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Russian Federation

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Approximate date of commencement of proposed sale to the public: As soon as practicable after this registration statement becomes effective.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act, check the following box. "  "

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. "  \_\_\_\_\_

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. "  \_\_\_\_\_

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. "  \_\_\_\_\_

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. "  \_\_\_\_\_

**CALCULATION OF REGISTRATION FEE**

| Title of each class of securities to be registered              | Amount to be registered <sup>(1)</sup> | Proposed maximum offering price per unit <sup>(2)</sup> | Proposed maximum aggregate offering price <sup>(2)</sup> | Amount of registration fee <sup>(4)</sup> |
|---|--|---|--|---|
| Common shares, nominal value 10 rubles per share <sup>(3)</sup> | 47,871,135                             | \$8.00  | \$382,969,080  | \$48,522.18                               |

(1) Includes common shares that (a) are to be offered in the United States by the registrant, (b) are to be offered in the United States by the selling shareholders, (c) may be offered in the United States pursuant to an over-allotment option granted by the selling shareholders to the underwriters and (d) are to be initially sold outside the United States pursuant to Regulation S that may thereafter be resold in the United States in transactions required to be registered under the Securities Act. All common shares being offered will be in the form of American Depositary Shares.

(2) Estimated solely for purposes of calculating the registration fee.

(3) A separate registration statement on Form F-6 has been filed with respect to the registration of ADSs evidenced by American depositary receipts issuable upon the deposit of the common shares registered hereby.

(4) Previously paid.

**The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the registration statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.**

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**The information contained in this preliminary prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This preliminary prospectus is not an offer to sell these securities and is not soliciting an offer to buy these securities in any jurisdiction where the offer or sale is not permitted.**

PRELIMINARY PROSPECTUS

Subject to Completion

•, 2004

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## **13,875,691 American Depositary Shares**

### **Representing 41,627,073 Common Shares**

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Each American depositary share, or ADS, represents three common shares of Mechel Steel Group OAO, a public company with limited liability incorporated under the laws of the Russian Federation. We are selling 33,301,659 common shares in the form of ADSs, and the selling shareholders are selling 8,325,414 common shares in the form of ADSs. We will not receive any proceeds from the sale of common shares in the form of ADSs by the selling shareholders. The ADSs will be evidenced by American depositary receipts, or ADRs.

Upon completion of this offering, the principal and selling shareholders will own 85.95% of our shares. If the underwriters' over-allotment option is exercised in full, the principal and selling shareholders will own 84.45% of our shares.

Our common shares are listed for trading on the Russian Trading System, or RTS, under the symbol SGML. On September 20, 2004, the last reported sale price per common share on RTS was \$3.80, equivalent to a price of \$11.40 per ADS. Before this offering, there has been no public market for our ADSs, and the trading price of our common shares on RTS will not necessarily be related to the initial public offering price per ADS. We currently expect that the initial public offering price per ADS in the offering will be between \$• and \$•. The ADSs have been approved for listing on the New York Stock Exchange under the symbol MTL.

**This investment involves a high degree of risk. Please see Risk Factors beginning on page 10 for a discussion of those risks.**

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

|         |                 | Underwriting | Proceeds to | Proceeds to |
|---------|-----------------|--------------|-------------|-------------|
|         | Price to Public | Discounts    | Mechel      | Selling     |
| Per ADS | \$•             | \$•          | \$•         | \$•         |
| Total   | \$•             | \$•          | \$•         | \$•         |

The selling shareholders have granted the underwriters a 30-day option to purchase up to an additional 6,244,062 common shares in the form of ADSs at the public offering price per ADS, less the underwriting discount, solely to cover any over-allotments.

The proceeds of this offering will be held in escrow and escrow-type accounts, and trading in the ADSs on the New York Stock Exchange will be subject to cancellation until the placement report for the common shares being offered by us is registered by the Russian Federal Service for the Financial Markets. If the placement report is not registered within 60 days after the closing date (or such later date as we and the selling shareholders agree with the underwriters), we will refund the public offering price, together with interest, if any, to the holders of the ADSs at the time of such cancellation, regardless of the then-prevailing market price of the ADSs.

The underwriters expect to deliver the ADRs evidencing the ADSs to purchasers on or about •, 2004.

*Sole Global Coordinator and Sole Bookrunner*

## UBS Investment Bank

**JPMorgan**

**Morgan Stanley**

**Troika Dialog**

The date of this prospectus is •, 2004



You should rely only on the information contained in this document or to which we have referred you. We have not authorized anyone to provide you with different information. This document may only be used where it is legal to sell these securities. The information in this document is accurate only as of the date of this prospectus.

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Our business consists of two segments: steel and mining. References in this prospectus to segment revenues are to revenues of the segment excluding intersegment sales, unless otherwise noted.

In May 2004, we acquired a controlling stake in Izhstal OAO, a Russian specialty steel producer. For purposes of describing our market position in periods prior to May 2004 in this prospectus, we include Izhstal's market shares.

In this prospectus, references to "U.S. dollars" or "\$" are to the currency of the United States, and references to "rubles" are to the currency of the Russian Federation. The term "tonne" as used herein means a metric tonne. A metric tonne is equal to 1,000 kilograms or 2,204.62 pounds.

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This document is only being distributed to and is only directed at persons who are outside the United Kingdom or to investment professionals falling within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 (all such persons together being referred to as relevant persons ). The ADSs are only available to, and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such ADSs will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely on this document or any of its contents.

None of the ADSs has been or will be qualified by prospectus for sale to the public in Canada under applicable Canadian securities laws and, accordingly, any offer or sale of the ADSs in Canada will be made pursuant to an exemption from the applicable prospectus filing requirements, and otherwise in compliance with applicable Canadian laws. Canadian investors should refer to the section of this prospectus entitled Information for Canadian Investors, and Ontario purchasers in particular should refer to Underwriting Information for Canadian Investors Statutory Rights of Action (Ontario Purchasers).

In connection with this offering, UBS Limited or any person acting for UBS Limited may over-allot or effect transactions with a view to supporting the market price of the common shares or ADSs at a level higher than that which might otherwise prevail for a limited period after the issue date. However, there is no obligation on UBS Limited or its agent or agents to do this. Such stabilizing, if commenced, may be discontinued at any time, and must be brought to an end after a limited period.

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## Prospectus summary

*This summary highlights information that we present more fully elsewhere in this prospectus. Because it is a summary, it does not contain all of the information that you should consider before investing. You should read the entire prospectus carefully, including the information discussed in Risk Factors and Cautionary Note Regarding Forward-Looking Statements. Unless the context otherwise requires, references to Mechel, we, us or our refer collectively to Mechel Steel Group OAO and its subsidiaries. Certain steel- and mining-related terms used in this prospectus are defined in Glossary.*

### OUR COMPANY

We are a low-cost integrated steel and mining group focused on the production of steel long products, as well as mining products such as coal, iron ore and nickel. In 2003 and in the first half of 2004, we had revenues of \$2.05 billion and \$1.63 billion, respectively. We are the largest and most comprehensive producer of specialty steels and alloys in Russia, producing 52% of total Russian specialty steel output, over three times as much as our nearest competitor. We are also the second largest producer of long products in Russia.

Our steel business comprises the production and sale of semi-finished steel products, carbon and specialty long products, carbon and stainless flat products and value-added downstream metal products including hardware, stampings and forgings. Our steel business also produces significant amounts of coke, both for internal use and for sales to third parties.

We have substantial coal, iron ore and nickel mining interests in Russia and Kazakhstan, with the flexibility to supply our own steel production or sell to third parties depending on price differentials between purchases from local suppliers and sales to foreign and domestic customers. We are capable of internally sourcing all of the coking coal, 92% of the iron ore and 55% of the nickel requirements of our steel segment, assuming in the case of iron ore that third parties process certain quantities of our iron ore concentrate into sinter and pellets. In addition, we are the only specialty steel manufacturer in the world capable of internally sourcing all three of these raw materials. We were the second largest producer of coking coal in Russia in 2003, with a 12% market share. We also control 24% of the coking coal washing capacity in Russia.

Additionally, we own 17.1% of the common shares of Magnitogorsk Iron and Steel Works OAO, or MMK, Russia's largest producer of flat products, with reported revenues of \$3.05 billion and \$2.17 billion in 2003 and in the first half of 2004, respectively, under International Financial Reporting Standards.

### STRATEGY

Our goal is to expand our position in Russia as a leading supplier of carbon long products and as the leading supplier of specialty long products, to further develop our position as a competitive exporter of these products, to expand our mining business and to capitalize on the synergies deriving from our status as an integrated group. We also intend to leverage our core businesses, where appropriate, with acquisitions of value-added downstream businesses.

The key elements of our strategy include the following:

Ø *Expand our Position as a Leading Producer of Carbon Long Products in Russia.* We have already built a solid presence in this sector, including a market-leading position in engineering steel and strong sales in rebar and wire rod. We intend to improve these positions further, including through the addition of substantial new production capacity achieved by targeted, cost-effective capital expenditures. We plan to increase our raw steel and rolled steel production capacity from

6.3 million and 5.0 million tonnes in 2004, respectively, to 8.2 million and 7.1 million tonnes in 2007, respectively. Additionally, we seek to benefit from the following factors in Russia:

If the economy continues to expand, the demand for long products, particularly in the construction industry, should increase, providing us with additional sales opportunities.

Substantial infrastructure repairs and industrial upgrade needs should also drive demand for our products.

- Ø *Develop and Expand our Position as a High-Quality, Low-Cost Producer of Specialty Long Products.* We are Russia's primary producer of specialty long products. We believe that this higher-margin business provides us with substantial opportunities to increase our revenues and profitability for the following reasons:

Our low-cost production provides us with a competitive base for expanding our market share in Europe, Asia and the CIS countries.

The Russian market for specialty long products has considerable room for growth if demand from domestic engineering and manufacturing sectors recovers from historic post-Soviet lows in the past few years.

- Ø *Expand our Mining Business.* We intend to build on our substantial mining experience to achieve the following goals:

Develop our existing coal and iron ore reserves, particularly in order to sell more high-quality coking coal and iron ore concentrate to third parties. We plan to increase our coal production from approximately 15.2 million tonnes in 2004 to 16.6 million tonnes in 2007, and our iron ore concentrate production from approximately 4.0 million tonnes in 2004 to 5.0 million tonnes in 2007.

Make selective acquisitions of coal and other mining enterprises, including new subsoil licenses, particularly in Russia and other CIS countries, as strategic opportunities present themselves.

Maintain our flexibility to internally source raw-material inputs for our steel-making business, depending on price differentials between purchases from local suppliers and sales to foreign and domestic customers.

- Ø *Enhance our Position as a Low-Cost Producer.* We intend to further increase our efficiency and reduce our manufacturing costs by:

Selectively investing in technology and capital improvements, including expanding our use of continuous casters in our steel-making.

Preserving our cost advantages in our labor, raw materials and energy inputs.

Achieving additional savings by fully integrating recent acquisitions into our operations.

- Ø *Further Capitalize upon Synergies between our Core Businesses.* In addition to synergies deriving from our status as an integrated group, we believe that additional cost savings and opportunities will arise as we benefit from economies of scale and continue to integrate recent acquisitions, in particular by implementing improvements in working practices and operational methods. We regularly evaluate the manner in which our subsidiaries source their raw material needs and transfer products within the group in order to operate in the most efficient way, and we expect to identify and take advantage of further synergies between our core businesses.

- Ø *Selectively Expand our Downstream Capacity.* We intend to continue to selectively acquire value-added downstream businesses such as hardware, stampings and forgings producers to help us reach our customer base, including in new markets. This downstream integration:

Is a logical extension of our specialty and low-carbon long product lines, representing a higher-margin, next value-added step for products that we already manufacture.

Is in a market less cyclical than the upstream market, reducing our exposure to market downturns.

Moves us closer to our final customers, enabling us to better understand customer needs, influence buyer behavior and respond quickly to change.

- Ø *Selectively Expand our Internal Logistics Capabilities.* We intend to selectively expand our internal logistics capabilities, currently centered on our railway freight and forwarding company, and enhanced by our recent acquisition of Port Posiet, located on the Sea of Japan, to help us to optimize our transportation expenses.
  
- Ø *Maintain Strong Export Sales.* We intend to maintain our strong relationships with our significant export customers. Although we are focused on maintaining our market position within Russia, export sales, which constituted 55% of our total sales in the first half of 2004, allow us to diversify our sales and reduce our reliance on the Russian market in the event that it were to experience a downturn.

Implementation of these strategies is subject to a number of risks. See [Risk Factors](#) for a description of these risks.

## **CORPORATE INFORMATION**

Mechel Steel Group OAO is an open joint stock company incorporated under the laws of the Russian Federation. We are a holding company and conduct our business through a number of subsidiaries. See [Business and Management's Discussion and Analysis of Financial Condition and Results of Operations](#). We are registered with the Ministry of Taxes and Duties of the Russian Federation under the state registration number 103770301896. Our principal executive offices are located at Krasnopresnenskaya Naberezhnaya 12, Moscow 123610, Russian Federation. Our telephone number is +7-095-258-1828. Our Internet address is [www.mechel.com](http://www.mechel.com). Information posted on our website is not a part of this prospectus.

## The offering

|   |   |
|---|---|
| ADSs representing common shares offered by us                       | 11,100,553 ADSs   |
| ADSs representing common shares offered by the selling shareholders | 2,775,138 ADSs  |
| Over-allotment option   | The selling shareholders have granted to the underwriters a 30-day option to purchase up to an additional 2,081,354 ADSs representing common shares to cover over-allotments, if any.   |
| ADSs  | Each ADS represents the right to receive three common shares (subject to certain restrictions as described under <a href="#">Escrow of proceeds and registration of placement report</a> below). The ADSs are evidenced by American depositary receipts, or ADRs.   |
| Lock-up   | We and our selling shareholders will agree, subject to certain conditions, not to issue, transfer or dispose of, directly or indirectly, any shares or ADSs or any securities convertible into or exercisable or exchangeable for shares or ADSs, for a period of 180 days after the date of this prospectus, nor to allow our affiliates to do so, without the prior written consent of UBS.   |
| Use of proceeds   | <p>The net proceeds we will receive from the offering will be approximately \$• million, assuming an offering price equal to the mid-point of the estimated price range. This amount represents net proceeds after deducting estimated discounts and fees and expenses incurred in connection with the offering. We expect to use the net proceeds from this offering for the following purposes:</p> <ul style="list-style-type: none"> <li>\$• million for capital expenditures, including the purchase of equipment and modernization of facilities; and</li> <li>\$• million for acquisitions of additional operations and subsoil licenses.</li> </ul> <p>We will not receive any of the proceeds from the sale of ADSs representing common shares offered by the selling shareholders. See <a href="#">Use of Proceeds</a> and <a href="#">Principal and Selling Shareholders</a> for additional information.</p> |
| Proposed NYSE symbol  | MTL   |

Settlement, delivery and trading

You must pay for the ADSs in same-day funds in U.S. dollars on the closing date of this offering, which is expected to be on or about ●, 2004.

The shares will be delivered to a custodian for Deutsche Bank Trust Company Americas, as depository, on the closing date, and the depository will issue the ADSs, subject to cancellation in the circumstances described in Escrow of proceeds and registration of placement report below.

The depository will initially issue the ADSs in the form of a single global ADR registered in the name of a nominee of The Depository Trust Company, or DTC. You will hold beneficial interests in the ADSs through DTC, and DTC and its direct and indirect participants will record your beneficial interests in their books.

We anticipate that trading in the ADSs sold in this offering on the NYSE will commence on a customary basis pursuant to normal settlement procedures on the closing date, but the ADSs will remain subject to cancellation in the circumstances described in Escrow of proceeds and registration of placement report below.

Escrow of proceeds and registration of placement report

The proceeds of this offering will be held in escrow and escrow-type accounts and trading in the ADSs on the NYSE will be subject to cancellation until the placement report for the common shares being offered by us is registered by the Federal Service for the Financial Markets. If the placement report is not registered within 60 days after the closing date (or such later date as we and the selling shareholders agree with the underwriters), we and the selling shareholders will refund the public offering price, together with interest, if any, accrued on the escrowed proceeds to the holders of the ADSs at the time of such cancellation, regardless of the then-prevailing market price of the ADSs. Such return of funds may be delayed due to Russian currency control regulations and may be prevented if there is a change in such regulations.

Until the registration of the placement report by the Federal Service for the Financial Markets, you will not be entitled to instruct the depository to exercise any voting rights on your behalf as our shareholder, and the depository and its nominee will not be entitled to exercise any voting rights as a shareholder.

You may not withdraw our shares or other property on deposit with the depository in respect of the ADSs sold in this offering prior to the registration of the placement report with the Federal Service for the Financial Markets.

See Escrow of Proceeds and Registration of Placement Report for additional information.

Risk Factors

You should carefully consider all the information in this prospectus. In particular, you should evaluate the information set forth in the section of the prospectus entitled Risk Factors beginning on page 10 before deciding whether to invest in our common shares and ADSs.

## Summary consolidated financial data

The financial data set forth below as of December 31, 2003, 2002 and 2001, and for the years then ended have been derived from our audited consolidated financial statements. The financial data set forth below as of June 30, 2004 and 2003, and for the six-month periods then ended have been derived from our unaudited interim consolidated financial statements. Our reporting currency is the U.S. dollar and we prepare our consolidated financial statements in accordance with U.S. GAAP.<sup>(1)</sup> The unaudited interim consolidated financial statements reflect all normal and recurring adjustments that are necessary for a fair presentation of the financial position and results of operations for the interim periods presented. Results of operations for the six-month period ended June 30, 2004, are not necessarily indicative of results for the full year ended December 31, 2004, for any other interim period or for any future fiscal year. The financial data for 1999 and 2000 are not presented, as financial statements for these years are not available without unreasonable effort and expense.

Our results of operations for the periods presented are significantly affected by acquisitions. Results of operations of these acquired businesses are included in our consolidated financial statements for the periods after their respective dates of acquisition. The financial data below should be read in conjunction with, and are qualified in their entirety by reference to, our consolidated financial statements and related notes included elsewhere in this prospectus and in Management's Discussion and Analysis of Financial Condition and Results of Operations.

|  | Six months ended                                      |                |                         |                |                |
|--|---|----------------|-------------------------|----------------|----------------|
|  | June 30,  |                | Year ended December 31, |                |                |
|  | 2004  | 2003           | 2003                    | 2002           | 2001           |
|  | (in thousands of U.S. dollars, except per share data) |                |                         |                |                |
| <b>Consolidated income statement data</b>  |   |                |                         |                |                |
| Revenue, net   | 1,630,063   | 930,595        | 2,050,088               | 1,314,149      | 1,019,726      |
| Cost of goods sold   | (985,370)   | (647,809)      | (1,440,053)             | (947,527)      | (721,089)      |
| <b>Gross margin</b>  | <b>644,693</b>  | <b>282,786</b> | <b>610,035</b>          | <b>366,622</b> | <b>298,637</b> |
| Selling, distribution and operating expenses   | (295,587)   | (193,430)      | (417,259)               | (277,478)      | (193,853)      |
| <b>Operating income</b>  | <b>349,106</b>  | <b>89,356</b>  | <b>192,776</b>          | <b>89,144</b>  | <b>104,784</b> |
| Other income and expense, net  | (12,630)  | (5,866)        | (20,018)                | (18,083)       | (12,178)       |
| Income before income tax, minority interest, discontinued operations, extraordinary gain and changes in accounting principle | 336,476   | 83,490         | 172,758                 | 71,061         | 92,606         |
| Income tax expense   | (74,100)  | (23,135)       | (47,759)                | (2,653)        | (30,184)       |
| Minority interest in loss (income) of subsidiaries   | (7,920)   | 6,632          | 18,979                  | 10,433         | (15,521)       |
| <b>Income from continuing operations</b>   | <b>254,456</b>  | <b>66,987</b>  | <b>143,978</b>          | <b>78,841</b>  | <b>46,901</b>  |
| Loss from discontinued operations, net of tax  |   | (1,317)        | (2,422)                 | (1,835)        | (735)          |
| Extraordinary gain, net of tax   |   | 5,740          | 5,740                   | 1,388          | 1,252          |
| Changes in accounting principle, net of tax  |   | 3,670          | (3,788)                 | 10,859         |                |
| <b>Net income</b>  | <b>254,456</b>  | <b>67,740</b>  | <b>143,508</b>          | <b>89,253</b>  | <b>47,418</b>  |
| Earnings per share from continuing operations  | 0.69  | 0.18           | 0.39                    | 0.24           | 0.21           |
| Loss per share effect of discontinued operations   |   |                | (0.01)                  | (0.01)         | (0.01)         |
| Earnings per share effect of extraordinary gain  |   | 0.02           | 0.02                    | 0.01           | 0.01           |
| Earnings per share effect of a changes in accounting principle   |   | (0.01)         | (0.01)                  | 0.03           | 0.00           |



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|   |             |             |             |             |             |
|---|-------------|-------------|-------------|-------------|-------------|
| Net income per share                          | 0.69        | 0.18        | 0.39        | 0.27        | 0.21        |
| Cash dividends per share <sup>(2)</sup>       | 0.00        |             | 0.07        | 0.04        | 0.04        |
| Weighted average number of shares outstanding | 367,150,968 | 366,178,815 | 366,178,815 | 333,243,450 | 225,271,391 |

|  | Six months ended |           |                         |           |           |
|--|------------------|-----------|-------------------------|-----------|-----------|
|  | June 30,         |           | Year ended December 31, |           |           |
|  | 2004             | 2003      | 2003                    | 2002      | 2001      |
| (in thousands of U.S. dollars, except per share data)  |                  |           |                         |           |           |
| <b>Steel segment income statement data</b>             |                  |           |                         |           |           |
| Revenue, net <sup>(3)</sup>                            | 1,307,903        | 778,846   | 1,678,395               | 1,050,554 | 680,314   |
| Cost of goods sold <sup>(3)</sup>                      | (964,118)        | (572,817) | (1,247,380)             | (801,481) | (546,885) |
| Gross margin   | 343,785          | 206,029   | 431,015                 | 249,073   | 133,429   |
| Selling, distribution and operating expenses           | (180,071)        | (145,147) | (301,689)               | (194,341) | 133,273   |
| Operating income                                       | 163,714          | 60,882    | 129,326                 | 54,732    | 155       |
| <b>Mining segment income statement data</b>            |                  |           |                         |           |           |
| Revenue, net <sup>(3)</sup>                            | 522,594          | 251,027   | 599,756                 | 372,216   | 339,971   |
| Cost of goods sold <sup>(3)</sup>                      | (221,686)        | (174,270) | (420,736)               | (254,667) | (174,763) |
| Gross margin   | 300,908          | 76,757    | 179,020                 | 117,549   | 165,208   |
| Selling, distribution and operating expenses           | (115,516)        | (48,283)  | (115,570)               | (83,137)  | 60,580    |
| Operating income                                       | 185,392          | 28,474    | 63,450                  | 34,412    | 104,627   |
| <b>Consolidated balance sheet data (at period end)</b> |                  |           |                         |           |           |
| Total assets   | 2,336,233        | n/a       | 1,834,509               | 1,387,378 | 1,116,473 |
| Shareholders' equity                                   | 705,903          | n/a       | 448,826                 | 278,051   | 195,122   |
| Long-term debt, net of current portion                 | 152,583          | n/a       | 122,311                 | 36,496    | 16,525    |
| <b>Consolidated cash flows data</b>                    |                  |           |                         |           |           |
| Net cash provided by operating activities              | 207,960          | 43,535    | 119,466                 | 81,069    | 34,751    |
| Net cash used in investing activities                  | (207,805)        | (49,963)  | (209,901)               | (86,633)  | (93,068)  |
| Net cash provided by financing activities              | 43,843           | 19,162    | 103,079                 | 3,422     | 65,701    |
| <b>Non-U.S. GAAP measures<sup>(4)</sup></b>            |                  |           |                         |           |           |
| Consolidated EBITDA                                    | 420,818          | 157,307   | 341,484                 | 207,452   | 105,506   |
| Steel segment EBITDA                                   | 206,739          | 116,420   | 245,832                 | 133,448   | 2,976     |
| Mining segment EBITDA                                  | 214,080          | 40,887    | 95,652                  | 74,004    | 102,529   |

(1) The value of property, plant and equipment pertaining to non-controlling shareholders in the accounting for minority interests resulting from acquisitions of various subsidiaries has been recorded at appraised values rather than at historical cost as required by U.S. GAAP.

(2) Mechel Steel Group declared a dividend of 149 million rubles (or approximately \$5.2 million) on June 24, 2004. Certain companies in our group paid dividends to our controlling shareholders in amounts of \$26.3 million, \$13.4 million and \$8.8 million in the years ended December 31, 2003, 2002 and 2001, respectively.

(3) Segment revenues and cost of goods sold include intersegment sales.

(4) EBITDA represents net income before interest expense, income taxes and depreciation, depletion and amortization. We present EBITDA because we consider it an important supplemental measure of our operating performance and believe it is frequently used by securities analysts, investors and other interested parties in the evaluation of companies in our industry. We also present EBITDA by segment because our overall performance is best explained with reference to results of each segment.

EBITDA has limitations as an analytical tool, and you should not consider it in isolation, or as a substitute for analysis of our operating results as reported under U.S. GAAP. Some of these limitations are as follows:

EBITDA does not reflect the impact of financing costs, which are significant and could further increase if we incur more debt, on our operating performance.

EBITDA does not reflect the impact of income taxes on our operating performance.

EBITDA does not reflect the impact of depreciation, depletion and amortization on our operating performance. The assets of our businesses which are being depreciated, depleted and/or amortized (including, for example, our mineral reserves) will have to be replaced in the future and such depreciation, depletion and amortization expense may approximate the cost to replace these assets in the future. By excluding such expense from EBITDA, EBITDA does not reflect our future cash requirements for such replacements.

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Other companies in our industry may calculate EBITDA differently or may use it for different purposes than we do, limiting its usefulness as a comparative measure.

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We compensate for these limitations by relying primarily on our U.S. GAAP operating results and using EBITDA only supplementally. See our consolidated income statements and consolidated statements of cash flows included elsewhere in this prospectus.

EBITDA is a measure of our operating performance that is not required by, or presented in accordance with, U.S. GAAP. EBITDA is not a measurement of our operating performance under U.S. GAAP and should not be considered as an alternative to net income, operating income or any other performance measures derived in accordance with U.S. GAAP or as an alternative to cash flow from operating activities or as a measure of our liquidity. In particular, EBITDA should not be considered as a measure of discretionary cash available to us to invest in the growth of our business.

Reconciliation of EBITDA to net income is as follows for the periods indicated:

|   | Six months ended               |                |                         |                |                |
|---|--------------------------------|----------------|-------------------------|----------------|----------------|
|   | June 30,                       |                | Year ended December 31, |                |                |
|   | 2004                           | 2003           | 2003                    | 2002           | 2001           |
|   | (in thousands of U.S. dollars) |                |                         |                |                |
| <b>Consolidated EBITDA reconciliation</b>   |                                |                |                         |                |                |
| Net income                                  | 254,456                        | 67,740         | 143,508                 | 89,253         | 47,418         |
| Add:  |                                |                |                         |                |                |
| Depreciation, depletion and amortization    | 62,240                         | 46,185         | 101,689                 | 78,773         | 13,378         |
| Interest expense                            | 30,022                         | 20,247         | 48,528                  | 36,773         | 14,526         |
| Income taxes                                | 74,100                         | 23,135         | 47,759                  | 2,653          | 30,184         |
| Consolidated EBITDA                         | <u>420,818</u>                 | <u>157,307</u> | <u>341,484</u>          | <u>207,452</u> | <u>105,506</u> |
| <b>Steel segment EBITDA reconciliation</b>  |                                |                |                         |                |                |
| Net income                                  | 91,542                         | 53,551         | 114,011                 | 57,977         | (16,924)       |
| Add:  |                                |                |                         |                |                |
| Depreciation, depletion and amortization    | 36,574                         | 32,490         | 67,272                  | 49,728         | 154            |
| Interest expense                            | 23,460                         | 17,638         | 38,363                  | 30,416         | 11,708         |
| Income taxes                                | 55,163                         | 12,741         | 26,186                  | (4,673)        | 8,038          |
| Steel segment EBITDA                        | <u>206,739</u>                 | <u>116,420</u> | <u>245,832</u>          | <u>133,448</u> | <u>2,976</u>   |
| <b>Mining segment EBITDA reconciliation</b> |                                |                |                         |                |                |
| Net income                                  | 162,915                        | 14,189         | 29,497                  | 31,274         | 64,341         |
| Add:  |                                |                |                         |                |                |
| Depreciation, depletion and amortization    | 25,666                         | 13,695         | 34,417                  | 29,045         | 13,224         |
| Interest expense                            | 6,562                          | 2,609          | 10,165                  | 6,357          | 2,818          |
| Income taxes                                | 18,937                         | 10,394         | 21,573                  | 7,328          | 22,146         |
| Mining segment EBITDA                       | <u>214,080</u>                 | <u>40,887</u>  | <u>95,652</u>           | <u>74,004</u>  | <u>102,529</u> |

## Risk factors

*Investment in our ADSs involves a high degree of risk. You should carefully consider the risks described below and the other information contained in this prospectus before making a decision to invest in our common shares and ADSs. Any of the following risks could adversely affect our business, financial condition and results of operations, in which case the trading price of our ADSs could decline and you could lose all or part of your investment.*

### **RISKS RELATING TO OUR BUSINESS AND INDUSTRY**

**We operate in a cyclical industry, and any local or global downturn in the steel industry may have an adverse effect on our results of operations and financial condition.**

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

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

We derived approximately 39% and 49% of our total revenues from sales to customers in Russia in the first half of 2004 and in 2003, respectively. The Russian economy has experienced significantly fluctuating growth rates over the past 10 years. From 1994 to 1998, the Russian economy contracted in real terms at an average rate of 3.7% per year; after the Russian crisis in 1998, the economy recovered and grew in real terms at an average rate of 6.7% per year from 1999 to 2003. Russian production of steel also suffered a substantial decline from over 77 million tonnes in 1991 to 44 million tonnes in 1998, but then recovered to 61 million tonnes in 2003. Further, our products in Russia are mainly used in the engineering, construction and automotive industries, which are particularly vulnerable to general economic downturns. In addition to Russia, Asia and the Middle East are also large destinations for our products, and these areas, like Russia, face greater risks of volatility. Accordingly, any significant decrease in demand for steel products or decline in the price of these products in Russia or other emerging market economies could result in significantly reduced revenues, thereby materially adversely affecting our results of operations and financial condition.

**The steel industry is highly competitive, and we may not be able to compete successfully.**

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

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**Risk factors**

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reported that MMK intends to spend 75 million to install long products production capacity sufficient to produce 1.5 million tonnes of long products annually commencing in 2005.

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

**Successful implementation of our strategy to expand our specialty long product sales depends on our ability to increase our export sales of these products.**

While we expect continued growth of demand in the Russian market for specialty long products, our strategy to expand these sales substantially is dependent on our ability to increase our exports of these products to other countries, particularly the European Union, or EU, countries. We face a number of obstacles to this strategy, including trade barriers and sales and distribution challenges.

**We will require a significant amount of cash to fund our capital improvements program. Our ability to generate cash or obtain financing depends on many factors beyond our control.**

The total cost of our capital improvements over the next five years is expected to be approximately \$900 million. Most of our current borrowing is from Russian banks. In the future, we expect to rely to a greater extent than currently on foreign capital markets and other foreign financing sources for our capital needs. It is possible that these foreign sources of financing, as well as domestic sources, may not be available in the future in the amounts we require or at an acceptable cost. See Risks Relating to the Economic Environment in Russia Emerging markets such as Russia are subject to greater risks than more developed markets, and financial turmoil in any emerging market could disrupt our business, as well as cause the price of our ADSs to suffer and Risk Relating to the Economic Environment in Russia The Russian banking system remains underdeveloped, and another banking crisis could place severe liquidity constraints on our business.

**Our business strategy foresees additional acquisitions and continued integration, and we may fail to identify suitable targets, acquire them on acceptable terms or successfully integrate them.**

Our strategy relies on our status as an integrated steel and mining group, which allows us to benefit from economies of scale, realize synergies, better satisfy the needs of our domestic and international steel customers and compete effectively against other steel producers. We also intend to enhance the profitability of our business by applying our integration strategy to a larger asset base and, towards that end, we need to identify suitable targets that would fit into our operations, acquire them on acceptable terms and successfully integrate them.

The acquisition and integration of new companies pose significant risks to our existing operations, including:

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additional demands placed on our senior management, who are also responsible for managing our existing operations;  
increased overall operating complexity of our business, requiring greater personnel and other resources;  
significant, initial cash expenditures to integrate new acquisitions;

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**Risk factors**

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incurrence of debt to finance acquisitions and higher debt service costs related thereto; and strains on our labor force as production may be shifted to new companies or locations to optimize our overall production.

Moreover, the integration of new businesses may also be difficult for a variety of reasons, including differing culture or management styles, poor records or internal controls and inability to establish control over cash flows. For example, regional governments have special perpetual rights, or a golden share, in our subsidiaries Beloretsk Metallurgical Plant and Izhstal, giving them the right to veto certain shareholder decisions and appoint a voting representative on the board of directors of these subsidiaries. The shareholder decisions that may be vetoed by the regional governments are as follows:

approval of amendments and supplements to the company's charter or approval of a new version of the charter;  
reorganization of the company;  
liquidation of the company;  
changes in the charter capital of the company; and  
approval of major and interested party transactions.

Furthermore, even if we are successful in integrating new businesses, expected synergies and cost savings may not materialize, resulting in lower than expected profit margins.

**Our independent registered public accounting firm reported material weaknesses in our internal control and we may not be able to remedy these material weaknesses or prevent future weaknesses. If we fail to maintain effective internal control, we may not be able to accurately report our financial results or prevent fraud. As a result, potential shareholders could lose confidence in our financial reporting, which would harm our business and the trading price of our shares and ADSs.**

We have in the past identified, and may in the future identify, areas of our internal control over financial reporting that need improvement. In connection with their audit of our consolidated financial statements for the year ended December 31, 2003, our independent registered public accounting firm reported material weaknesses in our internal control. The Public Company Accounting Oversight Board, or PCAOB, has defined a material weakness as a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim statements will not be prevented or detected. Specifically, our financial statement close process and the transformation of our Russian statutory financial statements into U.S. GAAP consolidated financial statements has not reduced to an acceptably low level the risk that errors in amounts that would be material in relation to those financial statements may occur and may not be detected within a timely period by management in the normal course of business. These deficiencies were considered in determining the nature, timing and extent of the procedures performed by our independent registered public accounting firm in their audit of our annual consolidated financial statements, and did not affect the report of our independent registered public accounting firm on our annual consolidated financial statements included herein.

Our business consists of many operating subsidiaries located across several time zones in Russia and Eastern Europe, each of which prepares stand-alone financial statements for statutory purposes under Russian accounting standards or other local country accounting standards. The preparation of our U.S. GAAP consolidated financial statements is a manual process which involves (1) the transformation of these statutory financial statements into U.S. GAAP consolidated financial statements through accounting adjustments and (2) a consolidation of all these stand-alone statutory financial statements. This process is complicated, time-consuming and requires significant attention and time from our senior



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**Risk factors**

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accounting personnel at our subsidiaries and corporate headquarters. Moreover, U.S. GAAP accounting adjustments tend to result in large differences between our statutory and U.S. GAAP financial position and results of operations, and go through substantial senior management review. These difficulties are compounded by the fact that most of our operating subsidiaries were recently acquired and, although we continue to successfully integrate them into our business, significant differences exist in the accounting practices and the level of experience and qualifications of their respective accounting personnel. Most importantly, we undertook the process of preparing U.S. GAAP consolidated financial statements for the first time in the beginning of 2003, resulting in our 2001 and 2002 U.S. GAAP consolidated financial statements being completed in early 2004. In summary, our system of internal control over financial reporting is not designed for the preparation of U.S. GAAP consolidated financial statements and significant adjustments were required to prepare our U.S. GAAP consolidated financial statements for each of the three years ended December 31, 2003, and for the six-month periods ended June 30, 2004 and 2003.

We have taken several steps to correct the material weaknesses reported by our independent registered public accounting firm. In the past year, we hired six accounting personnel who are ACCA-qualified or have passed the Uniform CPA examination administered by American Institute of Certified Public Accountants with experience at other NYSE-listed Russian companies and at Big Four accounting firms in order to improve our U.S. GAAP capabilities. We engaged external consultants to help us correct the material weaknesses and improve our internal control over financial reporting. We have implemented a uniform framework for all our subsidiaries to report their financial information for the close and transformation processes for the preparation of U.S. GAAP consolidated financial statements. Having recently completed the 2003 and six months 2004 U.S. GAAP consolidated financial statements, our accounting personnel at all of our subsidiaries are becoming increasingly familiar with U.S. GAAP and the process of preparing U.S. GAAP consolidated financial statements, which should result in improvements in this process in the future. In addition, our management believes that each of our subsidiaries has effective internal controls (including closing processes) to produce reliable statutory financial statements. Our senior management also devotes significant attention to the preparation of U.S. GAAP consolidated financial statements in order to mitigate the potential effects of the reported material weaknesses.

Notwithstanding the steps we are taking to address these issues, we may not be successful in remedying these material weaknesses or preventing future material weaknesses. We will not be able to obtain the view of our independent registered public accounting firm on whether we have successfully remedied these material weaknesses until our independent registered public accounting firm conducts its audit of our U.S. GAAP consolidated financial statements for the year ending December 31, 2004, which will be completed during the first half of 2005. If we are unable to remedy the material weaknesses, we may not be able to prevent or detect a material misstatement of our annual or interim U.S. GAAP consolidated financial statements.

In addition, any failure to implement new or improved internal controls, or resolve difficulties encountered in their implementation, could harm our operating results or cause us to fail to meet our reporting obligations. Inferior internal controls could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our shares and ADSs.

**We depend on key accounting staff for the preparation of U.S. GAAP financial information. Given the competition for such personnel and the remote locations of our subsidiaries, our key accounting staff may leave our company, which could disrupt our ability to timely and accurately report U.S. GAAP financial information.**

Our subsidiaries maintain their books and records in local currencies and prepare accounting reports in

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**Risk factors**

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

**The potential implementation by the Russian government of a law requiring companies to purchase or lease the land on which they operate may have a material adverse effect on our financial condition.**

Much of the land occupied by privatized Russian companies, including most of our subsidiaries, was not included in the privatizations of these companies and is still owned by federal, regional or municipal governments. The companies use the land pursuant to a special title of perpetual use whereby they have the right to use the land but do not have the right to alienate such land.

The Russian Land Code requires privatized Russian companies to purchase or lease the land on which they operate, and gives the current government land owners broad discretion in setting the purchase price and lease terms. This requirement was scheduled to take effect on January 1, 2004, but implementation has been delayed by the Russian legislature to January 1, 2006. At present, we estimate that the cost of purchasing the land on which we operate would be approximately \$115 million. Thus, if not eliminated or limited prior to implementation, the requirement that we purchase or lease the land we occupy will require significant expenditures by us and may have a material adverse effect on our financial condition.

**Increasing tariffs and restructuring in the energy sector could materially adversely affect our business.**

In 2003, our Russian operations purchased approximately 2.2 billion kWh of electricity, representing 55% of their needs, from local subsidiaries of RAO UES, the government-controlled national holding company for the Russian power sector. Domestic electricity prices are regulated by the Russian government. The government is currently in the early stages of implementing a restructuring plan for the power sector aimed at introducing competition, liberalizing the wholesale electricity market and moving from regulated pricing to a market-based system by 2008. This reform process could also cause disruptions to the supply of electricity to us. In addition, while subject to doubt as to whether it will be implemented as currently written, according to the Russian Energy Strategy approved by the Russian government in 2003, electricity tariffs for industrial users are expected to reach 3.2-3.6 cents per kWh by 2006. In 2003, our average cost of electricity was 2.7 cents per kWh. Assuming a price of 3.6 cents per kWh in 2003, our Russian operations would have incurred approximately \$27 million in additional costs. Further price increases for electricity may also occur in the future as the industry is restructured and controlled to a greater extent by the private sector. If we are required to pay higher prices for electricity in the future, our costs will rise and our business and prospects could be materially adversely affected.



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**Risk factors**

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Our Russian operations also purchase significant amounts of natural gas, primarily for the production of electricity at our own co-generation facilities, from Gazprom. Gazprom is a government-controlled company and the dominant producer and monopoly transporter of natural gas within Russia. Domestic natural gas prices are regulated by the government. These prices have been rising over the last few years. The average price for industrial consumers was approximately \$24 per thousand cubic meters (\$0.68 per thousand cubic feet) in 2003, and increased by 17% to approximately \$28 per thousand cubic meters (\$0.79 per thousand cubic feet) as of January 1, 2004. Further, domestic natural gas prices are significantly below Western European levels, which helps to provide us with a cost advantage over our competitors. Recently, in connection with Russia's potential accession to the World Trade Organization, or WTO, Russia and the EU agreed that Russia would raise domestic gas prices to \$37-42 per thousand cubic meters (\$1.05-1.19 per thousand cubic feet) by 2006 and to \$49-57 per thousand cubic meters (\$1.39-\$1.61 per thousand cubic feet) by 2010. Assuming a price of \$42 per thousand cubic meters in 2003, our Russian operations would have incurred approximately \$30 million in additional costs. If we are required to pay a higher price for natural gas, our costs will rise and our business and prospects could be materially adversely affected.

**The planned reorganization of the Russian Railways Ministry exposes us to uncertainties regarding transportation costs of raw materials and steel products.**

Railway transportation is our principal means of transporting raw materials and steel products to our facilities and to customers, as well as to ports for onward transportation overseas. In 2003, legislation was enacted which sets out the framework for the reorganization of the Russian Railways Ministry into OAO Russian Railroads, a joint stock company, to be followed by the eventual privatization of certain of its functions. It is currently unclear whether this reorganization and privatization will be completed as per the timetable contemplated in the legislation or at all. Currently, the Russian government sets rail tariffs and may further increase these tariffs, as it has done in the past. If the privatization of Russian Railroads or other factors result in increased railway transport costs, our results of operations could be materially adversely affected.

In addition, Russia's rolling stock is currently in a poor state of repair. Failure of Russian Railroads to upgrade its rolling stock within the next few years could result in a shortage of available working rolling stock, a disruption in transportation of our materials and products and cause rail tariffs to increase.

**We face numerous protective trade restrictions in the export of our steel products.**

We face numerous protective tariffs, duties and quotas which reduce our competitiveness in, and limit our access to, particular markets. Several key steel importing countries currently have import restrictions in place on steel products or intend to introduce them in the future. The EU has a quota system in place with respect to Russian steel imports, and our exports to other European countries that may join the EU in the future will also become subject to the EU's quota system. Our sales into the EU constituted approximately 20% of our steel segment sales in 2003, and we used 96% of our EU steel import quota allocation during 2003. The export of our steel into the EU is an important part of our growth strategy. If EU quotas are not increased in line with our sales growth objectives, our ability to expand our sales in the EU and pursue our growth strategy could be limited.

The United States has a quota system in place with respect to certain Russian steel imports (hot-rolled flat-rolled carbon quality steel products and certain cut-to-length carbon steel plate). It also had a quota system in place with respect to imports of pig-iron, cold-rolled steel, slabs, zinc-plated sheets and some other products from Russia which expired on July 12, 2004. We may attempt to expand our steel product exports to the U.S. market. We expect, however, that depending on market conditions, the United States may impose new anti-dumping duties or other types of trade restrictions which might force us to decrease



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**Risk factors**

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our exports to the United States below current levels. In December 2003, the United States also withdrew safeguard measures in the form of tariffs on most Russian steel exports to the United States after the WTO's Appellate Body had determined them to be inconsistent with the requirements of the WTO.

South Korea and Brazil have announced that they are also considering restrictions on steel imports in order to protect domestic producers. In January 2004, China imposed new anti-dumping duties on cold-rolled steel imports from Russia that are retroactive to September 2003 and will last for five years. In 2003, approximately 80% of our steel segment revenues were derived from sales of steel products that were subject to import restrictions. See Business Steel Business Trade Restrictions.

**Russian export tariffs reduce the margins we can obtain for our nickel products.**

The export of our nickel products out of Russia, excluding exports to certain other CIS countries, is subject to a 5% tariff prescribed by the Russian government, which results in lower margins in respect of our nickel products sales. The Russian government is considering indexing the tariff to world prices of nickel products as opposed to domestic prices, which would result in higher tariff payments and further reduce our margins from nickel products sales.

**We benefit from Russia's tariffs and duties on imported steel, which may be eliminated in the future.**

Russia has in place import tariffs with respect to certain steel products imported from outside of Russia, excluding certain other CIS countries. These tariffs generally amount to 5% of value, but also step up to 20% of value for certain higher value-added steel products. In addition, Russia has in place a 21% countervailing duty on Ukrainian rebars, which expires in 2005. Our Russian sales of steel products that are protected by these tariffs and duties accounted for approximately 38% of our steel segment revenues in 2003. We believe we benefit from these tariffs and duties because they prevent subsidized Ukrainian exports to Russia from reducing the prices we can obtain for these products in our domestic markets. These tariffs and duties may be reduced or eliminated in the future, which could materially adversely affect our revenues and results of operations.

Recently, Russia and the EU agreed on terms for Russia's entry into the WTO and, according to press reports, Russia may complete its negotiations with other countries to be able to join the WTO in 2005-2006. Russia's future accession to the WTO could negatively affect our business and prospects. In particular, Russia's entry into the WTO may require lowering or removing of tariffs and duties on steel products, causing increased competition in the domestic steel market from foreign producers. See also Increasing tariffs and restructuring in the energy sector could materially adversely affect our business.

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

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



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revenues, adversely affecting our results of operations. In 2003, the ruble appreciated in real terms against the U.S. dollar by 13.6% according to the Russian Central Bank, and further real appreciation of the ruble against the U.S. dollar may materially adversely affect our results of operations.

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## Risk factors

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### **Estimates of our reserves are subject to uncertainties.**

The estimates concerning our reserves contained in this prospectus are subject to considerable uncertainties. These estimates are based on interpretations of geological data obtained from sampling techniques and projected rates of production in the future. Actual production results may differ significantly from reserve estimates. In addition, it may take many years from the initial phase of drilling before production is possible. During that time, the economic feasibility of exploiting a discovery may change as a result of changes in the market price of coal, iron ore or nickel.

### **We are subject to mining risks.**

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

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

Hazards associated with our underground mining operations include:

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

We are at risk of experiencing any and all of these hazards. The occurrence of any of these hazards could delay production, increase production costs and result in injury to persons and damage to property, as well as liability for us. The liabilities resulting from any of these risks may not be adequately covered by insurance, and we may incur significant costs that could have a material adverse effect upon our business, results of operations and financial condition.

**More stringent environmental laws and regulations or more stringent enforcement of existing environmental laws and regulations in the jurisdictions where we operate may have a significant negative effect on our operating results.**

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Our operations and properties are subject to environmental, health and safety and other laws and regulations in the jurisdictions in which we operate. For instance, our operations generate large amounts of pollutants and waste, some of which are hazardous, such as benzapiren, sulphur oxide, sulphuric acid, nitrogen ammonium, sulphates, nitrites, phenicols and sludges (including sludges containing crome, copper, nickel, mercury and zinc). The discharge, storage and disposal of such hazardous waste is

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**Risk factors**

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subject to environmental regulations, including some requiring the clean-up of contamination and reclamation, such as requirements for cleaning up highly hazardous waste oil and iron slag. In addition, pollution risks and related clean-up costs are often impossible to assess unless environmental audits have been performed and the extent of liability under environmental laws is clearly determinable.

Generally, there is a greater awareness in Russia of damage caused to the environment by industry than existed during the Soviet era. For example, a recent news article cited us as Russia's tenth worst polluter. Environmental legislation in the jurisdictions where we operate, however, is generally weaker, and less stringently enforced, than in the EU or the United States. More stringent standards may be introduced or enforcement increased in Russia and elsewhere where we conduct our operations. Based on the current regulatory environment in these jurisdictions, as of June 30, 2004, we have not created any reserves for environmental liabilities and compliance costs, other than an accrual in the amount of \$23.6 million for asset retirement obligations (ARO), consistent with U.S. GAAP requirements and an accrual in the amount of \$3.6 million for our commitment to spend that amount for environmental protection measures at our subsidiary Industria Sarmei in Romania. Any change in this regulatory environment could result in actual costs and liabilities for which we have not provided.

Also, in the course, or as a result, of an environmental investigation, regulatory authorities can issue an order halting part or all of the production at a production facility which has violated environmental standards. In the event that production at one of our facilities was partially or wholly prevented due to this type of sanction, our business could suffer significantly and our operating results would be negatively affected.

In addition, we are generally not indemnified against environmental liabilities or any required land reclamation expenses of our acquired businesses that arise from activities that occurred prior to our acquisition.

**Russia's ratification of the Kyoto Protocol may negatively affect us.**

The Kyoto Protocol to the United Nations Framework Convention on Climate Change, if ratified by the requisite number of signatory countries, would require the signatory countries to make substantial reductions in greenhouse gas emissions. On September 30, 2004, Russia's government approved the Kyoto Protocol and Russian government officials have indicated that the ratification bill would be submitted to the Duma, or Russia's lower house of Parliament, so it can be ratified by the end of 2004. If ratified by Russia, the Kyoto Protocol will enter into force for all countries that have ratified it. As a step towards implementing the Kyoto Protocol, the EU has adopted a number of acts setting higher environmental standards. Even if Russia does not ratify the Kyoto Protocol, the EU will most likely unilaterally apply provisions of the Kyoto Protocol, raising environmental standards.

Russian industrial technologies may not be able to comply with the raised environmental standards of the EU and such non-compliance may become an additional basis for restricting Russian steel exports to the European market. The amount of EU anti-dumping duty on Russian exports may be increased as a result of adjustments to the relatively low environmental component of production costs of Russian companies used in the calculation of the EU dumping margin.

**Our business could be adversely affected if we fail to obtain or renew necessary licenses and permits or fail to comply with the terms of our licenses and permits.**

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Our business depends on the continuing validity of certain licenses and the issuance of certain new licenses and our compliance with the terms thereof, including subsoil licenses for our mining operations. Regulatory authorities exercise considerable discretion in the timing of license issuance, renewal and monitoring licensees' compliance with license terms. Requirements imposed by these authorities may be

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**Risk factors**

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costly and time-consuming and may result in delays in the commencement or continuation of exploration or production operations. Further, private individuals and the public at large possess rights to comment on and otherwise engage in the licensing process, including through intervention in courts and political pressure. Accordingly, the licenses we need may not be issued or renewed, or if issued or renewed, may not be issued or renewed in a timely fashion, or may involve requirements which restrict our ability to conduct our operations or to do so profitably.

Our competitors may also seek to deny our rights to develop certain natural resource deposits by challenging our compliance with tender rules and procedures or compliance with license terms. Political factors can also affect whether non-compliance with licensing regulations and terms of our licenses could lead to suspension or termination of our licenses and permits, and to administrative, civil and criminal liability.

We have a limited history of renewing our subsoil licenses. We recently extended the subsoil license for the Tatianinsk deposit, which was set to expire in June 2002, for a 10-year period. We have not had a need to extend any of our other subsoil licenses. Our five coal subsoil licenses expire on dates falling in 2012 through 2014; our three iron ore subsoil licenses expire on dates falling in 2009 through 2014; and our two nickel subsoil licenses expire on dates falling in 2012 and 2013. See Business Mining Business Mineral Reserves.

Accordingly, these factors may seriously affect our ability to obtain or renew necessary licenses, and if we are unable to obtain or renew necessary licenses or we are only able to obtain them with newly-introduced material restrictions, we may be unable to realize our reserves and our business and results of operations could be materially adversely affected.

In addition, as part of their obligations under licensing regulations and the terms of our licenses and permits, our companies have to comply with numerous industrial standards, recruit qualified personnel, maintain necessary equipment and a system of quality control, monitor our operations, maintain appropriate filings and, upon request, submit appropriate information to the licensing authorities, which are entitled to control and inspect their activities. In the event that the licensing authorities discover a material violation by our company, we may be required to suspend our operations or incur substantial costs in eliminating or remedying such violation, which could have a material adverse effect on our business or results of operations.

**Deficiencies in the legal framework relating to subsoil licensing subject our licenses to the risk of governmental challenges and, if our licenses are suspended or terminated, we would be unable to realize our reserves, which could materially adversely affect our business and results of operations.**

Most of the existing subsoil licenses in Russia date from the Soviet era. During the period between the dissolution of the Soviet Union in August 1991 and the enactment of the first post-Soviet subsoil licensing law in the summer of 1992, the status of subsoil licenses and Soviet-era mining operations was unclear, as was the status of the regulatory authority governing such operations. The Russian government enacted the Procedure for Subsoil Use Licensing, or Licensing Regulation, on July 15, 1992, which came into effect on August 20, 1992. As was common with legislation of this time, the Licensing Regulation was passed hastily, without adequate consideration of transition provisions, and contained numerous gaps. In an effort to address the problems in the Licensing Regulation, the Ministry of Natural Resources issued ministerial acts and instructions that attempted to clarify and, in some cases, modify the Licensing Regulation. Many of these acts contradicted the law and were beyond the scope of the Ministry's authority, but subsoil licensees had no option but to deal with the Ministry in relation to subsoil issues and comply with its ministerial acts and instructions. Thus, it is possible that licenses applied for and/or issued in reliance on the Ministry's acts and instructions could be challenged by the



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**Risk factors**

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prosecutor general's office as being invalid. In particular, deficiencies of this nature subject subsoil licensees to selective and arbitrary governmental claims.

Legislation on subsoil rights still remains internally inconsistent and vague, and the Ministry's acts and instructions are often arguably inconsistent with legislation. Subsoil licensees thus continue to face the situation where both failing to comply with the Ministry's acts and instructions and choosing to comply with them places them at the risk of being subject to arbitrary governmental claims, whether by the Ministry or the prosecutor general's office.

A provision that a license may be suspended or terminated if the licensee does not comply with the significant or material terms of a license is an example of such a deficiency in the legislation. However, the Ministry of Natural Resources has not issued any interpretive guidance on the meaning of these terms. Similarly, under Russia's civil law system, court decisions on the meaning of these terms do not have any precedential value for future cases and, in any event, court decisions in this regard have been inconsistent. These deficiencies result in the regulatory authorities, prosecutors and courts having significant discretion over enforcement and interpretation of the law, which may be used to challenge our subsoil rights selectively and arbitrarily.

Moreover, during the tumultuous period of the transformation of the Russian planned economy into a free market economy in the 1990s, documentation relating to subsoil licenses was not properly maintained and, in many cases, was lost or destroyed. Initially, during the period between the dissolution of the Soviet Union and the privatizations of the mid-1990s, as state subsidies ceased, many mining operations were forced to shut down or scale back production. In addition, during this time, complete governmental planning and oversight ceased, leaving the local management ill-equipped to operate these businesses, which faced severe liquidity problems. The employees, who were often unpaid for months, had little incentive to look after the businesses. In these circumstances, the maintenance of documentation relating to subsoil licenses, as well as compliance with the administrative requirements of the legislation of this period, was not a priority for management. The situation did not significantly improve as these mines were privatized in the mid-1990s, primarily since most Russian businesses during these times continued to face severe liquidity problems and the management focused on the operation of these mines. Thus, in many cases, although it may be clearly evident that a particular enterprise has mined a licensed subsoil area for decades, the historical documentation relating to their subsoil licenses may not be complete.

If, through governmental or other challenges, our licenses are suspended or terminated we would be unable to realize our reserves, which could materially adversely affect our business and results of operations.

**Our Romanian operations face certain risks.**

Romania is not self-sufficient in energy resources. Domestic energy prices, which are significantly higher than the prices we pay in Russia, have recently increased and may continue to increase in the future, which might hurt the profitability of our operations in Romania. For example, in 2003, the price of natural gas increased by approximately 30% in Romania and has been steadily increasing in 2004 at the rate of 5% per quarter. Shortages in energy supplies (including administrative limitations during peak usage) may limit our production capacity and efficiency and hinder our output. Our Romanian operations also purchase significant amounts of raw materials, such as scrap, for which prices increased significantly in 2003 and, while fluctuating considerably in 2004, scrap prices are expected to exceed 2003 levels at the end of this year. If we are unable to obtain these raw materials on economic terms, the operations of our Romanian subsidiaries could be materially adversely affected.





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**Risk factors**

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In addition, preparations in Romania for its possible admission into the EU will result in increased environmental liabilities and expenditures and labor costs for our Romanian operations, as well as potential trade duties and quotas on the export of steel finished and semi-finished products into Romania.

We also committed to make capital investments of approximately \$21.1 million at COST and approximately \$19.0 million at Industria Sarmei, as well as to maintain labor force levels over the next five years at these Romanian facilities in connection with their acquisition. Although we have complied with these undertakings to date, our failure to comply in the future could result in the forfeiture of part of our ownership stake in these companies.

**We will be controlled by two shareholders who run our business and affairs collectively and whose interests could conflict with those of the holders of the ADSs.**

Following the offering and depending on whether the underwriters exercise their over-allotment option in full, between 84.45% and 85.95% of our outstanding common shares will be owned by the Chairman of our Board of Directors, Mr. Igor Zyuzin, and our Chief Executive Officer, Mr. Vladimir Iorich. These two shareholders have acted in concert since signing an Ownership, Control and Voting Agreement dated August 1, 1995, which requires them to vote the same way. See Principal and Selling Shareholders Ownership, Control and Voting Agreement of August 1, 1995 for more information regarding this agreement. Following this offering, these two shareholders will continue to be bound by this agreement. This agreement will give them control over us and the ability to elect a majority of the directors, appoint management, issue additional shares and approve certain actions requiring the approval of a majority of our shareholders. The interests of these shareholders could conflict with those of holders of ADSs and materially adversely affect your investment.

In addition, these two shareholders currently provide leadership to the group as a team and consult extensively with each other before significant decisions are made. This may slow the decision-making process, and a disagreement among these individuals could prevent key strategic decisions from being made in a timely manner. In the event these shareholders are unable to continue to work well together in providing cohesive leadership, our business could be harmed.

**Our competitive position and future prospects depend on our senior management's experience and expertise.**

Our ability to maintain our competitive position and to implement our business strategy is dependent to a large degree on the services of our senior management team, particularly our Chairman and our Chief Executive Officer. The loss or diminution in the services of members of our senior management team or an inability to attract, retain and maintain additional senior management personnel could have a material adverse effect on our business, financial condition, results of operations or prospects. Moreover, competition in Russia for personnel with relevant expertise is intense due to the small number of qualified individuals, and this situation seriously affects our ability to retain our existing senior management and attract additional qualified senior management personnel.

**In the event the title to any privatized company we acquired is successfully challenged, we risk losing our ownership interest in that company or its assets.**

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Almost all of our business consist of privatized companies, and our business strategy will likely involve the acquisition of additional privatized companies. Privatization legislation in Russia is generally considered to be vague, internally inconsistent and in conflict with other domestic legislation. As the statute of limitations for challenging transactions entered into in the course of privatizations is 10 years, any transfers of title or ownership interests under privatizations are still vulnerable to challenge,

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## Risk factors

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including selective action by governmental authorities. In the event that any title to, or our ownership stakes in, the privatized companies acquired by us, including Chelyabinsk Metallurgical Plant, Southern Urals Nickel Plant, Southern Kuzbass Coal Company, Beloretsk Metallurgical Plant, Urals Stampings Plant, Korshunov Mining Plant or Izhstal, are subject to challenge as having been improperly privatized and we are unable to defeat this claim, we risk losing our ownership interest in such company or its assets, which could materially affect our business and results of operations.

**If the Federal Antimonopoly Service were to conclude that we acquired or created a new company in contravention of antimonopoly legislation, it could impose administrative sanctions and require the divestiture of this company or other assets.**

Our business has grown substantially through the acquisition and founding of companies, many of which required the prior approval or subsequent notification of the Russian Federal Antimonopoly Service or its predecessor agencies. In part, relevant legislation restricts the acquisition or founding of companies by groups of companies or individuals acting in concert without this approval or notification. This legislation is vague in certain parts and subject to varying interpretations. If the Federal Antimonopoly Service were to conclude that an acquisition or the creation of a new company was done in contravention of applicable legislation and competition has been reduced as a result, it could impose administrative sanctions and require the divestiture of this company or other assets, adversely affecting our business strategy and our results of operations.

**In the event that the minority shareholders of our subsidiaries were to successfully challenge past interested party transactions or do not approve interested party transactions in the future, we could be limited in our operational flexibility.**

We own less than 100% of the equity in many of our subsidiaries, with the remaining equity balance being held by minority shareholders. These subsidiaries have in the past carried out, and continue to carry out, numerous transactions with us and our other subsidiaries which may be considered interested party transactions under Russian law, requiring approval by disinterested directors, disinterested independent directors or disinterested shareholders. See Description of Capital Stock and Certain Requirements of Russian Legislation Interested Party Transactions. These transactions may not always have been properly approved, and therefore may be challenged by minority shareholders. In some cases, minority shareholders may not approve transactions which are interested party transactions requiring approval. In the event these minority shareholders were to successfully challenge past interested party transactions, or do not approve interested party transactions in the future, we could be limited in our operational flexibility and our results of operations could be materially adversely affected.

**Our existing arrangements with trade unions may not be renewable on terms favorable to us, and our operations could be adversely affected by strikes and lockouts.**

As of June 30, 2004, approximately 88% of our employees were represented by trade unions. Although we have not experienced any business interruption at any of our businesses as a result of labor disputes from the dates of their respective acquisition by us and we consider our employee relations to be good, large union representation subjects our businesses to interruptions through strikes, lockouts or delays in renegotiations of labor contracts. Our existing arrangements with trade unions also may not be renewed on terms favorable to us. In such events, our business and results of operations could be materially adversely affected.



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**Risk factors**

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**We do not carry the types of insurance coverage customary in more economically developed countries for a business of our size and nature, and a significant event could result in substantial property loss and inability to rebuild in a timely manner or at all.**

The insurance industry is not yet well developed in Russia, and many forms of insurance protection common in more economically developed countries are not yet available in Russia on comparable terms, including coverage for business interruption. At present, our facilities are not insured, and we have no coverage for business interruption or loss of key management personnel or for third-party liability, other than customary insurance coverage with respect to our international trading operations and sales. In the event that a major event were to affect one of our facilities, we could experience substantial property loss and significant disruptions in our production capacity, for which we would not be compensated. For example, if substantial production capacity were lost at our Chelyabinsk Metallurgical Plant, which is our primary steel production facility, we would not be able to replace a substantial portion of this capacity with capacity from our other plants, potentially resulting in the interruption of the production of a number of our products. Additionally, depending on the severity of the property damage, we may not be able to rebuild damaged property in a timely manner or at all. We do not maintain separate funds or otherwise set aside reserves for these types of events. Any such loss or third-party claim for damages may have a material adverse effect on our business, results of operations and financial condition.

**Russian currency control regulations hinder our ability to conduct our business.**

Over the past several years, the ruble has fluctuated dramatically against the U.S. dollar. The Central Bank of Russia has from time to time imposed various currency control regulations in attempts to support the ruble, and may take further actions in the future. For example, Central Bank regulations currently require us to convert into rubles 25% of our export proceeds. Furthermore, the government and the Central Bank may impose additional requirements on cash inflows and outflows into and out of Russia or on use of foreign currency in Russia, which could prevent us from carrying on necessary business transactions, or from successfully implementing our business strategy.

A new framework law on exchange controls took effect on June 18, 2004. This law empowers the government and the Central Bank of Russia to further regulate and restrict currency control matters, including operations involving foreign securities and foreign currency borrowings by Russian companies. The new law also abolishes the need for companies to obtain transaction-specific licenses from the Central Bank (except for opening bank accounts outside Russia), envisaging instead the implementation of generally applicable restrictions on currency operations. See Description of Capital Stock and Certain Requirements of Russian Legislation Exchange Controls for further description of Russia's currency control regulations. As the evolving regulatory regime is very recent and untested, it is unclear whether it will be more or less restrictive than the prior laws and regulations it has replaced.

**Vaguely drafted Russian transfer pricing rules and lack of reliable pricing information may potentially affect our results of operations.**

Russian transfer pricing rules entered into force in 1999, giving Russian tax authorities the right to make transfer pricing adjustments and impose additional tax liabilities in respect of all controlled transactions, provided that the transaction price differs from the market price by more than 20%. Controlled transactions include transactions between related entities and certain other types of transactions between independent parties, such as foreign trade transactions or transactions with significant (by more than 20%) price fluctuations. The Russian transfer pricing rules are vaguely drafted, leaving wide scope for interpretation by Russian tax authorities and courts. Due to the uncertainties in interpretation of transfer pricing legislation, the tax authorities may challenge our prices and propose adjustments. If such price adjustments are upheld by the Russian courts and implemented, our future financial results could be



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## Risk factors

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adversely affected. In addition, we could face significant losses associated with the assessed amount of prior tax underpaid and related interest and penalties, which could have an adverse effect on our financial condition and results of operations. See also [Risks Relating to Russian Legislation and the Russian Legal System](#) Weaknesses and changes in the Russian tax system could materially adversely affect our business and the value of our ADSs.

### **RISKS RELATED TO OUR ADSs AND THE TRADING MARKET**

**Because the depositary may be considered the beneficial holder of the shares underlying the ADSs, these shares may be arrested or seized in legal proceedings in Russia against the depositary.**

Because Russian law may not recognize ADS holders as beneficial owners of the underlying shares, it is possible that you could lose all your rights to those shares if the depositary's assets in Russia are seized or arrested. In that case, you would lose all the money you invested.

Russian law may treat the depositary as the beneficial owner of the shares underlying the ADSs. This is different from the way other jurisdictions treat ADSs. In the states of the United States, although shares may be held in the depositary's name or to its order, making it a legal owner of the shares, the ADS holders are the beneficial, or real owners. In those jurisdictions, an action against the depositary, the legal owner, would not result in the beneficial owners losing their shares. Russian law may not make the same distinction between legal and beneficial ownership, and it may only recognize the rights of the depositary in whose name the shares are held, not the rights of ADS holders, to the underlying shares. Thus, in proceedings brought against a depositary, whether or not related to shares underlying ADSs, Russian courts may treat those underlying shares as the assets of the depositary, open to seizure or arrest. We do not know yet whether the shares underlying the ADSs may be seized or arrested in Russian legal proceedings against a depositary. In the past, a lawsuit was filed against a depositary bank other than Deutsche Bank Trust Company Americas seeking the seizure of various Russian companies' shares represented by ADSs issued by that depositary. In the event that this type of suit were to be successful in the future against Deutsche Bank Trust Company Americas, and the shares underlying our ADSs were to be seized or arrested, the ADS holders involved would lose their rights to such underlying shares.

**The holder of an ADS cannot withdraw the shares underlying the ADS prior to the registration of a placement report for these shares, and the failure to register this placement report could result in the offering being held invalid and being withdrawn.**

Pursuant to Russian law and under the terms of the deposit agreement, all ADSs shall be deemed pre-released until a report regarding the placement of shares underlying the ADSs is registered by the Russian Federal Service for the Financial Markets. Until the report is registered, the holder of an ADS cannot withdraw the shares underlying the ADSs it holds or instruct the depositary to exercise voting rights with respect to the shares that will underlie the ADSs, as the holder would ordinarily be able to do. The form of the placement report requires us to disclose information about the recipients of the newly issued shares and the total number of shares actually placed. For purposes of such disclosure requirements, we will name the depositary as the recipient of the newly issued shares. The Federal Service for the Financial Markets is statutorily required to make its decision within two weeks after we file the placement report, but the current practice is that registration of a placement report takes between 30 and 44 days after filing. We may not file the placement report until after the closing of this offering. Accordingly, registration of the placement report may occur later than one month after the closing date for the offering or may not occur at all.



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The Federal Service for the Financial Markets may refuse to register the placement report or delay its registration in the event that we violated Russian law in the issuance process or if the placement report

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**Risk factors**

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contains false information. In the case of any such refusal or delay, the Federal Service for the Financial Markets must notify us of the alleged violation. If we fail to rectify the violation within the period specified by the Federal Service for the Financial Markets, which is generally 30 days, the placement will be held invalid. Additionally, prior to registration of the placement report, the Federal Service for the Financial Markets may declare the placement invalid to protect investors' rights. If the Federal Service for the Financial Markets declares the placement invalid, it will not register the placement report, the underlying shares will be cancelled, and we will be required by Russian law to return the proceeds we receive in this offering. In addition to the Federal Service for the Financial Markets, under Russian law, a court may also hold the placement invalid if the issuer violated Russian law in the issuance process or if the documents submitted to the Federal Service for the Financial Markets or its predecessor agency contained false information.

Pending the registration of the placement report, the proceeds of this offering to us and the selling shareholders will be deposited in rubles in escrow-type accounts and in U.S. dollars in escrow accounts, respectively. See [Escrow of Proceeds and Registration of Placement Report](#).

In the event that the registration of the placement report does not occur within 60 days after the closing date, or such other date to which we, the selling shareholders and the underwriters agree, called the termination date, we will be required to issue a press release and to notify the depositary, the escrow agent, the bank holding the escrow-type account, the underwriters and the New York Stock Exchange by the close of business on the termination date of the termination of this offering. In this instance, pursuant to the terms of the escrow and escrow-type account agreements and the underwriting agreement, all funds received in respect of the ADSs in the escrow-type and escrow accounts, together with interest, if any, accrued thereon for the period from the closing date to the termination date, and any additional amounts necessary so that the funds being released would be equal (after conversion of all ruble funds into U.S. dollars) to the original U.S. dollar proceeds of the offering will be released to the depositary. The depositary will promptly distribute in U.S. dollars through DTC to the holders of the ADSs as of the termination date the funds it has received from the escrow and escrow-type accounts in accordance with the provisions of the deposit agreement applicable to cash dividends and distributions. See [Description of American Depositary Shares](#) [Share Dividends and Other Distributions](#) [How will I receive dividends and other distributions on the shares underlying my ADSs?](#) [Cash](#) for more information.

The amount returned to the then-holders of the ADSs in the event that the registration of the placement report does not occur will be the public offering price together with interest accrued, if any, and will be paid to the holders of the ADSs as of the time of such cancellation regardless of prior trading and the then-prevailing market price for the ADSs. Any attempt to claim damages from us for the difference between the public offering price together with interest accrued, if any, and the then-prevailing market prices for the ADSs would be subject to significant difficulties. See [Limitation on Enforcement of Civil Liabilities](#) for more information. Moreover, the return of the funds may be delayed due to Russian currency control regulations, and may be prevented if there is a change in such regulations. See [Risks Relating to Our Business and Industry](#) [Russian currency control regulations hinder our ability to conduct our business](#).

**Your voting rights with respect to the shares represented by our ADSs are limited by the terms of the deposit agreement for our ADSs and relevant requirements of Russian law.**

You will be able to exercise voting rights with respect to the common shares represented by ADSs only in accordance with the provisions of the deposit agreement relating to the ADSs and relevant requirements of Russian law. However, there are practical limitations upon your ability to exercise your voting rights due to the additional procedural steps involved in communicating with you. For example, the Federal

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**Risk factors**

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Law on Joint Stock Companies of December 26, 1995, or the Joint Stock Company Law, and our charter require us to notify shareholders at least 20 days in advance of any meeting, at least 30 days in advance of a meeting relating to a reorganization and at least 50 days in advance of an extraordinary meeting relating to election of directors. Our common shareholders will receive notice directly from us and will be able to exercise their voting rights by either attending the meeting in person or voting by power of attorney.

As an ADS holder, you, by comparison, will not receive notice directly from us. Rather, in accordance with the deposit agreement, we will provide the notice to the depository. The depository has undertaken in turn, as soon as practicable thereafter, to mail to you notice of such meeting, copies of voting materials (if and as received by the depository from us) and a statement as to the manner in which instructions may be given by holders. To exercise your voting rights, you must then instruct the depository how to vote its shares. Because of this extra procedural step involving the depository, the process for exercising voting rights may take longer for you than for holders of common shares. ADSs for which the depository does not receive timely voting instructions will not be voted.

In addition, although securities regulations expressly permit the depository to split the votes with respect to the shares underlying the ADSs in accordance with instructions from ADS holders, this regulation remains untested, and the depository may choose to refrain from voting at all unless it receives instructions from all ADS holders to vote the shares in the same manner. You may thus have significant difficulty in exercising voting rights with respect to the shares underlying the ADSs. See [Description Of American Depositary Shares Voting Rights](#) for a description of the voting rights of holders of ADSs.

**Because there has been no prior active public trading market for our common shares and ADSs, this offering may not result in an active or liquid market for our ADSs, and their price may be highly volatile.**

Before this offering, there has been no public trading market for our ADSs and no active public market for our common shares. Although our ADSs have been admitted for listing on the New York Stock Exchange, an active public market may not develop or be sustained after this offering. Active, liquid trading markets generally result in lower price volatility and more efficient execution of buy and sell orders for investors. If a liquid trading market for our ADSs does not develop, the price of our ADSs may be more volatile and it may be more difficult to complete a buy or sell order for our ADSs.

The liquidity of a securities market is often a function of the volume of the underlying shares that are publicly held by unrelated parties. Although ADS holders are entitled to withdraw the shares underlying the ADSs from the depository (following the registration of the placement report with the Federal Service for the Financial Markets), there is very limited public free float of our shares (constituting less than 0.02%) on RTS, the Russian stock exchange where they are currently listed. In addition, the shares being sold by the company in this offering cannot be sold on the RTS until three months from the date of the registration of the placement report. During the period from the registration of the placement report until such time as the shares being sold by the company can be traded on the RTS (expected to be up to three months from the registration of the placement report), when you cancel your ADSs and deliver them to the depository, you will receive shares being sold by the selling shareholders, and only if all such shares shall have been withdrawn will you receive shares being sold by the company, irrespective of how you acquired your ADSs. Nevertheless, depending upon the demand for withdrawals, you may only be able to withdraw shares that cannot be sold on RTS during this period.

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**Risk factors**

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The trading prices of the ADSs may be subject to wide fluctuations in response to many factors, including:

variations in our operating results and those of other steel and mining companies;  
variations in national and industry growth rates;  
actual or anticipated announcements of technical innovations or new products or services by us or our competitors;  
changes in governmental legislation or regulation;  
general economic conditions within our business sector or in Russia; or  
extreme price and volume fluctuations on the Russian or other emerging market stock exchanges.

In addition, the Russian stock market has experienced extreme price and volume fluctuations. These market fluctuations could adversely affect the value of our ADSs. Moreover, the market price of our ADSs may decline below the offering price, which will be determined by negotiation between us and representatives of the underwriters.

**You may be unable to repatriate your earnings from our ADSs.**

Russian legislation currently requires dividends on common shares to be paid in rubles and permits such ruble funds to be converted into U.S. dollars by the depositary for distribution to owners of ADSs without restriction. Also, ADSs may be sold by non-residents of Russia for U.S. dollars outside Russia without regard to Russian currency control laws as long as the buyer is not a Russian resident for currency control purposes.

The ability to convert rubles into U.S. dollars is subject to the availability of U.S. dollars in Russia's currency markets. Although there is an existing market within Russia for the conversion of rubles into U.S. dollars, including the interbank currency exchange and over-the-counter and currency futures markets, the further development of this market is uncertain. At present, there is no market for the conversion of rubles into foreign currencies outside of Russia and no viable market in which to hedge ruble- and ruble-denominated investments.

**You will experience immediate and substantial dilution.**

The initial public offering price of the ADSs is substantially higher than the pro forma consolidated net tangible book value per ADS. You will pay a price per ADS that substantially exceeds the value of our assets after subtracting our liabilities. Additionally, holders of ADSs will contribute 20% of our total capitalization, but will own only 10.0% of our total equity outstanding, assuming no exercise of the underwriters over-allotment option. Therefore, you will incur immediate and substantial dilution in net tangible book value per ADS of \$1.00, assuming no exercise of the underwriters' over-allotment option.

**Future sales of shares or ADSs may affect the market price of our shares and ADSs.**

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Sales, or the possibility of sales, of substantial numbers of our shares or ADSs in the public markets, including the Russian stock market, following the offering could have an adverse effect on the market trading prices of our ADSs. Our subsequent equity offerings may reduce the percentage ownership of our shareholders. Moreover, newly issued preferred shares may have rights, preferences or privileges senior to those of our common shares.

### **You may not be able to benefit from the United States-Russia double tax treaty.**

In accordance with Russian legislation, dividends paid to a nonresident holder generally will be subject to Russian withholding at a 15% rate for legal entities, and at the rate of 30% for individuals. This tax may

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**Risk factors**

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be reduced to 5% to 10% under the United States-Russia income tax treaty for U.S. holders. However, the Russian tax rules applicable to U.S. holders are characterized by significant uncertainties and by the absence of interpretive guidance. Russian tax authorities have not provided any guidance regarding the treatment of ADS arrangements, and it is unclear how the Russian tax authorities will ultimately treat those arrangements. In particular, it is unclear whether Russian tax authorities will treat U.S. holders as the beneficial owners of the underlying shares for the purposes of the United States-Russia income tax treaty. If the Russian tax authorities were not to treat U.S. holders as the beneficial owners of the underlying shares, then the U.S. holders would not be able to benefit from the provisions of the United States-Russia double tax treaty. See [Taxation Russian Income and Withholding Tax Considerations United States-Russia Income Tax Treaty Procedures](#) and [Taxation of Dividends and United States Federal Income Tax Considerations Taxation of dividends on common shares or ADSs](#) for a more detailed discussion of this issue and administration procedures.

**Capital gain from sale of ADSs may be subject to Russian income tax.**

Under Russian tax legislation, gains arising from the disposition of Russian shares and securities, such as our common shares, as well as financial instruments derived from such shares, such as our ADSs, may be subject to Russian income or withholding taxes. However, no procedural mechanism currently exists to withhold any capital gains or for subsequent remittance of such amounts to the Russian tax authorities with respect to sales made between non-residents or sales of ADSs on the New York Stock Exchange. See [Taxation Russian Income and Withholding Tax Considerations United States-Russia Income Tax Treaty Procedures](#).

**You may have limited recourse against us and our directors and executive officers because we generally conduct our operations outside the United States and all of our directors and executive officers reside outside the United States.**

Our presence outside the United States may limit your legal recourse against us. Mechel Steel Group is incorporated under the laws of the Russian Federation. All of our directors and executive officers reside outside the United States, principally in Russia. All or a substantial portion of our assets and the assets of our directors and executive officers are located outside the United States. As a result, you may not be able to effect service of process within the United States upon us or our directors and executive officers or to enforce in U.S. court judgments obtained against us or our directors and executive officers in jurisdictions outside the United States, including actions under the civil liability provisions of U.S. securities laws. In addition, it may be difficult for you to enforce, in original actions brought in courts in jurisdictions outside the United States, liabilities predicated upon U.S. securities laws.

There is no treaty between the United States and the Russian Federation providing for reciprocal recognition and enforcement of foreign court judgments in civil and commercial matters. These limitations may deprive you of effective legal recourse for claims related to your investment in the ADSs. The deposit agreement provides for actions brought by any party thereto against us to be settled by arbitration in accordance with the Commercial Arbitration Rules of the American Arbitration Association, provided that any action under the U.S. federal securities laws or the rules or regulations promulgated thereunder may, but need not, be submitted to arbitration. The Russian Federation is a party to the United Nations (New York) Convention on the Recognition and Enforcement of Foreign Arbitral Awards, but it may be difficult to enforce arbitral awards in the Russian Federation due to a number of factors, including the inexperience of Russian courts in international commercial transactions, official and unofficial political resistance to enforcement of awards against Russian companies in favor of foreign investors, Russian courts' inability to enforce such orders and corruption.

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**Risk factors**

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**RISKS RELATING TO THE POLITICAL ENVIRONMENT IN RUSSIA**

**Political and governmental instability could adversely affect the value of our ADSs.**

Since 1991, Russia has sought to transform itself from a one-party state with a centrally-planned economy to a democracy with a market-oriented economy. As a result of the sweeping nature of the reforms, and the failure of some of them, the Russian political system remains vulnerable to popular dissatisfaction, including dissatisfaction with the results of privatizations in the 1990s, as well as to demands for autonomy from particular regional and ethnic groups. Moreover, the composition of the Russian government – the prime minister and the other heads of federal ministries – has at times been highly unstable. For example, six different prime ministers headed governments between March 1998 and May 2000. On December 31, 1999, President Yeltsin unexpectedly resigned. Vladimir Putin was subsequently elected president on March 26, 2000, and reelected for a second term on March 14, 2004. While President Putin maintained governmental stability and even accelerated the reform process during his first term, he may adopt a different approach over time. In February 2004, for example, President Putin dismissed his entire cabinet, including the prime minister. This was followed on March 12, 2004, by President Putin’s announcement of a far-reaching restructuring of the Russian government, with the stated aim of making the government more transparent and efficient. The changes included, for example, reducing the number of ministries from 30 to 14 and dividing the government into three levels: ministries, services and agencies. In addition to the restructuring of the Russian federal government, President Putin has recently proposed that the executives of sub-federal political units be no longer directly elected by population but instead be nominated by the President of the Russian Federation and confirmed by the legislature of the sub-federal political unit. Further, President Putin has proposed to eliminate individual races in State Duma elections, so that voters would only cast ballots for political parties. These new structures are largely not yet finalized and implemented.

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

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

The Russian Federation is a federation of 89 sub-federal political units, consisting of republics, territories, regions, cities of federal importance and autonomous regions and districts. The delineation of authority and jurisdiction among the members of the Russian Federation and the federal government is, in many instances, unclear and remains contested. Lack of consensus between the federal government and local or regional authorities often results in the enactment of conflicting legislation at various levels and may lead to further political instability. In particular, conflicting laws have been enacted in the areas of privatization, securities, corporate legislation and licensing. Some of these laws and governmental and administrative decisions implementing them, as well as certain transactions consummated pursuant to them, have in the past been challenged in the courts, and such challenges may occur in the future. This lack of consensus hinders our long-term planning efforts and creates uncertainties in our operating environment, both of which may prevent us from effectively and efficiently carrying out our business strategy. See also – Risks Relating to Our Business and Industry – In the event the title to any privatized company we acquired is successfully challenged, we risk losing our ownership interest in that company or its assets – and – Risks Relating to the Russian Legislation and the Russian Legal System – Weaknesses relating to the Russian legal system and Russian legislation create an uncertain environment





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**Risk factors**

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for investment and business activity and thus could have a material adverse effect on our business and the value of our ADSs.

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

**RISKS RELATING TO THE ECONOMIC ENVIRONMENT IN RUSSIA**

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

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

**Economic instability in Russia could adversely affect our business.**

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

- significant declines in gross domestic product;
- hyperinflation;
- an unstable currency;
- high government debt relative to gross domestic product;
- a weak banking system providing limited liquidity to Russian enterprises;
- a large number of loss-making enterprises that continued to operate due to the lack of effective bankruptcy proceedings;
- significant use of barter transactions and illiquid promissory notes to settle commercial transactions;
- widespread tax evasion;
- the growth of black and gray market economies;



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**Risk factors**

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pervasive capital flight;  
high levels of corruption and the penetration of organized crime into the economy;  
significant increases in unemployment and underemployment; and  
the impoverishment of a large portion of the Russian population.

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

Russia's inexperience with a market economy also poses numerous risks. The failure to satisfy liabilities is widespread among Russian businesses and the government. Furthermore, it is difficult for us to gauge the creditworthiness of some of our customers, as there are no reliable mechanisms, such as credit reports or credit databases, for evaluating their financial condition. Consequently, we face the risk that some of our customers or other debtors will fail to pay us or fail to comply with the terms of their agreements with us, which could adversely affect our results of operations.

Recent trends in the Russian economy such as the increase in the gross domestic product, a relatively stable ruble and a reduced rate of inflation may not continue or may be abruptly reversed. Additionally, because Russia produces and exports large quantities of oil and natural gas, the Russian economy is especially vulnerable to fluctuations in the price of oil and natural gas on the world market and a decline in the price of oil or natural gas could significantly slow or disrupt the Russian economy. Recent military conflicts and international terrorist activity have created significant uncertainty about the supply of oil and natural gas and delayed the expected recovery of the global economy, and such future events may continue to adversely affect the global economic environment, which could result in a decline in the demand for oil and natural gas. A strengthening of the ruble in real terms relative to the U.S. dollar, changes in monetary policy, inflation or other factors could adversely affect Russia's economy and our business in the future. Any such market downturn or economic slowdown could also severely limit our and our customers' access to capital, also adversely affecting our and our customers' businesses in the future.

**The Russian banking system remains underdeveloped, and another banking crisis could place severe liquidity constraints on our business.**

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

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## Risk factors

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Recently, there has been a rapid increase in lending by Russian banks, which many believe has been accompanied by a deterioration in the credit quality of the borrowers. In addition, a robust domestic corporate debt market is leading to Russian banks increasingly holding large amounts of Russian corporate ruble bonds in their portfolios, which is further deteriorating the risk profile of Russian bank assets. The serious deficiencies in the Russian banking sector, combined with the deterioration in the credit portfolios of Russian banks, may result in the banking sector being more susceptible to market downturns or economic slowdowns, including due to Russian corporate defaults that may occur during any such market downturn or economic slowdown. In addition, the Russian Central Bank has recently revoked the licenses of certain Russian banks, which resulted in market rumors about additional bank closures and many depositors withdrawing their savings. If a banking crisis were to occur, Russian companies would be subject to severe liquidity constraints due to the limited supply of domestic savings and the withdrawal of foreign funding sources that would occur during such a crisis.

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

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

Russia's physical infrastructure largely dates back to Soviet times and has not been adequately funded and maintained over the past decade. Particularly affected are the rail and road networks, power generation and transmission, communication systems and building stock. For example, during the winter of 2000-2001, electricity and heating shortages in Russia's far-eastern Primorye Region seriously disrupted the local economy. In August 2000, a fire at the main communications tower in Moscow interrupted television and radio broadcasting and the operation of mobile phones for weeks. Road conditions throughout Russia are poor, with many roads not meeting minimum requirements for use and safety. The federal government is actively considering plans to reorganize the nation's rail, electricity and telephone systems. Any such reorganization may result in increased charges and tariffs while failing to generate the anticipated capital investment needed to repair, maintain and improve these systems. Russia's poor physical infrastructure disrupts the transportation of goods and supplies and adds costs to doing business in Russia, and further deterioration in the physical infrastructure could have a material adverse effect on our business. In addition, there are a number of nuclear and other dangerous installations in Russia where safety systems to contain ecological risks may not be sufficiently effective. The occurrence of accidents in these installations, as well as the generally unfavorable ecological situation in Russia, may also have a material adverse effect on our business.

### **RISKS RELATING TO THE SOCIAL ENVIRONMENT IN RUSSIA**

#### **Crime and corruption could disrupt our ability to conduct our business.**

The political and economic changes in Russia in recent years have resulted in significant dislocations of authority, reduced policing and increased lawlessness. The local and international press have reported that significant organized criminal activity has arisen, particularly in large metropolitan centers. Property



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**Risk factors**

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crimes in large cities have increased substantially. In addition, the local and international press have reported high levels of official corruption, including the bribing of officials for the purpose of initiating investigations by government agencies. Press reports have also described instances in which government officials engaged in selective investigations and prosecutions to further the commercial interests of government officials or certain individuals. Additionally, published reports have indicated that a significant number of Russian media outlets regularly publish disparaging articles in return for payment. The depredations of organized or other crime, demands of corrupt officials or claims that we have been involved in official corruption or illegal activities may in the future bring negative publicity, which could disrupt our ability to conduct our business effectively and could thus materially adversely affect the value of our ADSs.

**Social instability could increase support for renewed centralized authority, nationalism or violence, materially adversely affecting our ability to conduct our business.**

The failure of the government and many private enterprises to pay full salaries on a regular basis and the failure of salaries and benefits generally to keep pace with the rapidly increasing cost of living in Russia have led in the past, and could lead in the future, to labor and social unrest. For example, in 1998, miners in several regions of Russia, demanding payment of overdue wages, resorted to strikes which included blocking major railroads. This type of labor and social unrest may have political, social and economic consequences, such as increased support for a renewal of centralized authority, nationalism, restrictions on foreign involvement in the Russian economy and violence. Any of these or similar consequences of social unrest could restrict our operations and lead to the loss of revenue, materially adversely affecting us.

**RISKS RELATING TO RUSSIAN LEGISLATION AND THE RUSSIAN LEGAL SYSTEM**

**Weaknesses relating to the Russian legal system and Russian legislation create an uncertain environment for investment and business activity and thus could have a material adverse effect on our business and the value of our ADSs.**

Russia is still developing the legal framework required to support a market economy. The following risks relating to the Russian legal system create uncertainties with respect to the legal and business decisions that we make, many of which do not exist in countries with more developed market economies:

- inconsistencies among (1) federal laws; (2) decrees, orders and regulations issued by the president, the government and federal ministries; and (3) regional and local laws, rules and regulations;
- the lack of judicial and administrative guidance on interpreting Russian legislation;
- substantial gaps in the regulatory structure due to delay or absence of implementing regulations;
- the relative inexperience of judges and courts in interpreting Russian legislation;
- corruption within the judiciary;
- a high degree of unchecked discretion on the part of governmental authorities; and
- bankruptcy procedures that are not well developed and are subject to abuse.

For example, over the last year one of our competitors tried to keep our iron ore operations, Korshunov Mining Plant, from emerging from bankruptcy proceedings in order to prevent us from exercising our

rights as the controlling shareholder, even though creditors representing almost all of its debt had agreed to a settlement plan. In September 2003, a Russian commercial court approved a settlement agreement.

Under Russian corporate law, negative net assets calculated on the basis of Russian accounting standards, or RAS, can serve as a basis for a court to order the liquidation of the company, upon a claim by governmental authorities. Numerous Russian companies have negative net assets due to very low

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**Risk factors**

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historical asset values reflected on their RAS balance sheets; however, their solvency, i.e., their ability to pay debts as they come due, is not otherwise adversely affected by such negative net assets. In a highly-publicized case a few years ago, a court ordered the liquidation of a company with negative net assets, although it was otherwise solvent. We currently have and may have in the future subsidiaries with negative net assets under RAS, and thus are subject to the potential for arbitrary government action in this regard.

Moreover, the regulation and supervision of the securities market, financial intermediaries and issuers are considerably less developed in Russia than in the United States and Western Europe. Securities laws, including those relating to corporate governance, disclosure and reporting requirements, have only recently been adopted, whereas laws relating to anti-fraud safeguards, insider trading restrictions and fiduciary duties are rudimentary. In addition, the Russian securities market is regulated by several different authorities which are often in competition with each other. These include

- the Federal Service for the Financial Markets;
- the Ministry of Finance;
- the Federal Antimonopoly Service;
- the Central Bank of Russia; and
- various professional self-regulatory organizations.

The regulations of these various authorities are not always coordinated and may be contradictory.

In addition, Russian corporate and securities rules and regulations can change rapidly, which may adversely affect our ability to conduct securities-related transactions. While some important areas are subject to virtually no oversight, the regulatory requirements imposed on Russian issuers in other areas result in delays in conducting securities offerings and in accessing the capital markets. It is often unclear whether or how regulations, decisions and letters issued by the various regulatory authorities apply to our company. As a result, we may be subject to fines or other enforcement measures despite our best efforts at compliance.

Additionally, several fundamental laws have only recently become effective. The enactment of new legislation in the context of a rapid evolution to a market economy and the lack of consensus about the scope, content and pace of economic and political reforms has resulted in ambiguities, inconsistencies and anomalies in the overall Russian legal system. The enforceability and underlying constitutionality of many recently enacted laws are in doubt, and many new laws remain untested. For example, the regulations governing approvals by the Russian Federal Service for the Financial Markets of placement reports in offerings like this, as well as the regulations regarding issuance of permissions for depositary receipt programs and voting by depositaries at the instruction of ADS holders, are relatively new and untested. This makes it difficult to assess the risk that the placement report will not be registered and that the shares underlying the ADSs in this offering will be cancelled. In addition, Russian legislation often contemplates implementing regulations that have not yet been promulgated, leaving substantial gaps in the regulatory infrastructure. All of these weaknesses could affect our ability to enforce our legal rights, including rights under our contracts, or to defend ourselves against claims by others.

**The judiciary's lack of independence and inexperience, the difficulty of enforcing court decisions and governmental discretion in instigating, joining and enforcing claims could prevent us or you from obtaining effective redress in a court proceeding, which could have a material adverse effect on our business or the value of our ADSs.**



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The independence of the judicial system and the prosecutor general's office and their immunity from economic, political and nationalistic influences in Russia is less than complete. The court system is

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**Risk factors**

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understaffed and underfunded. Judges and courts are generally inexperienced in the area of business and corporate law. Judicial precedents generally have no binding effect on subsequent decisions. Not all Russian legislation and court decisions are readily available to the public or organized in a manner that facilitates understanding. The Russian judicial system can be slow, and court orders are not always enforced or followed by law enforcement agencies. All of these factors make judicial decisions in Russia difficult to predict and effective redress uncertain. Additionally, court claims and governmental prosecutions are often used in furtherance of political aims, which the courts themselves support. We may be subject to such claims and may not be able to receive a fair hearing.

These uncertainties also extend to property rights. During Russia's transformation from a centrally planned economy to a market economy, legislation was enacted to protect private property against expropriation and nationalization. However, it is possible that, due to the lack of experience in enforcing these provisions and political factors, these protections would not be enforced in the event of an attempted expropriation or nationalization. Some government entities have tried to renationalize privatized businesses. Expropriation or nationalization of any of our entities, their assets or portions thereof, potentially without adequate compensation, could have a material adverse effect on our business.

**Unlawful, selective or arbitrary government action may have an adverse effect on our business and the value of our ADSs.**

Governmental authorities have a high degree of discretion in Russia and at times act selectively or arbitrarily, without hearing or prior notice, and sometimes in a manner that is contrary to law or influenced by political or commercial considerations. Moreover, the government also has the power in certain circumstances, by regulation or government act, to interfere with the performance of, nullify or terminate contracts. Unlawful, selective or arbitrary governmental actions have reportedly included denial or withdrawal of licenses, sudden and unexpected tax audits, criminal prosecutions and civil actions. Federal and local government entities have also used common defects in matters surrounding share issuances and registration as pretexts for court claims and other demands to invalidate such issuances and registrations or to void transactions, often for political purposes. S&P has expressed concerns that Russian companies and their investors can be subjected to government pressure through selective implementation of regulations and legislation that is either politically motivated or triggered by competing business groups. In this environment, our competitors may receive preferential treatment from the government, potentially giving them a competitive advantage over us.

In addition, in 2003 and thus far in 2004, the Ministry for Taxes and Levies has begun to aggressively crack down on certain Russian companies use of tax-optimization schemes, and press reports have speculated that these enforcement actions have been selective.

Unlawful, selective or arbitrary government action, if directed at us, could have a material adverse effect on our business and on the value of our ADSs.

**Shareholder liability under Russian legislation could cause us to become liable for the obligations of our subsidiaries.**

The Civil Code and the Joint Stock Company Law generally provide that shareholders in a Russian joint stock company are not liable for the obligations of the joint stock company and bear only the risk of loss of their investment. This may not be the case, however, when one person is capable of determining decisions made by another person. The person capable of determining such decisions is called an effective parent. The person whose decisions are capable of being so determined is called an effective subsidiary. The effective parent bears joint and several responsibility for transactions concluded by the effective subsidiary in carrying out these decisions if

this decision-making capability is provided for in the charter of the effective subsidiary or in a contract between such persons, and

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**Risk factors**

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the effective parent gives obligatory directions to the effective subsidiary.

Moreover, an effective parent is secondarily liable for an effective subsidiary's debts if an effective subsidiary becomes insolvent or bankrupt as a result of the action or inaction of an effective parent. This is the case no matter how the effective parent's capability to determine decisions of the effective subsidiary arises. For example, this liability could arise through ownership of voting securities or by contract. In these instances, other shareholders of the effective subsidiary may claim compensation for the effective subsidiary's losses from the effective parent which caused the effective subsidiary to take action or fail to take action knowing that such action or failure to take action would result in losses. Accordingly, given our status as a holding company, we could be liable in some cases for debts of our consolidated Russian subsidiaries. The total liabilities of our consolidated Russian subsidiaries, as of June 30, 2004, was \$966.8 million, excluding intercompany indebtedness.

**Because there is little minority shareholder protection in Russia, your ability to bring, or recover in, an action against us will be limited.**

In general, minority shareholder protection under Russian law derives from supermajority shareholder approval requirements for certain corporate action, as well as from the ability of a shareholder to demand that the company purchase the shares held by that shareholder if that shareholder voted against or did not participate in voting on certain types of action. Companies are also required by Russian law to obtain the approval of disinterested shareholders for certain transactions with interested parties. See "Description of Capital Stock and Certain Requirements of Russian Legislation" "Description of Capital Stock" "Rights Attaching to Common Shares" for a more detailed description of some of these protections. While these protections are similar to the types of protections available to minority shareholders in U.S. corporations, in practice, corporate governance standards for many Russian companies have proven to be poor, and minority shareholders in Russian companies have suffered losses due to abusive share dilutions, asset transfers and transfer pricing practices. Shareholder meetings have been irregularly conducted, and shareholder resolutions have not always been respected by management. Shareholders of some companies also suffered as a result of fraudulent bankruptcies initiated by hostile creditors.

In addition, the supermajority shareholder approval requirement is met by a vote of 75% of all voting shares that are present at a shareholders meeting. Thus, controlling shareholders owning slightly less than 75% of outstanding shares of a company may have a 75% or more voting power if certain minority shareholders are not present at the meeting. In situations where controlling shareholders effectively have 75% or more of voting power at a shareholders meeting, they are in a position to approve amendments to the charter of the company, which could be prejudicial to the interests of minority shareholders. It is possible that our majority shareholders and our management in the future may not run us and our subsidiaries for the benefit of minority shareholders, and this could materially and adversely affect the value of your investment in our ADSs. See "Risks Relating to Our Business and Industry" "We will be controlled by two shareholders who run our business and affairs collectively and whose interests could conflict with those of the holders of the ADSs" for more discussion of the potential control our current shareholders may have following this offering.

Disclosure and reporting requirements, as well as anti-fraud legislation, have only recently been enacted in Russia. Most Russian companies and managers are not accustomed to restrictions on their activities arising from these requirements. The concept of fiduciary duties of management or directors to their companies and shareholders is also relatively new and is not well developed. Violations of disclosure and reporting requirements or breaches of fiduciary duties to us and our subsidiaries or to our shareholders could materially adversely affect the value of your investment in our ADSs.

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**Risk factors**

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While the Joint Stock Companies Law provides that shareholders owning not less than 1% of the company's stock may bring an action for damages on behalf of the company, Russian courts to date do not have experience with respect to such lawsuits. Russian law does not contemplate class action litigation. Accordingly, your ability to pursue legal redress against us may be limited, reducing the protections available to you as a holder of ADSs.

**Shareholder rights provisions under Russian law may impose additional costs on us, which could cause our financial results to suffer.**

Russian law provides that shareholders, including holders of our ADSs, that voted against or did not participate in voting on certain matters have the right to sell their shares to the company at market value, as determined in accordance with Russian law. The decisions that trigger this right to sell shares include

decisions with respect to reorganization;  
approval by shareholders of a major transaction, which, in general terms, is a transaction involving property worth more than 25% of the book value of our assets calculated according to Russian accounting standards; and  
amendment of our charter that restricts the shareholder's rights.

Our obligation to purchase the shares in these instances is limited to 10% of our net assets calculated according to Russian accounting standards, at the time the matter at issue is voted upon. Our or our subsidiaries' obligation to purchase shares in these circumstances could have an adverse effect on our cash flows and our business.

**The lack of a central and rigorously regulated share registration system in Russia may result in improper record ownership of our shares, including the shares underlying your ADSs.**

Ownership of Russian joint stock company shares (or, if the shares are held through a nominee or custodian, then the holding of such nominee or custodian) is determined by entries in a share register and is evidenced by extracts from that register. Currently, there is no central registration system in Russia. Share registers are maintained by the companies themselves or, if a company has more than 50 shareholders or so elects, by licensed registrars located throughout Russia. Regulations have been issued regarding the licensing conditions for such registrars, as well as the procedures to be followed by both companies maintaining their own registers and licensed registrars when performing the functions of registrar. In practice, however, these regulations have not been strictly enforced, and registrars generally have relatively low levels of capitalization and inadequate insurance coverage. Moreover, registrars are not necessarily subject to effective governmental supervision. Due to the lack of a central and rigorously regulated share registration system in Russia, transactions in respect of a company's shares could be improperly or inaccurately recorded, and share registration could be lost through fraud, negligence, official and unofficial governmental actions or oversight by registrars incapable of compensating shareholders for their misconduct. This creates risks of loss not normally associated with investments in other securities markets. Further, the depositary, under the terms of the agreement governing the deposit of ADSs, will not be liable for the unavailability of shares or for the failure to make any distribution of cash or property with respect thereto due to the unavailability of the shares. See [Description of Capital Stock and Certain Requirements of Russian Legislation](#), [Description of Capital Stock](#), [Registration and Transfer of Shares](#) and [Description of American Depositary Shares](#), [Registrar](#) for more discussion of the share registration system and registrars in the Russian Federation.



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**Risk factors**

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**Weaknesses and changes in the Russian tax system could materially adversely affect our business and the value of our ADSs.**

Generally, taxes payable by Russian companies are substantial and numerous. These taxes include, among others:

- income taxes;
- value-added tax, or VAT;
- excise taxes;
- unified social tax; and
- property tax.

The tax environment in Russia has historically been complicated by the fact that various authorities have often issued contradictory pieces of tax legislation. Because of the political changes which have occurred in Russia over the past several years, there have recently been significant changes to the Russian taxation system.

Global tax reform commenced in 1999 with the introduction of Part One of the Tax Code, which sets general taxation guidelines. Since then, Russia has been in the process of replacing legislation regulating the application of major taxes such as corporate income tax, VAT and property tax with new chapters of the Tax Code. For instance, new chapters of the Tax Code on VAT, unified social tax and personal income tax came into force on January 1, 2001; the profits tax and mineral extraction tax chapters came into force on January 1, 2002; and the newly introduced corporate property tax chapter of the Tax Code came into force on January 1, 2004.

In practice, the Russian tax authorities often have their own interpretation of the tax laws that rarely favors taxpayers, who often have to resort to court proceedings to defend their position against the tax authorities. Differing interpretations of tax regulations exist both among and within government ministries and organizations at the federal, regional and local levels, creating uncertainties and inconsistent enforcement. Tax declarations, together with related documentation such as customs declarations, are subject to review and investigation by a number of authorities, each of which may impose fines, penalties and interest charges. Generally, taxpayers are subject to inspection for a period of three calendar years of their activities which immediately preceded the year in which the audit is carried out. As previous audits do not exclude subsequent claims relating to the audited period, the statute of limitations is not entirely effective. In addition, in some instances, new tax regulations have been given retroactive effect. Recently, the Constitutional Court of the Russian Federation ruled that VAT paid on a commercial enterprise's purchases, or input VAT, cannot be offset against VAT collected from sales to the extent that the input VAT was incurred on items purchased with borrowed funds.

Moreover, financial statements of Russian companies are not consolidated for tax purposes. Therefore, each of our Russian entities pays its own Russian taxes and may not offset its profit or loss against the loss or profit of another entity in our group. In addition, pursuant to legislation that entered into force on January 1, 2002, payments of intercompany dividends between two Russian entities are subject to a withholding tax of 6% at the time they are paid out of profits, though this tax does not apply to dividends once they have already been taxed.

The foregoing conditions create tax risks in Russia that are more significant than typically found in countries with more developed tax systems, imposing additional burdens and costs on our operations, including management resources. In addition to our substantial tax burden, these risks and uncertainties complicate our tax planning and related business decisions, potentially exposing us to significant fines and penalties and enforcement measures despite our best efforts at compliance, and could adversely affect our business and the value of our ADSs.





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**Risk factors**

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**RISKS RELATING TO OTHER JURISDICTIONS**

**We also face risks associated with conducting business in the countries of the former Soviet Union and former Soviet-bloc countries in Eastern and Central Europe.**

We currently have two steel mills in Romania, a hardware plant in Lithuania and coal operations in Kazakhstan. We may acquire additional operations in the countries of the former Soviet Union and former Soviet-bloc countries in Eastern and Central Europe. As with Russia, these countries are emerging markets subject to greater political, economic, social and legal risks than more developed markets. In many respects, the risks inherent in transacting business in these countries are similar to those in Russia, especially those risks set out above in Risks Relating to the Economic Environment in Russia, Risks Relating to the Social Environment in Russia and Risks Relating to Russian Legislation and the Russian Legal System.

Moreover, these countries are new operating environments for us, which are located, in many instances, a great distance from our Russian operations and across multiple international borders. We thus expect to have less control over their activities and these businesses may face more uncertainties with respect to their operational needs. These factors may hurt the profitability of our current and future operations in these countries.

## Cautionary note regarding forward-looking statements

Matters discussed in this prospectus may constitute forward-looking statements. Forward-looking statements include statements concerning plans, objectives, goals, strategies, future events or performance, and underlying assumptions and other statements, which are other than statements of historical facts. The words believe, expect, anticipate, intend, estimate, forecast, project, will, may, should and identify forward-looking statements. Forward-looking statements appear in a number of places including, without limitation, Risk Factors, Business and Management's Discussion and Analysis of Financial Condition and Results of Operations, and include statements regarding:

- strategies, outlook and growth prospects;
- future plans and potential for future growth;
- liquidity, capital resources and capital expenditures;
- growth in demand for our products;
- economic outlook and industry trends;
- developments of our markets;
- the impact of regulatory initiatives; and
- the strength of our competitors.

The forward-looking statements in this prospectus are based upon various assumptions, many of which are based, in turn, upon further assumptions, including without limitation, management's examination of historical operating trends, data contained in our records and other data available from third parties. Although we believe that these assumptions were reasonable when made, these assumptions are inherently subject to significant uncertainties and contingencies which are difficult or impossible to predict and are beyond our control and we may not achieve or accomplish these expectations, beliefs or projections. In addition to these important factors and matters discussed elsewhere herein, important factors that, in our view, could cause actual results to differ materially from those discussed in the forward-looking statements include the achievement of the anticipated levels of profitability, growth, cost and synergy of our recent acquisitions, the timely development and acceptance of new products, the impact of competitive pricing, the ability to obtain necessary regulatory approvals, the condition of the Russian economy, political stability in Russia, the impact of general business and global economic conditions and other important factors described herein and from time to time in the reports to be filed by us with the Securities and Exchange Commission, or the SEC.

Except to the extent required by law, neither we, nor any of our agents, employees or advisors intend or have any duty or obligation to supplement, amend, update or revise any of the forward-looking statements contained in this prospectus.

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## Escrow of proceeds and registration of placement report

Under Russian law, placement of the shares underlying the ADSs we offer pursuant to this prospectus is subject to our registration of a placement report with the Federal Service for the Financial Markets. The placement report may not be filed with the Federal Service for the Financial Markets until after the closing of this offering. We intend to file the placement report as soon as practicable following the closing of the offering. The Federal Service for the Financial Markets is statutorily required to make its decision within two weeks after we file the placement report but the current practice is that registration of a placement report takes between 30 and 44 days after filing.

Accordingly, prior to the registration of the placement report by the Federal Service for the Financial Markets, all sums paid for the ADSs will be held in escrow and escrow-type accounts. The underwriting agreement and agreements governing these accounts will provide that, pending the registration of the placement report by the Federal Service for the Financial Markets, the proceeds of this offering will be deposited as follows:

the net proceeds to us will be converted into rubles and deposited in ruble-denominated escrow-type accounts at Raiffeisenbank Austria ZAO, a Russian subsidiary of Raiffeisenbank Zentralbank Österreich AG; and  
the underwriters' commission and the net proceeds to the selling shareholders will be deposited in a U.S. dollar-denominated escrow account at UBS AG.

As Russian law does not allow for escrow accounts of the nature commonly seen in the United States, we have entered into a series of agreements with Raiffeisenbank Austria ZAO to replicate in substance the functions of an escrow account. We refer to the accounts established under these agreements as escrow-type accounts.

In the event that the placement report is not registered by the Federal Service for the Financial Markets within 60 days after the closing date (or such later date to which we and the selling shareholders agree with the underwriters), we will be required to issue a press release and to notify the depository, the banks holding the escrow and escrow-type accounts, the underwriters and the NYSE of the termination of this offering by the close of business on the termination date. In this instance, all funds received in respect of the ADSs in the escrow-type and escrow accounts will be released to the depository, together with interest, if any, accrued upon those funds from the closing date to the termination date and any additional amounts required so that the funds being released to the depository would be equal (after conversion of all ruble funds into U.S. dollars) to the original U.S. dollar proceeds of the offering. The depository will promptly distribute in U.S. dollars through DTC the funds it receives to the holders of the ADSs on the termination date.

**In these unlikely circumstances, the amount returned to the holders of the ADSs as of the termination date will be the offer price for the ADSs, including interest, if any, regardless of the then-prevailing market prices for the ADSs. The return of funds may be delayed due to Russian currency control regulations and may be prevented if there is a change in such regulations.**

Until the registration of the placement report by the Federal Service for the Financial Markets, you will not be entitled to instruct the depository to exercise any voting rights on your behalf as our shareholder, and the depository and its nominee will not be entitled to exercise any voting rights as a shareholder.

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You may not withdraw our shares or other property with the depositary in respect of the ADSs sold in this offering prior to the registration of the placement report with the Federal Service for the Financial Markets.

See Risk Factors Risks Related to our ADSs and the Trading Market The holder of an ADS cannot withdraw the shares underlying the ADS prior to the registration of a placement report for these shares, and the failure to register this placement report could result in the offering being held invalid and being withdrawn.

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## Use of proceeds

The net proceeds to us from the offering will be approximately \$• million, assuming an offering price equal to the mid-point of the estimated price range, which we will receive in rubles. This amount represents net proceeds after deducting estimated fees and expenses incurred in connection with the offering. We expect to use the net proceeds from this offering for the following purposes:

- \$• million for capital expenditures, including the purchase of equipment and modernization of facilities; and
- \$• million for acquisitions of additional operations and subsoil licenses.

We are not currently engaged in any discussions or negotiations with any acquisition target in which the completion of an acquisition has reached the probable stage.

We will not receive any of the proceeds from the sale of ADSs representing common shares offered by the selling shareholders.

Until the registration of a placement report regarding the placement of shares underlying the ADSs by the Federal Service for the Financial Markets, the proceeds from this offering will be held in escrow and escrow-type accounts at UBS AG and Raiffeisenbank Austria ZAO, a Russian subsidiary of Raiffeisenbank Zentralbank Österreich AG. The terms of the deposit of funds into these accounts will provide that the net proceeds will be released to us, and that the sums due to the selling shareholders and the underwriters will be released to them, only upon the registration of the placement report. Although under Russian law the placement report should be registered within two weeks after the report is filed with the Russian Federal Service for the Financial Markets, the registration may take longer or may not occur at all. See [Escrow of Proceeds and Registration of Placement Report](#) and [Risk Factors Risks Related to our ADSs and the Trading Market](#). The holder of an ADS cannot withdraw the shares underlying the ADS prior to the registration of a placement report for these shares, and the failure to register this placement report could result in the offering being held invalid and being withdrawn for more detail.

## Dividend policy

Mechel Steel Group declared a dividend of 149 million rubles (or approximately \$5.2 million) on June 24, 2004. Other than this dividend, Mechel Steel Group has not declared or paid any dividends on its common shares since its incorporation on March 19, 2003. Certain companies in our group paid dividends to our controlling shareholders in amounts of \$26.3 million, \$13.4 million and \$8.8 million in the years ended December 31, 2003, 2002 and 2001, respectively. Commencing in 2005, with respect to the year ended December 31, 2004, we expect to declare and pay an annual dividend equal to at least 15% of our annual net income, as determined under U.S. GAAP, subject to any applicable Russian legal restrictions. See Description of Capital Stock and Certain Requirements of Russian Legislation Description of Capital Stock Dividends.

Dividend payments, if any, must be recommended by our board of directors and approved by our shareholders. In particular, dividends may be declared only out of net profits calculated under Russian accounting standards and as long as the following conditions have been met:

- our charter capital has been paid in full;
- the value of our net assets, calculated under Russian accounting standards, is not less (and would not become less as a result of the proposed dividend payment) than the sum of our charter capital, our reserve fund and the difference between the liquidation value and the par value of our issued and outstanding preferred shares;
- we have repurchased all shares from shareholders having the right to demand repurchase; and
- we are not, and would not become as the result of the proposed dividend payment, insolvent.

For a further description, please refer to Description of Capital Stock and Certain Requirements of Russian Legislation Description of Capital Stock Dividends.

We anticipate that any dividends we may pay in the future on the common shares represented by the ADSs will be declared and paid to the depositary in rubles and will be converted into U.S. dollars by the depositary and distributed to holders of ADSs, net of the depositary's fees and expenses. Accordingly, the value of dividends received by holders of ADSs will be subject to fluctuations in the exchange rate between the ruble and the U.S. dollar.

## Capitalization

The following table sets forth our short-term debt and capitalization at June 30, 2004, on a historical basis and as adjusted to give effect to the issue and sale of 33,301,659 common shares in the offering at an assumed offering price of \$• per ADS (the mid-point of the estimated price range) and the application of the net proceeds of the offering as described under Use of Proceeds. You should read this table together with the information under Management's Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements included elsewhere in this prospectus.

|  | At June 30, 2004                             |             |
|--|--|-------------|
|  | Historical<br>(in thousands of U.S. dollars) | As Adjusted |
| Short-term debt (including current portion of long-term debt) <sup>(1)</sup> | 385,371                                      | •           |
| Long-term debt, net of current portion <sup>(1)</sup>                        | 152,583                                      | •           |
| Shareholders' equity:  |  |             |
| Common shares  | 121,935                                      | •           |
| Treasury shares  | (4,614)                                      | •           |
| Additional paid-in capital   | 93,327                                       | •           |
| Retained earnings  | 441,968                                      | •           |
| Accumulated other comprehensive income                                       | 53,287                                       | •           |
| Total shareholders' equity   | 705,903                                      | •           |
| Total capitalization   | 858,486                                      | •           |

(1) Of our total indebtedness at June 30, 2004, \$436.2 million, was secured and \$101.8 million was unsecured.

There has been no material change in our capitalization since June 30, 2004.

## Dilution

Our net tangible book value as of June 30, 2004, was \$512.9 million, or \$4.17 per ADS. Net tangible book value per ADS represents the amount of our total tangible assets less total liabilities and minority interest, divided by the product of the number of shares outstanding and the ratio of one ADS per three shares.

Dilution in net tangible book value per ADS represents the difference between the amount per ADS paid by purchasers of ADSs in this offering and the net tangible book value per ADS immediately after the completion of this offering. After giving effect to the sale by us of 33,301,659 shares represented by ADSs in the offering at an assumed initial offering price of \$• per ADS (the mid-point of the estimated price range), and after deducting the underwriting discount and estimated offering expenses payable by us, our net tangible book value as of June 30, 2004, as adjusted, would have been \$• million, or \$• per ADS. This represents an immediate increase in net tangible book value of \$• per ADS to existing shareholders and an immediate dilution of \$• per ADS to new investors purchasing ADSs in the offering.

The following table illustrates the per-ADS dilution.

|   |         |   |
|---|---------|---|
| Assumed initial public offering price per ADS                             |         | • |
| Net tangible book value before the offering                               | \$ 4.17 |   |
| Increase in net tangible book value per ADS attributable to new investors | •       |   |
| Pro forma net tangible book value per ADS after the offering              |         | • |
| Dilution to new investors   |         | • |

The following table sets forth, as of June 30, 2004, on an as adjusted basis and, in each case, as converted into ADSs for comparison purposes:

the number of shares purchased from us and the total consideration and the average price per share paid to us by existing shareholders;  
and

the number of shares to be sold by us in this offering and the total consideration and the average price per share to be paid by new investors purchasing ADSs representing these shares (before deducting the underwriting discount and estimated offering expenses).

|                       | ADSs Purchased |         | Total Consideration |         | Average Price<br>per ADS |
|-----------------------|----------------|---------|---------------------|---------|--------------------------|
|                       | Number         | Percent | Amount              | Percent |                          |
| Existing shareholders |                |         |                     |         |                          |
| New investors         |                |         |                     |         |                          |
| Total                 |                |         |                     |         |                          |



The preceding tables assume that the underwriters will not exercise their over-allotment option. If the underwriters' over-allotment option is exercised in full, the net tangible book value of as of December 31, 2003, as adjusted, would have been \$•, or \$• per ADS, which would result in dilution to new investors of \$• per ADS, and the number of shares held by the new investors would increase to • shares (represented by • ADSs), or •% of the total number of shares to be outstanding after this offering, and the number of shares held by existing shareholders would be • shares (equivalent to • ADSs), or •% of the total number of shares to be outstanding after this offering.

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|   |             |             |             |             |             |
|---|-------------|-------------|-------------|-------------|-------------|
| Net income per share                          | 0.69        | 0.18        | 0.39        | 0.27        | 0.21        |
| Cash dividends paid per share <sup>(2)</sup>  | 0.00        |             | 0.07        | 0.04        | 0.04        |
| Weighted average number of shares outstanding | 367,150,968 | 366,178,815 | 366,178,815 | 333,243,450 | 225,271,391 |

## Selected consolidated financial data

|  | Six months ended<br>June 30, |           | Year ended December 31, |           |           |
|--|------------------------------|-----------|-------------------------|-----------|-----------|
|  | 2004                         | 2003      | 2003                    | 2002      | 2001      |
| (in thousands of U.S. dollars, except per share data)      |                              |           |                         |           |           |
| <b>Steel segment income statement data</b>                 |                              |           |                         |           |           |
| Revenue, net <sup>(3)</sup>                                | 1,307,903                    | 778,846   | 1,678,395               | 1,050,554 | 680,314   |
| Cost of goods sold <sup>(3)</sup>                          | (964,118)                    | (572,817) | (1,247,380)             | (801,481) | (546,885) |
| Gross margin   | 343,785                      | 206,029   | 431,015                 | 249,073   | 133,429   |
| Selling, distribution and operating expenses               | (180,071)                    | (145,147) | (301,689)               | (194,341) | (133,273) |
| Operating income   | 163,714                      | 60,882    | 129,326                 | 54,732    | 155       |
| <b>Mining segment income statement data</b>                |                              |           |                         |           |           |
| Revenue, net <sup>(3)</sup>                                | 522,594                      | 251,027   | 599,756                 | 372,216   | 339,971   |
| Cost of goods sold <sup>(3)</sup>                          | (221,686)                    | (174,270) | (420,736)               | (254,667) | (174,763) |
| Gross margin   | 300,908                      | 76,757    | 179,020                 | 117,549   | 165,208   |
| Selling, distribution and operating expenses               | (115,516)                    | (48,283)  | (115,570)               | (83,137)  | (60,580)  |
| Operating income   | 185,392                      | 28,474    | 63,450                  | 34,412    | 104,627   |
| <b>Consolidated balance sheet data<br/>(at period end)</b> |                              |           |                         |           |           |
| Total assets   | 2,336,233                    | n/a       | 1,834,509               | 1,387,378 | 1,116,473 |
| Shareholders' equity                                       | 705,903                      | n/a       | 448,826                 | 278,051   | 195,122   |
| Long-term debt, net of current portion                     | 152,583                      | n/a       | 122,311                 | 36,496    | 16,525    |
| <b>Consolidated cash flows data</b>                        |                              |           |                         |           |           |
| Net cash provided by operating activities                  | 207,960                      | 43,535    | 119,466                 | 81,069    | 34,751    |
| Net cash used in investing activities                      | (207,805)                    | (49,963)  | (209,901)               | (86,633)  | (93,068)  |
| Net cash provided by financing activities                  | 43,843                       | 19,162    | 103,079                 | 3,422     | 65,701    |
| <b>Non-U.S. GAAP measures<sup>(4)</sup></b>                |                              |           |                         |           |           |
| Consolidated EBITDA  | 420,818                      | 157,307   | 341,484                 | 207,452   | 105,506   |
| Steel segment EBITDA                                       | 206,739                      | 116,420   | 245,832                 | 133,448   | 2,976     |
| Mining segment EBITDA                                      | 214,080                      | 40,887    | 95,652                  | 74,004    | 102,529   |

- (1) The value of property, plant and equipment pertaining to non-controlling shareholders in the accounting for minority interests resulting from acquisitions of various subsidiaries has been recorded at appraised values rather than at historical cost as required by U.S. GAAP.
- (2) Mechel Steel Group declared a dividend of 149 million rubles (or approximately \$5.2 million) on June 24, 2004. Certain companies in our group paid dividends to our controlling shareholders in amounts of \$26.3 million, \$13.4 million and \$8.8 million in the years ended December 31, 2003, 2002 and 2001, respectively.
- (3) Segment revenues and cost of goods sold include intersegment sales.
- (4) EBITDA represents net income before interest expense, income taxes and depreciation, depletion and amortization. We present EBITDA because we consider it an important supplemental measure of our operating performance and believe it is frequently used by securities analysts, investors and other interested parties in the evaluation of companies in our industry. We also present EBITDA by segment because our overall performance is best explained with reference to results of each segment.

EBITDA has limitations as an analytical tool, and you should not consider it in isolation, or as a substitute for analysis of our operating results as reported under U.S. GAAP. Some of these limitations are as follows:

EBITDA does not reflect the impact of financing costs, which are significant and could further increase if we incur more debt, on our operating performance.

EBITDA does not reflect the impact of income taxes on our operating performance.

EBITDA does not reflect the impact of depreciation, depletion and amortization on our operating performance. The assets of our businesses which are being depreciated, depleted and/or amortized (including, for example, our mineral reserves) will have to be replaced in the future and such depreciation, depletion and amortization expense may approximate the cost to replace these assets in the future. By excluding such expense from EBITDA, EBITDA

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does not reflect our future cash requirements for such replacements.

Other companies in our industry may calculate EBITDA differently or may use it for different purposes than we do, limiting its usefulness as a comparative measure.

We compensate for these limitations by relying primarily on our U.S. GAAP operating results and using EBITDA only supplementally. See our consolidated income statements and consolidated statements of cash flows included elsewhere in this prospectus.

EBITDA is a measure of our operating performance that is not required by, or presented in accordance with, U.S. GAAP. EBITDA is not a measurement of our operating performance under U.S. GAAP and should not be considered as an alternative to net income, operating income or any other performance measures derived in accordance with U.S. GAAP or as an alternative to cash flow from operating activities or as a measure of our liquidity. In particular, EBITDA should not be considered as a measure of discretionary cash available to us to invest in the growth of our business.

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**Selected consolidated financial data**


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Reconciliation of EBITDA to net income is as follows for the periods indicated:

|   | Six months ended               |                |                         |                |                |
|---|--------------------------------|----------------|-------------------------|----------------|----------------|
|   | June 30,                       |                | Year ended December 31, |                |                |
|   | 2004                           | 2003           | 2003                    | 2002           | 2001           |
|   | (in thousands of U.S. dollars) |                |                         |                |                |
| <b>Consolidated EBITDA reconciliation</b>   |                                |                |                         |                |                |
| Net income                                  | 254,456                        | 67,740         | 143,508                 | 89,253         | 47,418         |
| Add:  |                                |                |                         |                |                |
| Depreciation, depletion and amortization    | 62,240                         | 46,185         | 101,689                 | 78,773         | 13,378         |
| Interest expense                            | 30,022                         | 20,247         | 48,528                  | 36,773         | 14,526         |
| Income taxes                                | 74,100                         | 23,135         | 47,759                  | 2,653          | 30,184         |
|   | <u>420,818</u>                 | <u>157,307</u> | <u>341,484</u>          | <u>207,452</u> | <u>105,506</u> |
| <b>Steel segment EBITDA reconciliation</b>  |                                |                |                         |                |                |
| Net income                                  | 91,542                         | 53,551         | 114,011                 | 57,977         | (16,924)       |
| Add:  |                                |                |                         |                |                |
| Depreciation, depletion and amortization    | 36,574                         | 32,490         | 67,272                  | 49,728         | 154            |
| Interest expense                            | 23,460                         | 17,638         | 38,363                  | 30,416         | 11,708         |
| Income taxes                                | 55,163                         | 12,741         | 26,186                  | (4,673)        | 8,038          |
|   | <u>206,739</u>                 | <u>116,420</u> | <u>245,832</u>          | <u>133,448</u> | <u>2,976</u>   |
| <b>Mining segment EBITDA reconciliation</b> |                                |                |                         |                |                |
| Net income                                  | 162,915                        | 14,189         | 29,497                  | 31,274         | 64,341         |
| Add:  |                                |                |                         |                |                |
| Depreciation, depletion and amortization    | 25,666                         | 13,695         | 34,417                  | 29,045         | 13,224         |
| Interest expense                            | 6,562                          | 2,609          | 10,165                  | 6,357          | 2,818          |
| Income taxes                                | 18,937                         | 10,394         | 21,573                  | 7,328          | 22,146         |
|   | <u>214,080</u>                 | <u>40,887</u>  | <u>95,652</u>           | <u>74,004</u>  | <u>102,529</u> |

**Exchange Rates**

The following tables show, for the periods indicated, certain information regarding the exchange rate between the ruble and the U.S. dollar, based on data published by the Central Bank of Russia.

These rates may differ from the actual rates used in preparation of our financial statements and other financial information provided herein.

Rubles per U.S. dollar

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| <b>Year ended December 31,</b> | <b>High</b> | <b>Low</b> | <b>Average<sup>(1)</sup></b> | <b>Period End</b> |
|--------------------------------|-------------|------------|------------------------------|-------------------|
| 2003                           | 31.88       | 29.25      | 30.61                        | 29.45             |
| 2002                           | 31.86       | 30.14      | 31.39                        | 31.78             |
| 2001                           | 30.30       | 28.16      | 29.22                        | 30.14             |
| 2000                           | 28.87       | 26.90      | 28.13                        | 28.16             |
| 1999                           | 27.00       | 20.65      | 24.67                        | 27.00             |

(1) The average of the exchange rates on the last business day of each full month during the relevant period.

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**Selected consolidated financial data**

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|                | <b>High</b> | <b>Low</b> |
|----------------|-------------|------------|
| September 2004 | 29.26       | 29.21      |
| August 2004    | 29.28       | 29.14      |
| July 2004      | 29.13       | 29.04      |
| June 2004      | 29.09       | 29.00      |
| May 2004       | 29.08       | 28.87      |
| April 2004     | 29.00       | 28.50      |

The exchange rate between the ruble and the U.S. dollar on October 1, 2004, was 29.22 rubles per one U.S. dollar.

No representation is made that the ruble or U.S. dollar amounts in this prospectus could have been or can be converted into U.S. dollars or rubles, as the case may be, at any particular rate or at all. The ruble is generally not convertible outside Russia. A market exists within Russia for the conversion of rubles into other currencies, but the limited availability of other currencies may inflate their values relative to the ruble.

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## Unaudited condensed pro forma consolidated income statements

The following unaudited condensed pro forma consolidated income statements for the year ended December 31, 2003, and the six months ended June 30, 2004, are presented to give effect to (1) the acquisition of Korshunov Mining Plant OAO, or KMP, effected on October 16, 2003, as if it had been consummated on January 1, 2003; and (2) the acquisition of Izhstal OAO, or Izhstal, effected on May 14, 2004, as if it had been consummated on January 1, 2003.

We have prepared the unaudited condensed pro forma consolidated income statement for the year ended December 31, 2003, based on our audited consolidated financial statements for the year ended December 31, 2003, which include the results of operations of KMP from the date of acquisition, October 16, 2003, to December 31, 2003, and the audited consolidated financial statements of Izhstal for the year ended December 31, 2003.

We have prepared the unaudited condensed pro forma consolidated income statement for the six months ended June 30, 2004, based on our unaudited consolidated financial statements for the six months ended June 30, 2004, which include the results of operations of Izhstal from the date of acquisition, May 14, 2004, to June 30, 2004, and Izhstal unaudited historical financial data.

The following unaudited condensed pro forma consolidated income statements have been prepared to illustrate the effects of the acquisition of KMP and Izhstal by us accounted for using the purchase method of accounting. We believe the assumptions used to prepare the unaudited condensed pro forma consolidated income statements provide a reasonable basis for presenting the significant effects directly attributable to the acquisitions of KMP and Izhstal. The unaudited condensed pro forma consolidated income statements do not purport to represent what our results of operations would actually have been if the acquisitions of KMP and Izhstal had in fact occurred on January 1, 2003, or to project our results of operations for any future period or date.

The unaudited condensed pro forma consolidated income statements, including the notes thereto, should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations, our audited consolidated financial statements, our unaudited interim consolidated financial statements for the six months ended June 30, 2004, and the audited consolidated financial statements of KMP and Izhstal, with the related notes thereto included elsewhere in this prospectus.

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**Unaudited condensed pro forma consolidated income statements**


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**UNAUDITED CONDENSED PRO FORMA CONSOLIDATED INCOME STATEMENT**

For the year ended December 31, 2003

|  | Mechel<br>(A)     | KMP<br>(B)        | Izhstal<br>(C)     | Pro forma<br>adjustments<br>(D) | Notes | Pro forma         |
|--|-------------------|-------------------|--------------------|---------------------------------|-------|-------------------|
| (in thousands of U.S. dollars, except share and per share amounts)   |                   |                   |                    |                                 |       |                   |
| Revenue, net (including related party amounts of \$211,943, \$45,323 and \$138, in Mechel, KMP and Izhstal, respectively)            | \$ 2,050,088      | \$ 45,728         | \$ 140,650         | \$ (51,381)                     | F     | \$ 2,185,085      |
| Cost of goods sold (including related party amounts of \$212,492, \$39,418 and \$121, in Mechel, KMP and Izhstal, respectively)      | (1,440,053)       | (39,445)          | (132,679)          | 54,240                          | E, F  | (1,557,937)       |
| <b>Gross margin</b>  | <b>610,035</b>    | <b>6,283</b>      | <b>7,971</b>       |                                 |       | <b>627,148</b>    |
| <i>Selling, distribution and operating expenses:</i>   |                   |                   |                    |                                 |       |                   |
| Selling and distribution expenses  | (214,519)         | (633)             | (3,316)            |                                 |       | (218,468)         |
| General, administrative and other operating expenses   | (202,740)         | (7,165)           | (18,748)           | 1,543                           | E     | (227,110)         |
| <b>Total selling, distribution and operating expenses</b>  | <b>(417,259)</b>  | <b>(7,798)</b>    | <b>(22,064)</b>    |                                 |       | <b>(445,578)</b>  |
| Operating income (loss)  | 192,776           | (1,515)           | (14,093)           |                                 |       | 181,570           |
| <i>Other income and (expense):</i>   |                   |                   |                    |                                 |       |                   |
| Interest income  | 2,292             |                   | 8                  |                                 |       | 2,300             |
| Interest expense   | (48,528)          | (621)             | (1,125)            | (110)                           | G     | (50,384)          |
| Other income (expense), net  | 27,940            | (153)             | 117                |                                 |       | 27,904            |
| Foreign exchange gain  | (1,722)           | 49                | 273                |                                 |       | (1,400)           |
| <b>Total other income and (expense), net</b>   | <b>(20,018)</b>   | <b>(725)</b>      | <b>(727)</b>       |                                 |       | <b>(21,580)</b>   |
| Income (loss) before income tax, minority interest, discontinued operations, extraordinary gain and changes in accounting principles | 172,758           | (2,240)           | (14,820)           |                                 |       | 159,990           |
| Income tax (expense) benefit   | (47,759)          | 1,111             | 2,267              | 527                             | E     | (43,854)          |
| Minority interest in loss (income) of subsidiaries   | 18,979            |                   |                    | 4,874                           | H     | 23,853            |
| <b>Income (loss) from continuing operations</b>  | <b>\$ 143,978</b> | <b>\$ (1,129)</b> | <b>\$ (12,553)</b> |                                 |       | <b>\$ 139,989</b> |
| Basic and diluted income from continuing operations per common share (U.S. dollars per share)  |                   |                   |                    |                                 |       | \$ 0.38           |
| Shares used in computing basic and diluted income from continuing operations per common share  |                   |                   |                    |                                 |       | 366,178,815       |

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**Unaudited condensed pro forma consolidated income statements**


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**UNAUDITED CONDENSED PRO FORMA CONSOLIDATED INCOME STATEMENT**

For the six months ended June 30, 2004

|   | <b>Mechel</b>   | <b>Izhstal</b>    | <b>Pro forma<br/>adjustments</b> | <b>Notes</b> | <b>Pro forma</b>   |
|---|---|-------------------|----------------------------------|--------------|--------------------|
|   | <b>(A)</b>  | <b>(C)</b>        | <b>(D)</b>                       |              |                    |
|   | <b>(in thousands of U.S. dollars, except share and per share amounts)</b> |                   |                                  |              |                    |
| Revenue, net (including related party amounts of \$33,950 and \$25 in Mechel and Izhstal, respectively)                                     | \$ 1,630,063  | \$ 64,005         | \$ (2,953)                       | J            | \$ 1,691,115       |
| Cost of goods sold (including related party amounts of \$6,279 and \$25 in Mechel and Izhstal, respectively)                                | (985,370)   | (57,117)          | 4,743                            | I, J         | (1,037,744)        |
| <b>Gross margin</b>   | <b>644,693</b>  | <b>6,888</b>      |                                  |              | <b>653,371</b>     |
| <i>Selling, distribution and operating expenses:</i>  |   |                   |                                  |              |                    |
| Selling and distribution expenses   | (173,571)   | (656)             |                                  |              | (174,227)          |
| General, administrative and other operating expenses  | (122,016)   | (5,783)           | 876                              | I            | (126,923)          |
| <b>Total selling, distribution and operating expenses</b>   | <b>(295,587)</b>  | <b>(6,439)</b>    |                                  |              | <b>(301,150)</b>   |
| <b>Operating income (loss)</b>  | <b>349,106</b>  | <b>449</b>        |                                  |              | <b>352,221</b>     |
| <i>Other income and (expense):</i>  |   |                   |                                  |              |                    |
| Interest income   | 1,125   | 11                |                                  |              | 1,136              |
| Interest expense  | (30,022)  | (604)             |                                  | G            | (30,626)           |
| Other income (expense), net   | 13,230  | (2,249)           |                                  |              | 10,981             |
| Foreign exchange gain   | 3,037   | 34                |                                  |              | 3,071              |
| <b>Total other income and (expense), net</b>  | <b>(12,630)</b>   | <b>(2,808)</b>    |                                  |              | <b>(15,438)</b>    |
| <b>Income (loss) before income tax, minority interest, discontinued operations, extraordinary gain and changes in accounting principles</b> | <b>336,476</b>  | <b>(2,359)</b>    |                                  |              | <b>336,783</b>     |
| Income tax (expense) benefit  | (74,100)  | (361)             | 293                              | I            | (74,168)           |
| Minority interest in loss (income) of subsidiaries  | (7,920)   |                   | 1,044                            | H            | (6,876)            |
| <b>Income (loss) from continuing operations</b>   | <b>\$ 254,456</b>   | <b>\$ (2,720)</b> |                                  |              | <b>\$ 255,739</b>  |
| <b>Basic and diluted income from continuing operations per common share (U.S. dollars per share)</b>  |   |                   |                                  |              | <b>\$ 0.70</b>     |
| <b>Shares used in computing basic and diluted income from continuing operations per common share</b>  |   |                   |                                  |              | <b>367,150,968</b> |

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**Unaudited condensed pro forma consolidated income statements**

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**Notes**

**(A) Mechel Steel Group OAO Historical Financial Data**

Mechel Steel Group OAO historical financial data is derived from our audited consolidated financial statements for the year ended December 31, 2003, and the unaudited consolidated financial statements for the six months ended June 30, 2004, presented elsewhere in this prospectus. We acquired our control in KMP in October 2003 and, accordingly, KMP is included in our historical results of operations from the date of acquisition, October 16, 2003, to December 31, 2003. We acquired our control in Izhstal in May 2004 and, accordingly, Izhstal is included in our historical results of operations from the date of acquisition, May 14, 2004, to June 30, 2004, and in our historical consolidated balance sheet as of June 30, 2004.

**(B) Korshunov Mining Plant OAO Historical Financial Data**

On December 25, 2002, we acquired 62.5% of the common shares of KMP for total consideration of \$34.5 million in cash. The voting rights for these shares, however, were restricted due to the bankruptcy proceedings, and the investment was carried at cost. Until the ratification on September 29, 2003, by a court of the Settlement Agreement with KMP's creditors (we were the second largest creditor after the government, which was owed in arrears for taxes and social charges, including various penalties and interest), the equity interest did not provide for the ability to exercise either control or significant influence. The control restrictions were completely removed and we obtained full control over KMP's operations in October 2003, upon which the acquisition of KMP was accounted for using the purchase method of accounting.

Despite the lack of control over KMP, we continued to increase our stake in KMP's equity and, in February 2003, acquired an additional 7.7% of the common shares for approximately \$1,000 in cash. Together with the cash paid for the shares of KMP, we provided loans and other continuing support to KMP which were aimed to pay the current liabilities and the tax and commercial debt arrears of KMP pursuant to the Settlement Agreement. At the date of acquisition, the cost of our investment in KMP's equity, in total comprising 70.3% of its voting shares, and the amount of loans and advances provided to KMP amounted to \$132.3 million.

**(C) Izhstal OAO Historical Financial Data**

On May 14, 2004, we acquired a 26.9% interest in Izhstal at an auction held by the government, increasing our total interest in Izhstal to 59.4% of its total voting shares, comprising common and preferred shares. Subsequent to May 14, 2004, we continued to increase our interest in Izhstal, buying shares in the open market, and by the end of May 2004, we had accumulated 61.6% of the voting stock. Izhstal was accounted for using the purchase method of accounting. For our total holding of shares of Izhstal, we paid \$25.1 million in cash.

**(D) Acquisition of KMP and Izhstal**

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These reflect the acquisition adjustments relating to the KMP and Izhstal acquisitions. The acquisitions were accounted for in accordance with the purchase method of accounting. The acquisition adjustments reflect the allocation of purchase price for each acquisition to the respective acquired tangible and intangible assets and liabilities. The allocation reflects the estimated fair values of the tangible and intangible assets and liabilities on the respective acquisition dates of KMP and Izhstal. Negative goodwill, i.e., the excess of the fair value of the net assets acquired over the purchase price paid, if any, has been allocated as a pro rata reduction of the amounts that otherwise would have been assigned to all of the acquired assets except (1) financial assets other than investments accounted for by the equity method; (2) assets to be disposed of by sale; (3) deferred tax assets; and (4) any other current assets.

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**Unaudited condensed pro forma consolidated income statements**


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We believe the assumptions underlying the unaudited condensed pro forma consolidated income statements are reasonable. The unaudited condensed pro forma consolidated income statements are being furnished solely for informational purposes and are not necessarily indicative of the combined results of operations that might have been achieved for the period indicated, nor is it necessarily indicative of our future results. For example, the pro forma information does not reflect cost savings that we expect to realize from operational synergies, as these expected cost savings and operational synergies may not be realized, and does not reflect integration costs, in each case, for the periods presented.

**(E) Purchase Accounting Adjustments**

- a. Adjustments to depreciation and amortization as a result of the impact of the purchase accounting adjustments for KMP and Izhstal property, plant and equipment; these adjustments also affected the valuation of cost of goods sold and general, administrative, selling and other operating expenses, as well as the amount of loss recognized on the disposal of property, plant and equipment in the normal course of business during 2003.
- b. Adjustment to record the impact on depletion of the acquired mineral licenses with the total estimated fair value of \$76.7 million for KMP during the period before October 16, 2003; Izhstal had no mineral licenses.

The above pro forma adjustments are summarized below as an increase or (decrease) to a respective item in our pro forma income statement:

|   | KMP     | Izhstal    | Total      |
|---|---------|------------|------------|
| <i>Cost of goods sold:</i>  |         |            |            |
| Depreciation and amortization(a)  | \$      | \$ (5,927) | \$ (5,927) |
| Depletion and amortization of acquired mineral licenses(b)                          | (2,652) |            | (2,652)    |
|   | <hr/>   | <hr/>      | <hr/>      |
| Total pro forma adjustments to cost of goods sold                                   | (2,652) | (5,927)    | (8,579)    |
|   | <hr/>   | <hr/>      | <hr/>      |
| <i>General, administrative and other operating expenses(a):</i>                     |         |            |            |
| Disposal of property, plant and equipment   |         | (938)      | (938)      |
| Depreciation and amortization   |         | (605)      | (605)      |
|   | <hr/>   | <hr/>      | <hr/>      |
| Total pro forma adjustments to general, administrative and other operating expenses |         | (1,543)    | (1,543)    |
|   | <hr/>   | <hr/>      | <hr/>      |

- c. The adjustment to the income tax expense reflects the amount necessary to present the pro forma income tax expense at our year-end effective tax rate of 27.6%.

**(F) Intercompany Transactions**

Reflects the elimination of intercompany revenue (\$51.4 million) and intercompany purchases in cost of goods sold (\$45.7 million) relating to the trade operations between KMP and us during the period from January 1, 2003, to October 15, 2003. We did not have transactions with Izhstal during 2003.

**(G) Interest Expense**

Reflects the pro forma adjustments to interest expense arising from the debt incurred to finance the acquisition of Izhstal shares. We obtained a \$13.6 million ruble-denominated, short-term loan bearing 10% interest per annum and the interest charged on the debt outstanding until repayment was included as a pro forma adjustment as interest expense, for a total of \$110,000 for the year ended December 31, 2003. No pro forma adjustment was made for the six months ended June 30, 2004, as the above \$110,000 is already included in the Mechel interest expense for this period.

**(H) Minority Interests**

Reflects the pro forma adjustment to record the minority's 38.4% interest in the losses of Izhstal during 2003 and for the six months ended June 30, 2004.

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**Unaudited condensed pro forma consolidated income statements**

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**(I) Purchase Accounting Adjustments**

Adjustments to depreciation and amortization as a result of the impact of the purchase accounting adjustments for Izhstal property, plant and equipment; these adjustments also affected the valuation of cost of goods sold (\$1.8 million) and general, administrative and other operating expenses (\$0.9 million). The adjustment to the income tax expense reflects the amount necessary to present the pro forma income tax expense at our effective tax rate of 22.0% for the six months ended June 30, 2004.

**(J) Intercompany Transactions**

Reflects the elimination of intercompany revenue and intercompany purchases in cost of goods sold (\$3.0 million) relating to trade operations between Izhstal and us during the period from January 1, 2004, to May 14, 2004.

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## Management's discussion and analysis of financial condition and results of operations

*The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements, related notes and other information included elsewhere in this prospectus. This section contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those discussed in forward-looking statements as a result of various factors, including those described under "Risk Factors" and "Cautionary Note Regarding Forward-Looking Statements."*

### THE REORGANIZATION

Mechel Steel Group OAO was incorporated on March 19, 2003, under the laws of the Russian Federation in connection with a reorganization to serve as a holding company for various steel and mining companies owned by Messrs. Igor Zyuzin and Vladimir Iorich. These individuals acquired these companies at various times from 1995 to the present and have acted in concert since that time pursuant to an Ownership, Control and Voting Agreement which requires them to vote the same way. The reorganization involved the contribution of these companies by these individuals to Mechel in exchange for all the outstanding capital stock of Mechel. Many of the contributed companies had shareholders other than Messrs. Zyuzin and Iorich, and these shareholders were not involved in the reorganization and continue to retain minority interests in certain of our subsidiaries.

The acquisition of these companies by Mechel Steel Group represents a reorganization under common control, and has been accounted for in a manner akin to a pooling. Mechel Steel Group's consolidated financial statements, therefore, have been prepared on the basis that Mechel Steel Group existed for all periods presented since its inception and owned these companies to the same extent as owned by Messrs. Zyuzin and Iorich in those periods.

In connection with the reorganization, in late 2003 and the first half of 2004, we disposed of our controlling stakes in (1) Belov Insurance Company ZAO, a small insurance company in which we had acquired a controlling stake in 2001, and (2) Uglemetbank ZAO, a small bank in which we had acquired a controlling stake in 1999, to their management and other unrelated investors. These companies provided our coal companies and their employees with routine banking, finance and insurance services. The results for these businesses have been classified as discontinued operations for all periods presented.

In August 2004, we terminated production at Mechel Zeljezara, a Croatian steel mill that produced pipes. Mechel Zeljezara's assets were acquired out of bankruptcy proceedings in March 2003. See note 2(g) to our audited consolidated financial statements. We decided to terminate production at Mechel Zeljezara due to significant increases in input costs and a persistent weakness in pipe prices. In September 2004, we concluded a termination agreement providing for the return to the seller of the Mechel Zeljezara assets, the redemption of the bank guarantee that we granted to the government of Croatia in the amount of \$4.3 million and the donation of spare parts at Mechel Zeljezara in the amount of \$1.8 million, in return for a waiver of any and all claims against us. See note 10 to our interim consolidated financial statements.

### BUSINESS STRUCTURE

**Segments**

We have organized our businesses into two segments:

the steel segment, comprising production and sale of semi-finished steel products; carbon and

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**Management s discussion and analysis of financial condition and results of operations**


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specialty long products; carbon and stainless flat products; value-added downstream metal products including hardware, forgings and stampings; and coke and coking products; and

the mining segment, comprising production and sale of coal (coking and steam), iron ore and nickel, which supplies raw materials to our steel business and also sells substantial amounts of raw materials to third parties.

The table below sets forth by segment our primary steel and mining subsidiaries, presented in chronological order by date of acquisition:

| <b>Name</b>                       | <b>Location</b> | <b>Business</b>   | <b>Date Control Acquired</b> | <b>Voting Interest<sup>(1)</sup></b> |
|-----------------------------------|-----------------|---|------------------------------|--------------------------------------|
| <b>Steel Segment</b>              |                 |   |                              | <b>%</b>                             |
| Chelyabinsk Metallurgical Plant   | Russia          | Semi-finished steel products, carbon and specialty long and flat steel products, forgings, coke and coking products | December 2001                | 82.7                                 |
| Vyartsilya Metal Products Plant   | Russia          | Hardware  | May 2002                     | 93.3                                 |
| Beloretsk Metallurgical Plant     | Russia          | Long steel products, hardware, limestone <sup>(2)</sup>   | June 2002                    | 90.2                                 |
| COST                              | Romania         | Carbon and specialty long steel products, forgings, hardware  | August 2002                  | 81.0                                 |
| Urals Stampings Plant             | Russia          | Stampings   | April 2003                   | 93.8                                 |
| Industria Sarnei                  | Romania         | Semi-finished steel products, long steel products, hardware   | June 2003                    | 81.0                                 |
| Mechel Nemunas                    | Lithuania       | Hardware  | October 2003                 | 100.0                                |
| Izhstal                           | Russia          | Specialty and carbon steel long products, hardware, stampings and forgings  | May 2004                     | 62.2                                 |
| <b>Mining Segment</b>             |                 |   |                              |                                      |
| Southern Kuzbass Coal Company     | Russia          | Coking coal concentrate, steam coal, steam coal concentrate   | January 1999                 | 96.7                                 |
| Sibirginsk Open Pit Mine          | Russia          | Coking coal, steam coal, steam coal concentrate   | January 1999                 | 86.3                                 |
| Krasnogorsk Open Pit Mine         | Russia          | Steam coal, steam coal concentrate  | January 1999                 | 77.7                                 |
| Tomusinsk Open Pit Mine           | Russia          | Coking coal, steam coal   | January 1999                 | 74.4                                 |
| Olzherassk Open Pit Mine          | Russia          | Coking coal, steam coal   | December 1999                | 78.9                                 |
| Tomusinsk Group Processing Plant  | Russia          | Coking coal concentrate   | December 2000                | 94.8                                 |
| Kuzbass Central Processing Plant  | Russia          | Coking coal concentrate   | December 2000                | 88.4                                 |
| Siberian Central Processing Plant | Russia          | Coking coal concentrate   | December 2000                | 90.8                                 |
| Southern Urals Nickel Plant       | Russia          | Ferro nickel  | December 2001                | 79.3                                 |
| Lenin Mine                        | Russia          | Coking coal   | December 2001                | 53.5                                 |
| Korshunov Mining Plant            | Russia          | Iron ore concentrate  | October 2003                 | 75.0                                 |
| Mechel Coal Resources             | Kazakhstan      | Coking coal, coking coal concentrate  | December 2003                | 100.0                                |
| Port Posiet                       | Russia          | Shipping  | February 2004                | 80.0                                 |

(1) As of October 1, 2004. Some of our Russian subsidiaries have preferred shares outstanding which have voting rights commensurate with common shares if dividends on these shares have not been paid. We have calculated voting interest by including these preferred shares for subsidiaries where dividends have not been paid.

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(2) Our Pugachev limestone quarry is owned by Beloretsk Metallurgical Plant and is within the steel segment.

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**Management's discussion and analysis of financial condition and results of operations**

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**Intersegment sales**

We are an integrated steel and mining group. Our mining segment supplies 100% of our steel segment's coking coal requirements and a substantial portion of the steel segment's nickel requirements. Our steel segment also supplies wires, ropes and other hardware to our mining segment for use in its day-to-day operations, as well as coke for use in the production of nickel. The prices at which we record these transfers are based on market prices, and these transactions are eliminated as intercompany transactions for purposes of our consolidated financial statements. For the six months ended June 30, 2004, and for the years ended December 31, 2003 and 2002, mining segment sales to the steel segment amounted to \$160.3 million, \$185.8 million and \$69.6 million, respectively. For the six months ended June 30, 2004, and for the years ended December 31, 2003 and 2002, steel segment sales to the mining segment amounted to \$40.1 million, \$42.3 million and \$39.0 million, respectively.

Following our acquisition of a majority stake in Korshunov Mining Plant in December 2002, our steel segment purchased a significant portion of its iron ore requirements from Korshunov Mining Plant. These purchases were priced on an arm's-length basis. We subsequently consolidated Korshunov Mining Plant in October 2003. These purchases, to the extent they date from prior to our consolidation of Korshunov Mining Plant, are not eliminated as intercompany transactions for purposes of our consolidated financial statements. Additionally, we sell Korshunov Mining Plant's products to third parties. In 2003, we sourced approximately 39% of our iron ore requirements from Korshunov Mining Plant. In 2004, in response to market conditions, we began to export iron ore concentrate to China, and increased sales to neighboring Russian steel plants, while purchasing iron ore concentrate from Russian suppliers to meet our own requirements. We retain the flexibility to continue to sell iron ore concentrate to China and to neighboring Russian steel plants, and elsewhere, and to source our iron ore requirements from local Russian iron ore producers, depending upon conditions in the Russian and global iron ore markets.

**SUMMARY OF ACQUISITIONS**

We have sought to develop an integrated steel and mining business through the purchase of under-performing assets which we believe offer significant upside potential, particularly as we implement improvements in working practices and operational methods. Pending the implementation of these practices and our other integration strategies, our margins are initially adversely affected after each acquisition.

Following is a summary of the terms of acquisition of our primary steel and mining subsidiaries since 2001. Each of the acquisitions was accounted for using the purchase method of accounting, so the results of operations of each acquired business are included in our consolidated income statements since their respective dates of acquisition of control. In certain cases where we acquired our interest in these businesses over a period of time and thus control was not acquired until subsequent acquisitions of shares, until such controlling stake was acquired, these businesses were accounted for using the equity method of accounting or at cost, as appropriate. Our results of operations for the periods presented herein are thus not comparable from period to period due to these acquisitions and their accounting treatment.

*Chelyabinsk Metallurgical Plant.* Chelyabinsk Metallurgical Plant is an integrated blast furnace and BOF/EAF steel mill that produces coke, semi-finished and rolled carbon and specialty steel products and forgings. Glencore International, an international trading company, which is currently one of our biggest customers, acquired a 65.1% stake in Chelyabinsk Metallurgical Plant during its privatization by the Russian government in 1992. In December 2001, we acquired Glencore's stake in Chelyabinsk Metallurgical Plant. We have paid a total of \$133.0 million for our current stake in Chelyabinsk Metallurgical Plant.



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**Management s discussion and analysis of financial condition and results of operations**

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*Southern Urals Nickel Plant.* Southern Urals Nickel Plant operates two open-pit nickel mines and a nickel processing facility. Southern Urals Nickel Plant was privatized by the Russian government in 1993. We acquired a 46.0% stake in Southern Urals Nickel Plant in September 2001 and increased that stake to a controlling stake in December 2001. We have paid a total of \$9.9 million for our current stake in Southern Urals Nickel Plant.

*Lenin Mine.* Lenin Mine produces coking coal. Lenin Mine was privatized by the Russian government in 1993. We acquired a 26.9% stake in Lenin Mine through market purchases beginning from 1997. We acquired another 25% stake as a result of our acquisition of Mezhdurechensk Coal Company in December 2001 from the Russian government. We subsequently merged Mezhdurechensk Coal Company into Southern Kuzbass Coal Company. We have paid a total of \$0.3 million for our current stake in Lenin Mine.

*Vyartsilya Metal Products Plant.* Vyartsilya Metal Products Plant is a hardware plant that produces wire, nails and steel nets. Vyartsilya Metal Products Plant was formed in June 1996 as a spin-off from Vyartsilya Metal Products Plant OAO, which was privatized by the Karelian government in 1994. We acquired a 88.1% stake in Vyartsilya Metal Products Plant from employee-shareholders in May 2002. We have paid a total of \$0.1 million for our current stake in Vyartsilya Metal Products Plant.

*Beloretsk Metallurgical Plant.* Beloretsk Metallurgical Plant is a hardware plant that produces wire rod and a broad range of hardware. Beloretsk Metallurgical Plant was privatized by the Bashkir government in 1994. We acquired a 33.3% stake in Beloretsk Metallurgical Plant from third parties in 2001, and increased our stake to a controlling interest in June 2002. In November 2003, we acquired another 29.4% stake in Beloretsk Metallurgical Plant from the regional government, and in March 2004, we acquired another 9.7% stake in Beloretsk Metallurgical Plant, bringing our total stake to 90.2%. Beloretsk Metallurgical Plant also owns the Pugachev limestone quarry. We paid a total of \$15.2 million for our current stake in Beloretsk Metallurgical Plant. The regional government has a golden share in Beloretsk Metallurgical Plant, giving it the right to veto certain shareholder decisions and appoint a voting representative on the board of directors.

*Combinatul de Oteluri Speciale Targoviste.* COST is a Romanian steel mill that produces long products and forgings. We acquired an 79.7% stake in COST from the Romanian government in August 2002. At the time we acquired COST, it was in bankruptcy proceedings. The consideration consisted of \$3.5 million in cash and a commitment on our part to invest \$21.1 million in the modernization of the plant and upgrade of its capacity over five years, as well as a commitment to maintain its workforce level for five years. Under the transaction documents, our stake in COST is pledged to the Romanian government until we fulfill our commitments.

*Urals Stampings Plant.* Urals Stampings Plant is Russia s largest producer of stampings from specialty steel and heat-resistant titanium alloys for the aerospace, power and other industries. Urals Stampings Plant was privatized by the Russian government in 1993. We acquired a 93.8% stake in Urals Stampings Plant from third parties in April 2003 for \$11.3 million in cash.

*Industria Sarmei.* Industria Sarmei is a Romanian steel mill that produces rolled products and hardware, including wires, ropes and nails. We acquired a 73.4% stake in Industria Sarmei from the Romanian government in June 2003. The consideration consisted of \$2.8 million in cash and a commitment on our part to invest \$19.0 million in the modernization of the plant and upgrade of its capacity over five years, a commitment to spend \$3.6 million in environmental protection, as well as a commitment to maintain its workforce level for five years. In connection with the acquisition, certain debt of Industria Sarmei was converted into shares, and we subsequently acquired these shares for \$1.3 million, increasing our stake to 79.8%. Under the transaction

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**Management s discussion and analysis of financial condition and results of operations**

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documents, our stake in Industria Sarnei is pledged to the Romanian government until we fulfill our commitments.

*Mechel Nemunas.* Mechel Nemunas is a Lithuanian hardware plant that produces wire, calibrated steel products, nails, rods and nets. We acquired a 75.1% stake in Mechel Nemunas for \$4.0 million in cash in October 2003. From November to December 2003, we acquired the remaining 24.9% stake in Mechel Nemunas for \$1.0 million in cash.

*Korshunov Mining Plant.* Korshunov Mining Plant operates three surface iron ore mines and an iron ore concentrating plant. Korshunov Mining Plant was privatized by the local government in 1993. We acquired a 62.5% interest in Korshunov Mining Plant in December 2002 when it was in bankruptcy proceedings. In September 2003, a court approved a debt settlement plan. We recorded our investment in Korshunov Mining Plant at cost until we acquired control in October 2003, and have consolidated its results since that time. We have paid a total of \$132.3 million (including loans and advances) for our current stake in Korshunov Mining Plant.

*Mechel Coal Resources.* Mechel Coal Resources is a newly-formed Kazakh company holding our Kazakh coal assets. It consists of (1) the assets of Coal Washing Factory-38, a coal washing plant, which we acquired in December 2003 for \$1.0 million in cash and \$1.0 million in assumed debt; and (2) the assets of K.O. Gorbachev Mine, an underground coal mine primarily producing coking coal, which we acquired in May 2004 for \$1.6 million in cash.

*Port Posiet.* Port Posiet is located in Russia s Far East on the Sea of Japan. We acquired an 80.0% stake in Port Posiet for \$30.0 million in cash in February 2004. We intend to ship primarily our coking coal concentrate, as well as steel products, to Asia through this port.

*Izhstal.* Izhstal is a Russian specialty steel plant which produces rolled products, hardware, stampings and forgings. We acquired a 61.6% stake in Izhstal for \$25.1 million in cash in February through May 2004. The regional government has a golden share in Izhstal, giving it the right to veto certain shareholder decisions and appoint a voting representative on the board of directors.

The acquisition of Chelyabinsk Metallurgical Plant in December 2001, an integrated steel mill with its own coking batteries, was the most significant steel acquisition and it is the center of our steel segment operations. Prior to its acquisition, we were primarily a coal mining and trading company. In the year of its acquisition, we had been running Chelyabinsk Metallurgical Plant on a contract basis, our trading operations had been selling Chelyabinsk Metallurgical Plant s products and we had supplied it with most of its coking coal requirements, so we were already familiar with its operations and customers. The addition of Beloretsk Metallurgical Plant in June 2002, a market leader in hardware in Russia and whose products our trading operations had been selling prior to its acquisition, significantly expanded our presence in this product category, and this presence was also bolstered by our acquisition of Vyartsilya Metal Products Plant in May 2002. Beloretsk Metallurgical Plant and Vyartsilya Metal Products Plant are supplied with semi-finished steel by Chelyabinsk Metallurgical Plant. Our downstream product mix was also further widened by the purchase of Urals Stampings Plant in April 2003, which uses Chelyabinsk Metallurgical Plant s specialty steel to make value-added stampings. We further solidified our presence in the Russian specialty steel market by the acquisition of Izhstal in May 2004. Additionally, our Eastern European acquisitions, COST in August 2002, Industria Sarnei in June 2003 and Mechel Nemunas in October 2003, marked our expansion outside Russia. COST produces specialty long products and Industria Sarnei and Mechel Nemunas produce hardware. Mechel Nemunas is supplied with semi-finished steel from our Russian operations.

Within the mining segment, our acquisitions of Southern Urals Nickel Plant in December 2001 and Korshunov Mining Plant in October 2003 added ferro nickel and iron ore concentrate production to our mining segment, and provided us with the ability to internally source a substantial portion of our raw



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**Management s discussion and analysis of financial condition and results of operations**


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material needs. Mechel Coal Resources represents the expansion of our mining operations beyond Russia, focusing on the coal-rich regions of Kazakhstan. It consists of a coal washing plant and an underground coal mine producing primarily coking coal.

**RESULTS OF OPERATIONS**

The following table sets forth our income statement data for the six months ended June 30, 2004 and 2003.

|  | Six months ended<br>June 30, 2004                      |                  | Six months ended<br>June 30, 2003 |                  |
|--|--|------------------|-----------------------------------|------------------|
|  | amount   | % of<br>revenues | amount                            | % of<br>revenues |
|  | (in thousands of U.S. dollars, except for percentages) |                  |                                   |                  |
| Revenue, net   | 1,630,063  | 100.0            | 930,595                           | 100.0            |
| Cost of goods sold   | (985,370)  | (60.4)           | (647,809)                         | (69.6)           |
| Gross margin   | 644,693  | 39.6             | 282,786                           | 30.4             |
| Selling, distribution and operating expenses   | (295,587)  | (18.1)           | (193,430)                         | (20.8)           |
| Operating income   | 349,106  | 21.4             | 89,356                            | 9.6              |
| Other income and expense, net  | (12,630)   | (0.8)            | (5,866)                           | (0.6)            |
| Income before income tax, minority interest, discontinued operations, extraordinary gain and changes in accounting principle | 336,476  | 20.6             | 83,490                            | 9.0              |
| Income tax expense   | (74,100)   | (4.5)            | (23,135)                          | (2.5)            |
| Minority interest in loss (income) of subsidiaries   | (7,920)  | (0.5)            | 6,632                             | 0.7              |
| Income from continuing operations  | 254,456  | 15.6             | 66,987                            | 7.2              |
| Loss from discontinued operations, net of tax  |  |                  | (1,317)                           | (0.1)            |
| Extraordinary gain, net of tax   |  |                  | 5,740                             | 0.6              |
| Changes in accounting principle, net of tax  |  |                  | (3,670)                           | (0.4)            |
| Net income   | 254,456  | 15.6             | 67,740                            | 7.3              |

The following table sets forth our income statement data for the years ended December 31, 2003, 2002 and 2001.

|                    | Year ended<br>December 31, 2003                        |                  | Year ended<br>December 31, 2002 |                  | Year ended<br>December 31, 2001 |                  |
|--------------------|--|------------------|---------------------------------|------------------|---------------------------------|------------------|
|                    | amount   | % of<br>revenues | amount                          | % of<br>revenues | amount                          | % of<br>revenues |
|                    | (in thousands of U.S. dollars, except for percentages) |                  |                                 |                  |                                 |                  |
| Revenue, net       | 2,050,088  | 100.0            | 1,314,149                       | 100.0            | 1,019,726                       | 100.0            |
| Cost of goods sold | (1,440,053)  | (70.2)           | (947,527)                       | (72.1)           | (721,089)                       | (70.7)           |

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|  |           |        |           |        |           |        |
|--|-----------|--------|-----------|--------|-----------|--------|
| Gross margin   | 610,035   | 29.8   | 366,622   | 27.9   | 298,637   | 29.3   |
| Selling, distribution and operating expenses   | (417,259) | (20.4) | (277,478) | (21.1) | (193,853) | (19.0) |
| Operating income   | 192,776   | 9.4    | 89,144    | 6.8    | 104,784   | 10.3   |
| Other income and expense, net  | (20,018)  | (1.0)  | (18,083)  | (1.4)  | (12,178)  | (1.2)  |
| Income before income tax, minority interest, discontinued operations, extraordinary gain and changes in accounting principle | 172,758   | 8.4    | 71,061    | 5.4    | 92,606    | 9.1    |
| Income tax expense   | (47,759)  | (2.3)  | (2,653)   | (0.2)  | (30,184)  | (3.0)  |
| Minority interest in loss (income) of subsidiaries   | 18,979    | 0.9    | 10,433    | 0.8    | (15,521)  | (1.5)  |
| Income from continuing operations  | 143,978   | 7.0    | 78,841    | 6.0    | 46,901    | 4.6    |
| Loss from discontinued operations, net of tax  | (2,422)   | (0.1)  | (1,835)   | (0.1)  | (735)     | (0.1)  |
| Extraordinary gain, net of tax   | 5,740     | 0.3    | 1,388     | 0.1    | 1,252     | 0.1    |
| Changes in accounting principle, net of tax  | (3,788)   | (0.2)  | 10,859    | 0.8    |           |        |
| Net income   | 143,508   | 7.0    | 89,253    | 6.8    | 47,418    | 4.7    |

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**Management s discussion and analysis of financial condition and results of operations**


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**Six months ended June 30, 2004, compared to six months ended June 30, 2003****Revenues**

Consolidated revenues increased by \$699.5 million, or 75.2%, to \$1,630.1 million in the six months ended June 30, 2004, from \$930.6 million in the six months ended June 30, 2003. The following table sets out revenues by segment.

|                       | Six months ended               |         |
|-----------------------|--------------------------------|---------|
|                       | June 30,                       |         |
| Revenues by segment   | 2004                           | 2003    |
|                       | (in thousands of U.S. dollars) |         |
| <b>Steel segment</b>  |                                |         |
| To third parties      | 1,267,754                      | 759,693 |
| To mining segment     | 40,149                         | 19,153  |
|                       | <hr/>                          | <hr/>   |
| Total                 | 1,307,903                      | 778,846 |
|                       | <hr/>                          | <hr/>   |
| <b>Mining segment</b> |                                |         |
| To third parties      | 362,309                        | 170,902 |
| To steel segment      | 160,285                        | 80,125  |
|                       | <hr/>                          | <hr/>   |
| Total                 | 522,594                        | 251,027 |
|                       | <hr/>                          | <hr/>   |
| Eliminations          | 200,434                        | 99,278  |
|                       | <hr/>                          | <hr/>   |
| Consolidated revenues | 1,630,063                      | 930,595 |
|                       | <hr/>                          | <hr/>   |
| % from steel segment  | 77.8                           | 81.6    |
| % from mining segment | 22.2                           | 18.4    |

**Steel segment**

Our steel segment revenues in the six months ended June 30, 2004, increased by \$529.1 million, or 67.9%, to \$1,307.9 million from \$778.8 million in the six months ended June 30, 2003. The increase in steel segment revenues is primarily explained by the following increases:

Rebar sales increased by \$120.6 million, or 79.5%, due to price increases, and wire rod sales increased by \$69.2 million, or 83.5%, due to price increases and particularly as a result of sharp increases in prices for the higher-quality wire rod we produce at Beloretsk Metallurgical Plant.

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Sales of semi-finished products increased by \$123.5 million, or 226.3%, due equally to price and volume increases. Hardware sales were higher by \$48.8 million, or 85.8%, including an increase in wire sales of \$33.8 million, or 83.6%, and an increase in rope sales of \$8.7 million, or 85.3%, both due to price increases.

Sales of carbon and low-alloy flat products increased by \$37.9 million, or 94.3%, primarily due to price increases. Sales of stainless and alloyed long products increased by \$7.7 million, or 23.7%, primarily due to price increases. Carbon and low-alloyed long product sales grew by \$41.0 million, or 59.7%, mostly as a result of price increases. High quality forgings and forged alloy sales increased by \$15.7 million, or 41.9%, due equally to price and volume increases. Sales of coke and coking products to third parties increased by \$7.9 million, or 34.6%, and sales to the mining segment, which uses coke in the production of nickel, grew by \$20.1 million, or 114.0%, in both cases primarily as a result of substantial increases in the price of coke.

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**Management's discussion and analysis of financial condition and results of operations**

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Tube sales increased by \$8.6 million, or 157.6%, primarily as a result of volume increases.  
Pig iron sales increased by \$31.0 million, or 465.6%, primarily as a result of price increases.  
Sales of steel products to our mining segment increased by \$0.9 million.

In addition to the above, the following increases were related to acquisitions:

Revenues at Mechel Zeljezara for the first two months of 2004, Urals Stampings Plant for the first three months of 2004 and Industria Sarnei for the first five months of 2004, which are not included in the comparative analysis by product above, amounted to \$74.2 million.  
Revenues at Mechel Nemunas and Izhstal for the six months ended June 30, 2004, amounted to \$53.5 million.

These increases in steel products sales were offset by sales decreases as follows:

Sales of MMK products in the six months ended June 30, 2003, amounted to \$105.1 million. Starting in January 2004, we stopped reselling MMK products. See Certain Transactions Related Party Transactions Magnitogorsk Iron & Steel Works.  
Stainless flat product sales decreased by \$6.8 million, or 13.4%, mostly due to a volume decrease.  
Trading sales of iron ore from Korshunov Mining Plant in the six months ended June 30, 2003, amounted to \$19.8 million and were included in steel segment sales; after Korshunov Mining Plant's consolidation in October 2003, its revenues are being reflected in the mining segment.

Excluding intersegment sales, export sales were 50.2% of steel segment sales in the six months ended June 30, 2004, compared to 47.3% in the six months ended June 30, 2003.

#### *Mining segment*

Our total mining segment sales in the six months ended June 30, 2004, increased by \$271.6 million, or 108.2%, to \$522.6 million from \$251.0 million in the six months ended June 30, 2003.

Coking coal concentrate sales to third parties increased by \$74.7 million, or 91.9%, primarily due to price increases, as well as to a 15.5% increase in sales volume. Coking coal concentrate supplied to the steel segment increased by \$56.2 million, or 92.9%, to satisfy increased steel production at Chelyabinsk Metallurgical Plant. Steam coal and steam coal concentrate sales to third parties increased by \$37.2 million, or 70.0%, due equally to price and volume increases.

Nickel sales to third parties increased by \$34.0 million, or 148.7%, primarily due to price increases. Nickel supplied to the steel segment increased by \$2.0 million, or 10.2%.

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We recorded iron ore sales in the mining segment beginning in October 2003 with our consolidation of Korshunov Mining Plant. For the six months ended June 30, 2004, sales to third parties amounted to \$48.4 million and supplies to the steel segment amounted to \$22.0 million, for a total of \$70.4 million.

These increases in mining products sales were partly offset by a decrease of \$4.3 million in other products and services sales, consisting primarily of transportation, blasting, and municipal services, as well as sales of energy.

Excluding intersegment sales, export sales were 72.6% of mining segment sales in the six months ended June 30, 2004, compared to 43.7% in the six months ended June 30, 2003. The increase in the proportion of our export sales was due to higher export prices in relation to domestic prices (the weighted average export price of our mining products increased by \$18 per tonne, whereas the weighted average domestic price of our mining products increased by \$6 per tonne), as well as increased export volume levels in response to the higher export prices.

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**Cost of goods sold and gross margin**

Consolidated cost of goods sold was 60.4% of consolidated revenues in the six months ended June 30, 2004, as compared to 69.6% of consolidated revenues in the six months ended June 30, 2003, resulting in an increase in the consolidated gross margin percentage in the six months ended June 30, 2004, to 39.6% from 30.4% in the six months ended June 30, 2003. Cost of goods sold primarily consists of costs relating to raw materials (including products purchased for resale), direct payroll, depreciation and energy. The table below sets forth cost of goods sold and gross margin by segment for the six months ended June 30, 2004 and 2003, including as a percentage of segment revenues.

|   | Six months ended<br>June 30, 2004 |                             | Six months ended<br>June 30, 2003 |                             |
|---|-----------------------------------|-----------------------------|-----------------------------------|-----------------------------|
|   | amount                            | % of<br>segment<br>revenues | amount                            | % of<br>segment<br>revenues |
| <b>Cost of goods sold and gross margin by segment</b> |                                   |                             |                                   |                             |
| <b>Steel segment</b>                                  |                                   |                             |                                   |                             |
| Cost of goods sold                                    | 964,118                           | 73.7                        | 572,817                           | 73.5                        |
| Gross margin  | 343,785                           | 26.3                        | 206,029                           | 26.5                        |
| <b>Mining segment</b>                                 |                                   |                             |                                   |                             |
| Cost of goods sold                                    | 221,686                           | 42.4                        | 174,270                           | 69.4                        |
| Gross margin  | 300,908                           | 57.6                        | 76,757                            | 30.6                        |

*Steel segment*

Steel segment cost of goods sold increased by \$391.3 million, or 68.3%, to \$964.1 million in the six months ended June 30, 2004, from \$572.8 million in the six months ended June 30, 2003. Steel segment cost of goods sold was 73.7% of segment revenues, as compared to 73.5% in the six months ended June 30, 2003.

*Mining segment*

Mining segment cost of goods sold increased by \$47.4 million, or 27.2%, to \$221.7 million in the six months ended June 30, 2004, from \$174.3 million in the six months ended June 30, 2003. Mining segment gross margin percentage increased from 30.6% in the six months ended June 30, 2003, to 57.6% in the six months ended June 30, 2004. The improvement in the mining segment's gross margin was attributable to a substantial increase in the average sales price of coal and nickel, which increased by 57% and 69%, respectively.

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**Management s discussion and analysis of financial condition and results of operations**


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**Selling, distribution and operating expenses**

Selling, distribution and operating expenses increased by \$102.2 million, or 52.8%, to \$295.6 million in the six months ended June 30, 2004, from \$193.4 million in the six months ended June 30, 2003. As a percentage of consolidated revenues, selling, distribution and operating expenses decreased to 18.1% in the six months ended June 30, 2004, as compared to 20.8% in the six months ended June 30, 2003. Our selling, distribution and operating expenses consist primarily of selling and distribution expenses, taxes other than income tax, provision for doubtful accounts and general, administrative and other operating expenses. The table below sets forth these costs by segment for the six months ended June 30, 2004 and 2003, including as a percentage of segment revenues.

|  | Six months ended                                       |                  | Six months ended |                  |
|--|--|------------------|------------------|------------------|
|  | June 30, 2004  |                  | June 30, 2003    |                  |
|  | % of   |                  | % of             |                  |
|  | amount   | segment revenues | amount           | segment revenues |
|  | (in thousands of U.S. dollars, except for percentages) |                  |                  |                  |
| <b>Selling, distribution and operating expenses by segment</b> |  |                  |                  |                  |
| <b>Steel segment</b>   |  |                  |                  |                  |
| Selling and distribution expenses                              | 96,550   | 7.4              | 79,163           | 10.1             |
| Taxes other than income tax                                    | 18,086   | 1.4              | 16,328           | 2.1              |
| Provision for doubtful accounts                                | 1,058  | 0.1              | 6,622            | 0.9              |
| General, administrative and other operating expenses           | 64,377   | 4.9              |                  |                  |