</b>	<b>3434</b>	<b>1611</b>	<b>1259</b>	<b>2213</b>	<b>2624</b>	<b>2554</b>	<b>2662</b>	<b>2933</b>	<b>2802</b>
CAPEX	-2437	-5099	-1073	-1366	-2042	-2096	-1952	-1355	-1429	-917
Other investing CF	337	288	819	-133	0	0	0	0	0	0
<b>Operating CF net of Investing CF</b>	<b>136</b>	<b>-1377</b>	<b>1357</b>	<b>-240</b>	<b>171</b>	<b>528</b>	<b>602</b>	<b>1307</b>	<b>1503</b>	<b>1884</b>
Change in total debt inflow	937	4313	-1029	-1085	-500	-400	-400	-400	0	0
Dividends	736	1347	116	130	44	456	572	499	458	524
Other financing outflow	491	1390	1052	-822	0	0	0	0	0	0
<b>Free CF</b>	<b>-154</b>	<b>200</b>	<b>-840</b>	<b>-633</b>	<b>-373</b>	<b>-328</b>	<b>-370</b>	<b>408</b>	<b>1045</b>	<b>1361</b>

Source: Company data, Grandis Capital estimates

**Severstal: multiples comparison**

Company	Ticker	MCap USD mn	EV USD mn	P/E			EV/EBITDA			EV/Sales		
				2010	2011 E	2012 E	2010	2011 E	2012 E	2010	2011 E	2012 E
MMK	magn rx	6946	9786	19.3	8.3	5.4	6.3	4.6	3.5	1.2	0.9	0.7
Evraz	evr li	10408	17592	neg	7.8	5.7	7.3	5.2	4.6	1.4	1.1	1.0
NLMK	nlmk rx	16451	17905	12.9	8.7	6.2	7.5	5.6	4.0	2.2	1.6	1.2
Mechel	mtl us	7218	14376	10.2	4.7	4.4	7.3	4.4	4.0	1.5	1.1	1.0
<b>Average</b>				<b>14.1</b>	<b>7.4</b>	<b>5.4</b>	<b>7.1</b>	<b>4.9</b>	<b>4.0</b>	<b>1.6</b>	<b>1.2</b>	<b>1.0</b>
<b>Severstal</b>	<b>chmf rx</b>			<b>neg</b>	<b>8.1</b>	<b>6.5</b>	<b>5.9</b>	<b>4.5</b>	<b>4.4</b>	<b>1.4</b>	<b>1.2</b>	<b>1.0</b>
	premium(discount)				10%	20%	-17%	-8%	10%	-10%	-2%	0%
<b>Emerging markets</b>												
Usiminas	usim5 bz	11288	13214	13.5	39.4	20.8	7.8	13.6	8.5	1.7	1.6	1.3
Gerdau	ggbr4 bz	12862	20388	10.3	10.4	8.1	6.2	6.7	5.4	1.1	0.9	0.9
CSN	csna3 bz	12582	18516	7.0	6.9	6.6	4.8	4.6	4.1	2.1	1.8	1.6
POSCO	ks	31653	36960	8.1	7.2	6.4	5.0	4.4	3.9	0.8	0.6	0.5
	004020											
Hyundai	KS	7763	13690	9.3	7.4	6.5	10.6	7.1	6.3	1.5	1.0	0.9
	600019											
Baoshan Steel	CH	14345	22819	7.5	7.4	5.8	4.6	4.7	3.9	0.8	0.6	0.6
China Steel	2002 TT	14563	16871	11.9	16.0	13.2	7.7	7.8	7.0	1.4	1.1	1.0
Tata Steel	tata is	10009	20467	neg	7.0	6.7	13.0	6.0	5.9	1.0	0.8	0.8
Steel Authority of India Ltd (India)	SAIL IN	9989	8853	7.0	8.2	8.7	4.0	4.7	4.6	1.0	0.9	0.8
<b>Average</b>				<b>9.3</b>	<b>12.2</b>	<b>9.2</b>	<b>7.1</b>	<b>6.6</b>	<b>5.5</b>	<b>1.3</b>	<b>1.0</b>	<b>0.9</b>
<b>Severstal</b>	<b>chmf rx</b>			<b>neg</b>	<b>8.1</b>	<b>6.5</b>	<b>5.9</b>	<b>4.5</b>	<b>4.4</b>	<b>1.4</b>	<b>1.2</b>	<b>1.0</b>
	premium(discount)				-33%	-30%	-17%	-31%	-19%	12%	13%	6%
<b>Developed markets</b>												
Nippon Steel	5401 jt	19662	34812	neg	15.9	12.4	10.9	6.0	5.9	0.9	0.7	0.6
JFE Holdings	5411 jt	13540	31352	42.1	14.1	13.2	8.6	5.9	6.1	1.0	0.8	0.7
Nucor Corp.	nue us	9964	11778	87.4	11.6	8.5	12.1	5.5	4.4	0.7	0.6	0.5
ThyssenKrupp	tka gr	15670	20260	16.3	11.1	6.7	4.9	3.8	3.0	0.4	0.3	0.3
United States Steel	x us	3683	6868	neg	11.6	5.1	13.0	5.1	3.4	0.4	0.3	0.3
ArcelorMittal	mt us	30500	50203	8.9	7.3	4.9	5.8	4.4	3.7	0.6	0.5	0.5
Voestalpine AG	VOE AV	6264	10897	53.2	9.0	5.9	8.8	4.9	4.1	1.0	0.7	0.6
<b>Average</b>				<b>41.6</b>	<b>11.5</b>	<b>8.1</b>	<b>9.2</b>	<b>5.1</b>	<b>4.4</b>	<b>0.7</b>	<b>0.6</b>	<b>0.5</b>
<b>Severstal</b>	<b>chmf rx</b>			<b>neg</b>	<b>8.1</b>	<b>6.5</b>	<b>5.9</b>	<b>4.5</b>	<b>4.4</b>	<b>1.4</b>	<b>1.2</b>	<b>1.0</b>
					-30%	-20%	-36%	-11%	2%	93%	108%	98%

Source: Bloomberg, Grandis Capital estimates

We see EV/EBITDA and P/E for 2011 and 2012 as the most reasonable multiples in terms of multiple comparisons for Severstal.

EV/EBITDA 2011 implies a discount of 8%, 31% and 11% in the Russian market, emerging markets and developed markets peers. EV/EBITDA 2012 assumes a discount of 19% in emerging markets. P/E 2011 and 2012 implies a discount of 20-30% in emerging markets and developed markets.



- **Gold segment (Nordgold) IPO - mid-term growth driver.**

At the beginning of 2011 Severstal attempted to hold an IPO of Nordgold, but due to weak interest from investors the IPO did not happen. We believe that a successful IPO will have a positive impact on Severstal capitalization.

In our view the market historically has estimated the financial contribution of the Severstal gold segment in terms of EBITDA using a multiple leading EV/EBITDA 5.7X, but estimates of the gold business of comparable analogs is significantly higher. In terms of EV/EBITDA Russian counterparts trade with the value of 8.3X, and international counterparts trade with the value of 9.4X.

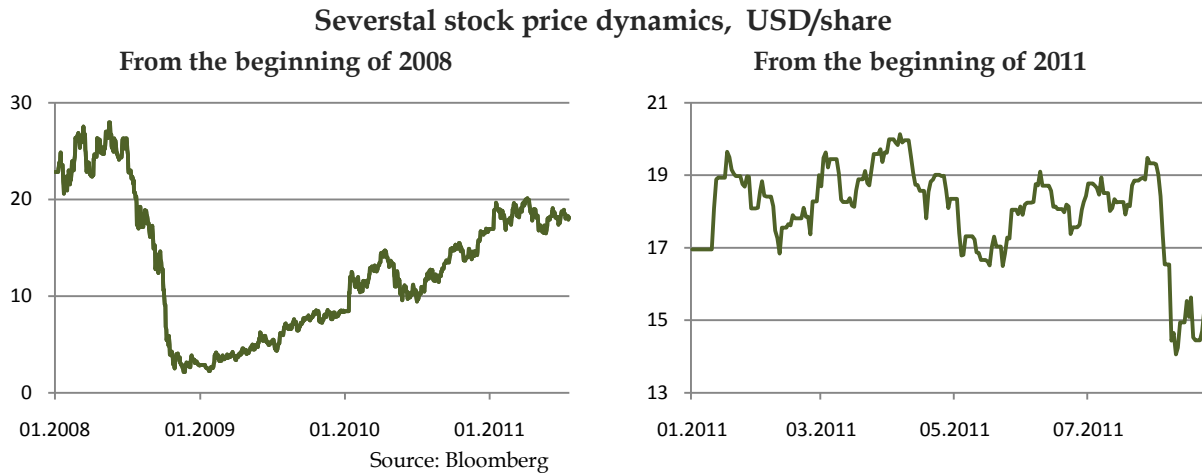
Taking into account this comparative valuation, we believe that the fair value of leading EV/EBITDA for Nordgold is 8.9X.

In the case of a Nordgold IPO, increasing the multiplier to 3.2X and using an estimated EBITDA 2011 of USD633 mn, the capitalization of Severstal will grow by at least USD2 bn or USD2 per share.

**Thus, in the event of a successful IPO of Nordgold at the end of this year, the view the target price of Severstal stocks as \$ 20.9 per share by the end of 2011.**

Company	Ticker	MCap USD mn	EV USD mn	P/E			EV/EBITDA			EV/Sales		
				2010	2011 E	2012 E	2010	2011 E	2012 E	2010	2011 E	2012 E
<b>Russian peers</b>												
Polyus Gold	PLZL LI	11636	11335	16.7	12.7		10.4	9.1		5.0	4.0	
Polymetal	PMTL LI	8638	9318	36.2	17.2	12.6	22.4	12.2	9.2	10.1	6.4	5.1
Highland Gold Mining	HGM LN	1065	880	13.5	8.9	8.4	7.6	5.1	4.7	3.6	2.8	2.5
Petropavlovsk	POG LN	2498	2669	17.1	10.2	10.0	11.2	5.6	5.4	4.1	2.6	2.3
<b>Average</b>				<b>22.3</b>	<b>13.2</b>	<b>10.9</b>	<b>13.8</b>	<b>8.3</b>	<b>7.1</b>	<b>5.9</b>	<b>4.2</b>	<b>3.5</b>
<b>International peers</b>												
Barrick Gold	ABX CN	52261	54985	16.3	11.0	9.9	9.2	6.3	5.5	5.1	3.9	3.5
Goldcorp	GG US	44147	44298	43.8	24.2	18.9	20.6	13.9	10.7	12.1	8.2	6.6
Newmont Mining	NEM US	31070	31342	16.3	13.7	12.3	6.1	5.8	5.3	3.3	3.0	2.8
Newcrest Mining	NCM AU	32572	33230	55.2	29.9	21.7	27.5	15.0	11.3	13.6	7.7	6.3
Kinross Gold	K CN	20120	19156	36.0	21.0	15.8	12.2	9.1	7.5	6.4	4.8	4.2
AngloGold Ashanti	ANG SJ	17554	19678	35.4	14.2	11.3	9.8	6.8	5.9	3.7	3.1	2.7
Gold Fields	GFI SJ	12161	13671	22.1	13.7	10.8	7.7	5.7	5.2	3.1	2.5	2.2
Minas Buenaventura	BVN PE	12453	11859	19.3	12.9	12.0	26.0	8.8	9.2	11.1	7.5	6.9
Zijin Mining	2899 HK	16872	17343	22.2	17.6	15.6	13.0	10.2	8.7	4.3	3.6	3.2
Agnico Eagle Mines	AEM CN	11588	12036	40.0	30.6	20.3	18.1	13.3	9.3	8.3	6.3	5.2
Yamana Gold	YRI CN	12064	12220	28.9	16.2	14.1	14.1	8.8	7.7	7.4	5.4	4.8
<b>Average</b>				<b>30.5</b>	<b>18.6</b>	<b>14.8</b>	<b>14.9</b>	<b>9.4</b>	<b>7.8</b>	<b>7.1</b>	<b>5.1</b>	<b>4.4</b>

Source: Bloomberg, Grandis Capital estimates



- **Instability in the financial market may harm the overall economy.**

Since mid-July there has been a serious correction in the financial markets - the S&P500 index fell by 17%, FTSE100 index fell by 15%, RTS and MICEX indexes decreased by 16- 20%.

Shares in the metallurgical sector are characterized by high sensitivity to fluctuations in the financial markets. Severstal is no an exception. Since the end of July the company's share price has fallen 20%.

In our view, if the uncertainty and volatility in financial markets persist until the second half of September, it could have a negative effect on the level of demand for steel products in both the Russian market and major export markets of Severstal.

We consider the scenario where instability and increased volatility in the financial markets increase concerns about the prospects for the world economy, which then leads to a drop in demand for steel products.

In the crisis period 2008-2009 the reduction in sales prices for Severstal products on the Russian segment amounted to 38-50% (the decrease of an average prices in 2009 relative to an average prices in 2008), and reduction of finished products sales was about 5% (the flat-rolled products sales declined by 11%)

In Severstal North America 2009 realized prices decreased by 27-38% y-o-y, sales volumes were almost flat y-o-y.

- **In the case of a negative scenario a decrease in Severstal sales prices for finished products in 2012 might be in the range of 15-28% y-o-y.**

We consider a scenario where the development of the crisis leads to a decrease in sales prices and production volumes from the 4th quarter of this year. In this scenario we assume a drop in steel products prices for Severstal's Russian Steel division in 2012 in the range of 15-28% y-o-y, and by 20% y-o-y in Severstal's North America division. We also assume a decrease of sales volumes in 2012 - by 5% y-o-y on the Russian Steel and 16% in the North America division.

At the same time, we expect cash costs to decrease in a negative scenario due to the ruble's depreciation and a drop in prices for raw materials.



In the case of a crisis we believe that gold prices will remain at high levels, and a decrease in operating profit in the main business will be partially offset by increased profitability of the gold mining segment. We expect average gold prices to be USD1585 per ounce in 2011 (USD1500 in a basic scenario), and USD1600 per ounce in 2012 (USD1400 in a basic scenario). The long-term level of USD1400 remains unchanged.

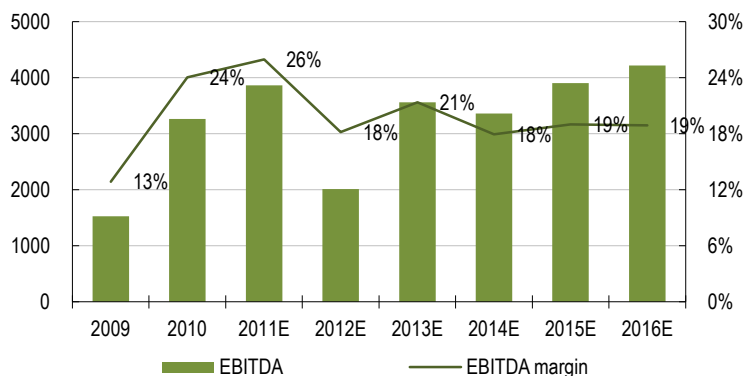
### Severstal: main assumptions in case of a crisis scenario

		2008A	2009A	2010A	2011E	2012E	2013E	2014E	2015E	2016E
<b>Russian steel</b>										
HRC	\$/tonne	908	453	582	690	510	663	724	785	857
	change y-o-y		-50%	28%	19%	-26%	30%	9%	8%	9%
CRC	\$/tonne	910	504	656	800	578	748	817	886	966
	change y-o-y		-45%	30%	22%	-28%	29%	9%	8%	9%
Galvanized products	\$/tonne	1153	719	839	950	808	956	1010	1065	1128
	change y-o-y		-38%	17%	13%	-15%	18%	6%	5%	6%
Cash costs of final products	\$/tonne	879	537	658	755	641	769	876	926	1014
	change y-o-y		-39%	23%	15%	-15%	20%	14%	6%	10%
<b>North America</b>										
HRC	\$/tonne				725	578	715	781	847	924
	change y-o-y					-20%	24%	9%	8%	9%
CRC	\$/tonne				794	633	780	852	924	1008
	change y-o-y					-20%	23%	9%	8%	9%
Galvanized products	\$/tonne				857	683	842	920	998	1089
	change y-o-y					-20%	23%	9%	8%	9%
Cash costs of final products	\$/tonne				821	667	752	804	843	899
	change y-o-y					-19%	13%	7%	5%	7%

<b>Nordgold</b>		2009A	2010A	2011E	2012E	2013E	2014E	2015E	2016E
Gold price	\$/ounce	982	1226	1585	1600	1500	1400	1400	1400
	change y-o-y		25%	29%	1%	-6%	-7%	0%	0%
Cash costs of gold production	\$/ounce	532	643	681	671	718	769	807	868
	change y-o-y		21%	6%	-1%	7%	7%	5%	8%

Source: Company data, Grandis Capital estimates

In a crisis scenario, we assume that the recovery in the market would begin in the second half of 2012, and that Severstal continues implementation of its major investment projects.

**Severstal: financials and forecasts in the case of a crisis scenario, USD mn**

Source: Company data, Grandis Capital estimates

We forecast that EBITDA of Severstal will amount to USD3.9 bn in 2011, that is 18% more than the previous year, but in 2012 EBITDA will decrease by almost in 2 times y-o-y to USD2 bn.

- In the negative scenario our target price for Severstal stocks is USD13.1 per share

In the negative scenario we estimate the fair value of Severstal using DCF and multiples methods.

**Severstal: discounted cash flows model in the negative scenario**

USD mn	2009A	2010A	2011E	2012E	2013E	2014E	2015E	2016E
Revenue	11872	13573	14884	11078	16678	18720	20542	22344
EBITDA	1529	3263	3866	2014	3561	3358	3906	4219
margin %	13%	24%	26%	18%	21%	18%	19%	19%
EBIT	577	2498	3043	1156	2662	2442	2970	3282
Taxes	115	500	609	231	532	488	594	656
NOPAT	461	1999	2434	925	2130	1954	2376	2625
+ Depreciation	952	765	823	858	899	916	937	937
- CAPEX	-1073	-1366	-1935	-1946	-2021	-1243	-1329	-941
Change in working capital	1622	631	-538	633	-1104	-516	-353	-383
FCF	1963	2028	784	470	-97	1112	1631	2238

WACC Calculation	
Terminal growth rate	3.5%
Cost of Equity	13.3%
After tax cost of debt	8.0%
Debt/(Debt+Equity)	20%
<b>WACC</b>	<b>12.3%</b>
DCF	4192
Terminal value	26397
Discounted terminal value	14795
Total DCF	18987
Net Debt of 31/12/10	4259
Equity value (common shares)	14729
Number of common shares, mn	1007.7
<b>Target price by the end of 2011, \$</b>	<b>14.6</b>

Sensitivity analysis							
Discount rate (WACC)							
Terminal growth rate (%)	10.8%	11.3%	11.8%	12.3%	12.8%	13.3%	13.8%
5.0%	24.3	21.8	19.7	17.9	16.3	14.9	13.7
4.5%	22.3	20.1	18.3	16.7	15.3	14.0	12.9
4.0%	20.5	18.7	17.0	15.6	14.3	13.2	12.2
3.5%	19.1	17.4	15.9	<b>14.6</b>	13.5	12.4	11.5
3.0%	17.7	16.3	14.9	13.8	12.7	11.8	10.9
2.5%	16.6	15.3	14.1	13.0	12.0	11.2	10.4
2.0%	15.6	14.4	13.3	12.3	11.4	10.6	9.9

Source: Company data, Grandis Capital estimates



In our DCF model we imply the terminal growth rate to be 3.5% and the discount rate WACC to be 12.3% (in the main scenario WACC 11.2%).

We use leading EV/EBITDA for multiples valuation and take 5.7X as a target value for this multiple. As the EBITDA estimate we infer an average between estimates of EBITDA for 2012 (crisis value, USD2.0 billion) and 2013 (post-crisis value, USD3.6 billion). The average EBITDA is USD 2.8 bn.

- **Thus, in the case of a crisis scenario, our target price for Severstal at the end of 2011 is USD 13.1 per share**

Multiples valuation, EV/EBITDA 5.7X, USD/share	Weight 0.5	11.6
DCF valuation, USD/share	Weight 0.5	14.6
<b>Fair value by the end of 2011, USD/share</b>		<b>13.1</b>
<b>Upside</b>		<b>-11%</b>

- **Return to risk ratio gives a buy signal**

We see investments in Severstal stocks as the most attractive in terms of return to risk ratio. If the current instability in the financial markets does not lead to a recession, we see a fundamental upside potential of 28% for the company`s stocks. In case of a second wave of the crisis there is a fundamental downside potential of 11% for the company`s stocks.

Given the high liquidity of Severstal shares compared to other Russian steelmakers stocks and a low probability of the crisis scenario, we believe that Severstal shares are the most attractive investment idea in the Russian steel sector for a wide range of investors.



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