

ИНВЕСТИЦИОННАЯ КОМПАНИЯ

ГРАНДИС КАПИТАЛ



Обзор компаний

Экономика

Превью



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## Mechel: Preferred Shares Still Attractive BUY

**In this report we revise our estimates of both Mechel's financials and the target prices for its common and preferred shares. Our investment recommendations remain unchanged.**

Ticker NYSE	MTL MTL/P
Мсрп*, USD mn	5760
EV, USD mn	13 699
Number of common shares, mn.	416
Free float	33%
Number of preferred shares, mn.	139
Free float	41%

Common shares	Hold
Target price by the end of 2011, USD	32.6
Current price	11.99
Upside	172%

Preferred ADS:	BUY
Target price by the end of 2011, USD	10.0
Current price	4.62
Upside	116%

Financials, USD mn			
	2010A	2011E	2012E
Revenue	9746	13101	14742
EBITDA*	2015	2234	2830
Net profit	657	775	1092

Margins, %			
	2010A	2011E	2012E
EBITDA* margin	21%	17%	19%
Net profit margin	7%	6%	7%

Multiples			
	2010A	2011E	2012E
EV/S	1.4	1.0	0.9
EV/EBITDA*	6.8	6.1	4.8
P/E	8.8	7.4	5.3

Dividends, USD per share			
for the year	2010A	2011E	2012E
Common shares	0.32	0.28	0.39
Preferred ADS	0.47	0.56	0.79

Due to the fact that the company's 1H11 financial and production results were below our expectations, and that demand for metallurgical raw materials and steel products has fallen in 3Q11, we have lowered our estimates for Mechel EBITDA in 2011 by 21% to USD2.2 bn and the US GAAP consolidated net profit by 39% to USD775 mn.

We note that, in 2Q11, the company's EBITDA increased only by 4 q-o-q and that consolidated net profit decreased by 38% q-o-q. EBITDA growth was moderate relative to the 2Q11 results of Severstal and Evraz (+ 19-20% q-o-q), as well as those of NLMK (+ 43% q-o-q). This moderate growth is due to the weak financial results reported by Mechel's metallurgical segment.

**Mid-term profitability estimates are downgraded, but long-term estimates remain unchanged.** We have downgraded our EBITDA estimates for 2012-2013 by 12-15% and net profit estimates have decreased by 27-29%. This downgrade is based on large increases in the company's cash costs in 2011 compared to the previous year. While the long-term EBITDA estimates are unchanged, the estimates of consolidated net profit are downgraded by 8%.

**The dividend yield on preferred shares is expected to exceed 12%.** Mechel's Charter requires the payment 20% of US GAAP consolidated net profit on its preferred shares. Based on our lower estimates of net profit, we have lowered dividend estimates in 2011 by 39% to USD0.56 on preferred ADS as well. However, at the current price of ADS, the expected dividend yield may exceed 12%.

**Debt burden remains one of the highest in the sector.** We estimate Mechel's net debt at the end of 2011 to be USD8.4 bn, which is 20% higher than at the beginning of the year. We believe that Net Debt/EBITDA ratio will be above 3.5X by the end of 2011. Because of the expansive investment program planned for the next few years, the company is not expected to reduce this ratio below 3.0X before 2014. This fact makes investments in Mechel rather risky should market conditions in the metallurgical raw materials and steel products markets deteriorate.

**Preferred shares are still attractive due to an expected high dividend yield.** Mechel common shares are not as attractive due to a possible reduction in demand for the Mechel Mining IPO.

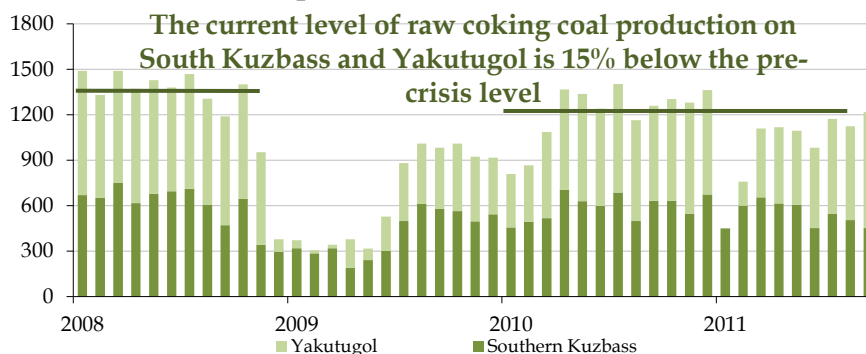
*We downgrade our common shares TP by 5% to USD32.6 per share, recommendation HOLD. We also downgrade our preferred ADS TP by 17% to USD10, recommendation BUY.*

\* We calculate Mechel market capitalization as a sum of common and preferred shares capitalization, excluding treasuries shares.



- Due to weak production results this year, raw coking coal production estimates for South Kuzbass and Yakutugol are lower.

### South Kuzbass and Yakutugol monthly raw coking coal production, th. tonnes



Source: Company Data, Grandis Capital estimates

- Mine production estimates for 2011 have been decreased by 5%. For 2012-2013 mine production estimates have been lowered by 10-17%.

### Mechel: South Kuzbass and Yakutugol raw coking coal production estimates

mn. tonnes	2011E	2012E	2013E	2014E	2015E	2016E
Raw coking coal production (new estimates)	12.8	15.0	17.5	20.0	20.0	20.0
Raw coking coal production (old estimates)	13.5	18.0	19.5	20.0	20.0	20.0
Difference between new and old estimates, %	-5%	-17%	-10%	0%	0%	0%

Source: Grandis Capital estimates

- Estimates for coking coal concentrate prices have increased slightly.

### Coking coal concentrate, USD per tonne

	2008	2009	2010	2011E	2012E	2013E	2014E	2015E
Coking coal concentrate (new estimates)	166	61	135	183	196	204	212	220
difference y-o-y, %		-63%	121%	36%	7%	4%	4%	4%
Coking coal concentrate (old estimates)	166	61	135	180	192	199	204	209
difference y-o-y, %		-63%	121%	34%	7%	4%	3%	2%
Difference between new and old estimates, %				1%	2%	2%	4%	5%

Source: Metal Expert, Grandis Capital estimates

\*Average between brands GZH, ZH и KO



- Due to weak 1H11 financial results, we lower our estimates of Mechel EBITDA in 2011 by 21% to USD2.2 bn and US GAAP consolidated net profit by 39% - down to USD775 mn. For 2012-2013 our EBITDA forecast is downgraded by 12-15% and the consolidated net profit estimate has decreased by 27-29%. The long-term EBITDA estimate has not changed, while the net profit estimate is downgraded by 8%.

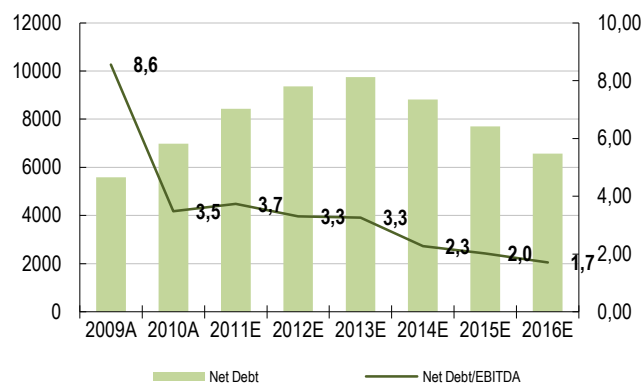
**Revise of financial estimates**

	2011E	2012E	2013E	2014E	2015E	2016E
EBITDA (new estimates)	2234	283	2991	3879	3817	3839
EBITDA (old estimates)	2817	3327	3382	3966	3960	3820
Difference between new and old estimates, %	-21%	-15%	-12%	-2%	-4%	0%
Net Profit (new estimates)	77	1092	1124	1732	1695	1712
Net Profit (old estimates)	127	154	1530	1958	1964	1869
Difference between new and old estimates, %	-39%	-29%	-27%	-12%	-14%	-8%

Source: Grandis Capital estimates

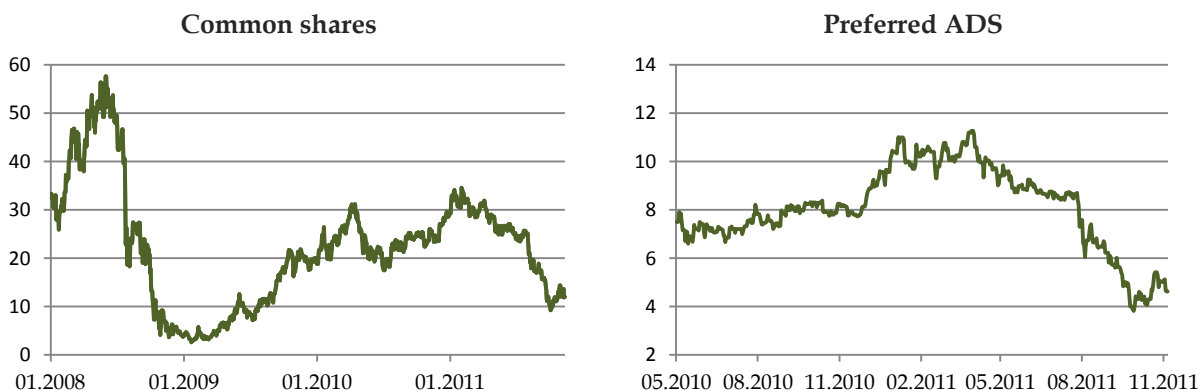
- We expect Mechel’s net debt level to be high in the mid-term. We estimate net debt to be in the range of USD8-10 bn, Net Debt/EBITDA 3.3-3.7X in 2011-2013. Net Debt/EBITDA ratio will move below the 3.0X level in 2014 when the company’s major investment projects are completed.

**Mechel: Net Debt, USD mn**



Source: Company Data, Grandis Capital estimates

**Share price dynamics, USD**



Source: Bloomberg



## Mechel: DCF model

USD mn		2009A	2010A	2011E	2012E	2013E	2014E	2015E	2016E
Revenue		5754	9746	13101	14742	16251	17878	18558	19336
EBITDA		687	2015	2234	2830	2991	3879	3817	3839
margin %		12%	21%	17%	19%	18%	22%	21%	20%
EBIT		246	1532	1709	2217	2334	3211	3151	3163
Taxes		49	306	342	443	467	642	630	633
NOPAT		196	1226	1367	1773	1867	2569	2521	2531
+ Depreciation		407	475	550	614	657	668	667	676
- CAPEX		-610	-990	-2187	-1822	-1480	-870	-650	-645
Change in working capital		127	-1246	-256	-440	-295	-262	-144	-157
FCF		120	-535	-526	125	748	2105	2393	2404

WACC Calculation	
Terminal growth rate	3.5%
Cost of Equity	14.6%
After tax cost of debt	7.2%
Debt/(Debt+Equity)	40%
<b>WACC</b>	<b>11.7%</b>
DCF	4624
Terminal value	30526
Discounted terminal value	17593
Total DCF	22217
Net Debt of 31/12/10	6978
Preferred shares	1665
Equity value (common shares)	13575
Number of common shares, mn	416.3
<b>Target price by the end of 2011, \$</b>	<b>32.6</b>

Sensitivity analysis								
		Discount rate (WACC)						
		10.2%	10.7%	11.2%	11.7%	12.2%	12.7%	13.2%
Terminal growth rate (%)	5.0%	63.6	55.5	48.7	42.9	37.9	33.6	29.9
	4.5%	56.8	49.9	44.0	39.0	34.6	30.8	27.4
	4.0%	51.2	45.2	40.1	35.6	31.7	28.2	25.1
	3.5%	46.4	41.2	36.6	<b>32.6</b>	29.1	26.0	23.1
	3.0%	42.3	37.6	33.6	30.0	26.8	23.9	21.3
	2.5%	38.7	34.5	30.9	27.6	24.7	22.1	19.7
	2.0%	35.5	31.8	28.5	25.5	22.9	20.4	18.2

Source: Company Data, Grandis Capital estimates

- The discounted cash flow model indicates an estimate of Mechel common shares at USD32.6 per share (TP was downgraded by 5% from USD34.4 per share), WACC is 11.7%



## Mechel: DDM

USD mn	2011A	2012E	2013E	2014E	2015E	2016E
Dividends on preferred shares	131	155	218	225	346	339

Calculation	
Terminal growth rate	3.5%
Cost of Equity	13.0%
Discounted dividend flow	993
Terminal value	3706
Discounted terminal value	1783
Equity value (preferred shares)	2775
Number of preferred shares (mn)	139
<b>Target price by the end of 2011, USD</b>	<b>20.0</b>
<b>Target price by the end of 2011 (ADS), USD</b>	<b>10.0</b>

		Sensitivity analysis						
		Discount rate (WACC)						
		11.5%	12.0%	12.5%	13.0%	13.5%	14.0%	14.5%
Terminal growth rate (%)	5.0%	14.0	13.0	12.1	11.3	10.6	10.0	9.5
	4.5%	13.3	12.3	11.5	10.8	10.2	9.6	9.1
	4.0%	12.6	11.8	11.0	10.4	9.8	9.3	8.8
	3.5%	12.0	11.2	10.6	<b>10.0</b>	9.5	9.0	8.6
	3.0%	11.5	10.8	10.2	9.6	9.2	8.7	8.3
	2.5%	11.0	10.4	9.8	9.3	8.9	8.5	8.1
	2.0%	10.6	10.0	9.5	9.0	8.6	8.2	7.9

Source: Company Data, Grandis Capital estimates

- The discounted dividend model indicates an estimate of Mechel preferred ADS at USD10.0 per ADS (TP is downgraded by 17% from USD12 per ADS) and a discount rate of 13%.

## Mechel: 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
Mechel*	mtl us	5760	13699	8.8	7.4	5.3	6.8	6.1	4.8	6.8	6.1	4.8
Raspadskaya	RASP RX	2369	2356	9.8	7.4	4.9	6.1	4.4	3.2	3.3	2.5	1.9
KTK	KBTK RX	530	586	18.8	7.4	5.9	8.1	4.7	3.4	1.2	0.8	0.7
<b>Average</b>				<b>12.5</b>	<b>7.4</b>	<b>5.3</b>	<b>7.0</b>	<b>5.1</b>	<b>3.8</b>	<b>3.8</b>	<b>3.2</b>	<b>2.5</b>
Severstal*	chmf rx	14688	18778	neg	8.0	6.4	5.8	4.5	4.4	1.4	1.1	1.0
NLMK	nlnk rx	13944	15398	11.0	8.0	5.9	6.5	6.0	4.0	1.9	1.4	1.1
MMK	magn rx	5090	7930	14.2	10.3	4.9	5.1	4.4	3.2	1.0	0.8	0.6
Evrz**	evrz li **	6085	13269	neg	5.2	4.6	5.5	4.2	4.1	1.0	0.8	0.8
<b>Average</b>				<b>-0.1</b>	<b>7.9</b>	<b>5.4</b>	<b>5.7</b>	<b>4.8</b>	<b>3.9</b>	<b>1.3</b>	<b>1.0</b>	<b>0.9</b>
BHP	BHP US	188698	194521	14.2	8.6	7.6	8.3	5.3	4.4	3.7	2.7	2.3
Teck	TCK US	21855	25995	11.8	8.5	8.1	5.9	4.7	4.4	2.8	2.3	2.2
Alpha	ANR US	5598	5798	23.5	19.6	12.6	7.4	4.5	3.2	1.5	0.8	0.7
Anglo American	AAL LN	50228	57266	10.1	7.5	6.7	5.0	4.0	3.6	2.0	1.7	1.5
Xstrata	XTA LN	47353	55103	9.2	7.5	6.5	5.5	4.4	3.9	1.9	1.6	1.5
Rio Tinto	RIO LN	110108	113980	7.8	6.4	6.3	4.4	3.9	3.7	2.0	1.8	1.7
Peabody	BTU US	10843	12298	13.7	9.9	7.4	6.7	5.6	4.3	1.8	1.5	1.3
Walter	WLT US	4417	4292	10.9	9.7	7.7	6.1	4.6	3.5	2.6	1.6	1.3
Patriot	PCX US	985	1247	neg	-9.1	13.7	12.4	7.1	3.6	0.6	0.5	0.5
<b>Average</b>				<b>12.7</b>	<b>7.6</b>	<b>8.5</b>	<b>6.8</b>	<b>4.9</b>	<b>3.8</b>	<b>2.1</b>	<b>1.6</b>	<b>1.4</b>

Source: Bloomberg, Grandis Capital estimates

\* Grandis Capital estimates

\*\* Without share of Raspadskaya



- Despite a significant decline in the market price of ordinary and preferred shares of Mechel since the beginning of this year, the company looks relatively expensive compared to its main peers – using the multiples approach.  
Due to the fact that, in the next 5 years, Mechel is going to implement an extensive program of capital expenditures, estimates of the company's share prices from DCF and DDM models, in our opinion, better reflect the fair value of Mechel than does the multipliers method.

### Mechel: financial performance under US GAAP and forecasts, USD mn

P&L	2007A	2008A	2009A	2010A	2011E	2012E	2013E	2014E	2015E	2016E
<b>Sales</b>	<b>6684</b>	<b>9951</b>	<b>5754</b>	<b>9746</b>	<b>13101</b>	<b>14742</b>	<b>16251</b>	<b>17878</b>	<b>18558</b>	<b>19336</b>
Operational expenses	4996	6931	5102	7740	10841	11912	13260	13999	14741	15497
Depreciation & Amortization	290	463	407	475	550	614	657	668	667	676
Operating profit	1398	2556	246	1532	1709	2217	2334	3211	3151	3163
<b>EBITDA</b>	<b>1659</b>	<b>2047</b>	<b>687</b>	<b>2015</b>	<b>2234</b>	<b>2830</b>	<b>2991</b>	<b>3879</b>	<b>3817</b>	<b>3839</b>
Net interest expenses	87	312	478	544	593	683	756	781	771	760
Other expenses (income)	-75	896	-327	19	-144	0	0	0	0	0
Profit before taxes	1385	1348	95	969	1260	1533	1578	2431	2379	2403
Profit tax	356	119	19	277	413	383	394	608	595	601
Minority interest	116	89	3	35	72	57	59	91	89	90
<b>Net profit</b>	<b>913</b>	<b>1141</b>	<b>74</b>	<b>657</b>	<b>775</b>	<b>1092</b>	<b>1124</b>	<b>1732</b>	<b>1695</b>	<b>1712</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	237	255	415	341	127	96	16	939	2055	3194
Accounts receivable	347	429	453	1211	1488	1843	2031	2235	2320	2417
Inventories	1007	1365	1036	1867	2086	2292	2551	2693	2836	2981
Other current assets	646	696	579	772	779	901	998	1074	1123	1176
Property, plant and equipment	5833	7708	9594	10385	12861	14070	14893	15095	15078	15048
Other non-current assets	1158	1556	1106	1200	1461	1598	1692	1715	1713	1709
<b>Total assets</b>	<b>9228</b>	<b>12010</b>	<b>13183</b>	<b>15776</b>	<b>18801</b>	<b>20799</b>	<b>22181</b>	<b>23750</b>	<b>25125</b>	<b>26525</b>
Accounts payable	350	822	644	987	1226	1347	1500	1583	1667	1753
Short-term debt	1135	5149	1923	2078	2062	2512	2662	2662	2662	2662
Other current liabilities	506	371	454	635	1107	1138	1170	1188	1208	1228
Long-term debt	2322	220	4074	5241	6497	6947	7097	7097	7097	7097
Other non-current liabilities	1410	1418	1758	1885	2341	2405	2473	2511	2555	2595
Equity	3505	4031	4331	4951	5568	6451	7280	8709	9936	11191
<b>Total liabilities and equity</b>	<b>9228</b>	<b>12010</b>	<b>13183</b>	<b>15776</b>	<b>18801</b>	<b>20799</b>	<b>22181</b>	<b>23750</b>	<b>25125</b>	<b>26525</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	1398	2556	246	1532	1709	2217	2334	3211	3151	3163
Income tax expense	356	119	19	277	413	383	394	608	595	601
Depreciation and amortization	290	463	407	475	550	614	657	668	667	676
Change NWC	-374	31	127	-1246	-256	-440	-295	-262	-144	-157
Other operating expenses	53	702	199	632	130	223	150	133	73	80
<b>Operating CF</b>	<b>905</b>	<b>2230</b>	<b>562</b>	<b>-147</b>	<b>1460</b>	<b>1784</b>	<b>2151</b>	<b>2876</b>	<b>3006</b>	<b>3001</b>
CAPEX	-3325	-3313	-610	-990	-2187	-1822	-1480	-870	-650	-645
Other investing CF	-85	12	-57	-129	0	0	0	0	0	0
<b>Operating CF net of Investing CF</b>	<b>-2505</b>	<b>-1071</b>	<b>-148</b>	<b>-1267</b>	<b>-727</b>	<b>-38</b>	<b>671</b>	<b>2006</b>	<b>2356</b>	<b>2356</b>
Change in total debt inflow	2968	1912	628	1321	1600	900	300	0	0	0
Dividends	318	468	208	23	210	209	295	304	468	458
Other financing outflow	80	355	112	105	593	683	756	781	771	760
<b>Free CF</b>	<b>64</b>	<b>18</b>	<b>160</b>	<b>-74</b>	<b>69</b>	<b>-30</b>	<b>-80</b>	<b>922</b>	<b>1117</b>	<b>1139</b>

Source: Company Data, Grandis Capital estimates



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