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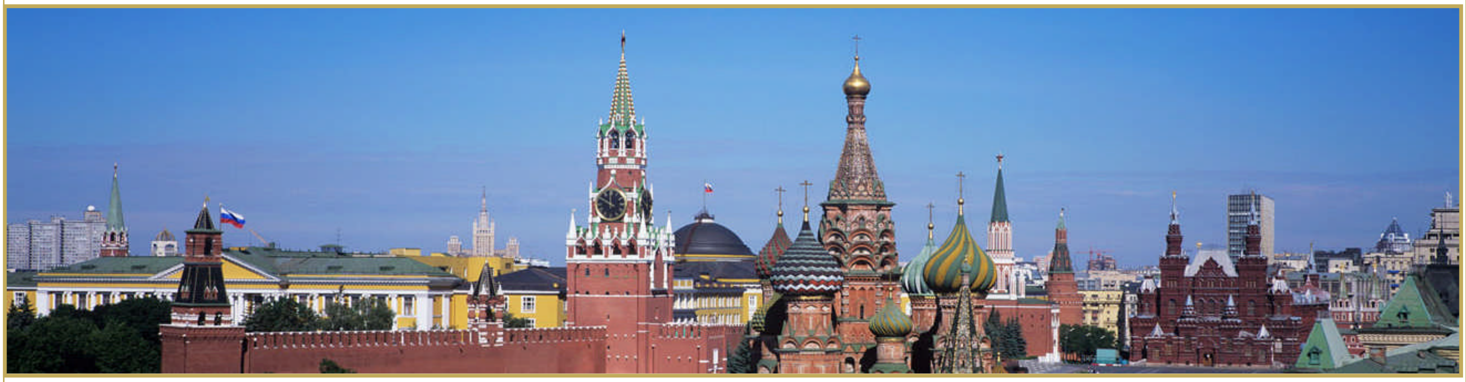


BRIC Spotlight Report

January 2011

Sitting on a Gold Mine: Metals and Mining in Russia

The metals and mining industry, comprised of the iron and steel, aluminum, precious metals and minerals, and base metal markets, is Russia's largest private enterprise and a bellwether for the economy. Lead, zinc, copper, nickel, and tin make up the base metals market.

Russia is the largest country in the world in terms of geographic area. The country has rich reserves of major industrial raw materials and some non-fuel minerals. As well, Russia possesses abundant reserves of nickel, platinum, iron ore, manganese, diamonds, phosphates, gold, chromium, titanium, copper, tin, lead,

Fast Facts

- The Russian metals and mining industry consists of aluminum, iron and steel, precious metals and minerals, as well as coal and base metals.
- Russia has huge reserves of nearly all major industrial raw materials.
- Russia is one of the world's largest mineral producers, accounting for about 14% of the world's total mineral extraction.
- Metals account for about 14% of Russia's total exports, second only to the oil and natural gas industry. Raw metals and aluminum comprise the majority of the country's metal exports. Most of Russia's metal production is exported.
- Russia's proved iron ore reserves are the biggest in the world, accounting for about 15% of the total iron ore production.
- Russia holds the world's second largest recoverable coal reserves and is the world's third largest exporter of black coal.
- Unlike the oil and natural gas industry, the country's metals and mining sector is Russia's largest private industry and the economy bellwether.
- The dilapidated state of existing mines and technological handicaps impact productivity.

and tungsten. Mercury, tin, tungsten, and bauxite were among the few imports during the Soviet period.

The iron and steel market consists of the production of crude steel, blast furnace iron, and direct reduced iron. The precious metals and minerals market refers to producers of gold, silver, platinum, palladium, rhodium, as well as industrial and gem-quality diamonds.

For a long time, coal was the dominant fuel supporting the industrial sector in the erstwhile Soviet Union. Understandably, the central planners decided to build industrial towns around the country's coal deposits. However, the huge expenses involved in extracting coal compared to other fuels made the fuel unattractive in due course. Moreover, with the discovery of huge oil and natural gas reserves in the 1960s, the coal shafts located in the European part of the Soviet Union fell into disuse. Still, it is estimated that current Russian coal reserves stand at 200 billion tons, a sizable volume.

Under Vladimir Lenin, industrial modernization in Russia was a priority. But industrialization reached its peak under Stalin's leadership when investment resources were channeled to support the needs of military-industrial complex (MIC) usage. During the late 1980s, Gorbachev tried to shift the focus to consumer goods but without much success. The privatization of the Russian mining industry began in the first half of the 1990s. During the decade, manufacturing output underwent a decline, until 1995 when production began to rise gradually. The initiation of economic reforms, which involved dismantling the centrally planned Soviet economic system and the opening up of the free market, helped the country successfully emerge from the transition.

Yet, an undesirable result of the reforms was the emergence of a group of powerful individuals, some of whom were close associates of senior government officials. The oligarchs, as they came to be known, became immensely rich after acquiring control of prized natural resource assets in the notorious 'shares-for-loans' privatization auctions in late 1995. The nearly bankrupt Russian administration under Boris Yeltsin had no other option but to approach these businessmen for loans in return for huge stakes in some of the nation's big resource companies. The government failed to repay the loans on time, thus making the oligarchs the virtual owners of these prized companies. In fact, the refinancing of Yeltsin's re-election in 1996 marked the beginning of the unorthodox nexus between Russian politicians and the business community. The newly emerged crop of powerful business tycoons also set a bad example for corporate governance in Russia by not disclosing proper information to investors and abusing minority shareholder rights.

However, history has curious ways of repeating itself. The onset of the financial crisis in the second half of 2008 and the ensuing crash in commodity prices had the oligarchs running for cover as many of them had borrowed heavily to expand their businesses during the boom years. Many of them who had pledged shares of their companies to raise loans, found their net worth erode as stock markets plunged during the financial crisis. Luckily for the oligarchs, the Kremlin, armed with huge foreign exchange and gold reserves, exercised damage control. The state promised to lend up to $50 billion to Russian private companies to help them repay their loans to foreign banks.

Russia, which has been riding the wave of a commodity boom and strong capital inflows during the period from 2003-2007, was hit hard by the financial crisis because of its over-dependence on commodity exports. International investors turned more risk-adverse in the aftermath of the collapse of Lehman Brothers in September 2008. To make matters worse, the military conflict between Russia and Georgia in August 2008 further dented investor confidence and triggered massive outflows of portfolio investment and capital flight. Overall, Russia's capital account reported net outflows of US$164 billion in the last four months of 2008.

Understandably, Russia's GDP grew only 5.6% in 2008, the lowest since 2002. Adding to this, the economy contracted by 7.9 percent in 2009, the country's worst growth rate since 1994, when it shrunk more than 10 percent following the collapse of the Soviet Union. The country's metals and mining sector, which suffered from the slump in global demand for commodities in the wake of the recession, has gradually started recovering.

The drastic fall in commodity prices during the second half of 2008 and 2009 forced many leading steel producers to cut production. Naturally, decreased production resulted in significant revenue shortfall for these companies during 2009. Thanks to cost-cutting measures and rising steel prices, the profit margins of many of these companies improved by the first half of 2010.

Metal prices continued to decline in the first half of 2009, followed by a sharp spike in the last six months of the year. The price of steel, the most important commodity in the sector, gradually started climbing toward the end of 2009 and has continued to rise in 2010, thanks to increasing demand. The jump in prices continued into 2010 for most other commodities. Copper prices, which had reached $7,342 per ton in 2009 rose to $7,631 in September 2010. The price of nickel also improved in 2010, benefiting from the waiving of export duties on the commodity in 2009, and increased demand during the second half of 2009 and 2010. Aluminum prices also went up consistently during 2009 and the first half of 2010.

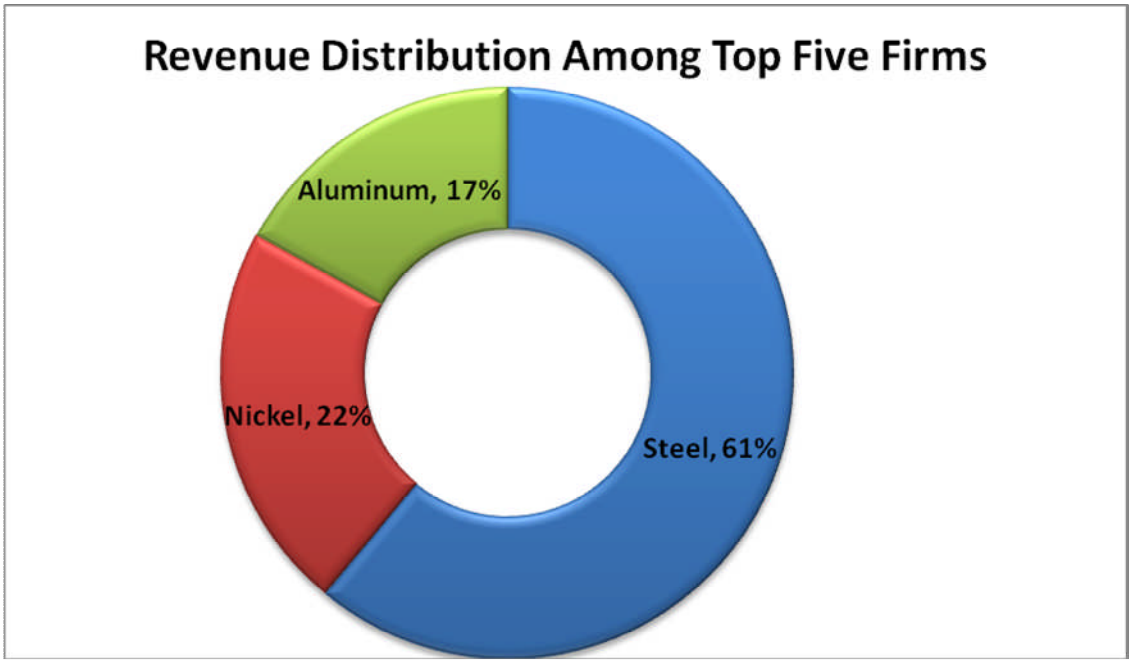
The Russian Metals and Mining Players

Rank	Company	Stock Exchanges	ADR/GDRs	Market Cap (USD)	Production Volumes in 2009
1	Norilsk Nickel	RTS, MICEX	27% of shares trade as ADRs	$31.6 billion	232,000 tons of nickel
2	UC Rusal	Hong Kong, NYSE Euronext Paris	10% of shares offered in Hong Kong IPO	$21 billion	11.2 mln tons of alumina
3	Novolipetsk Steel	RTS, MICEX, LSE	8% shares listed as GDS on LSE	$19.8 billion	10.5 mln tons of steel
3	Evraz Group	LSE	Almost all of its 30% free float trade as GDRs	$14.7 billion	15.3 mln tons of steel
4	Severstal	RTS, MICEX, LSE	9% of free float trade as	$12.6 billion	19.2 mln tons of steel

			GDRs		
5	Magnitogorsk	RTS, MICEX, LSE	--	$11.4 billion	2.83 mln tons of steel
6	Polyus Gold	RTS, MICEX, LSE, US OTC	34.9% of free float trade as ADRs	$11.0 billion	1.3 mln ounces of gold

The Russian metals and mining sector is second only to the oil and natural gas industry in terms of exports and total production. A majority of the companies in the sector are engaged in the production of iron and steel, the flagship industry in the wider context of the metals and mining sector.

According to recent data from the World Steel Association, Russia produced 67.0 million tons of steel in 2010 of the total 1.41 billion ton global production. Most of the steel companies in Russia are vertically integrated. Major steel producers own coal and iron ore mines, which supply the raw materials required to run their production facilities. Some companies in the mining segment, such as Mechel and Norislk Nickel, garner considerable revenues from their power-generating operations. The country stands fourth among the global steel producers after China, Japan, and the United States. In fact, large steel companies in the sector accounted for 56% of industry revenues in 2009. The balance is contributed by producers of gold, nickel, and copper, apart from miners of diamonds and minerals.



Source: PwC Review of trends in the metals and mining industry

The country is home to some of the world's biggest producers of steel and other industrial metals such as aluminum and nickel. Metalloinvest, which ranks fourth in iron-ore mining, and possesses the largest iron-ore deposits in the world, is based in this resource-rich country. Besides, Russia is the world's sixth-largest gold miner after China, South Africa, Australia, the United States, and Peru. Norilsk Nickel, the world's largest producer of nickel and palladium, is located in Russia. The company accounts for more than 20% of global nickel output, more than 10% of cobalt production, and 3% of the world's copper production. In a recent development, Norilsk Nickel offered Russian aluminum producer UC Rusal about $12 billion to buy back its 25% stake in the company. However, Rusal rejected the offer, prompting Norilsk to launch a $4.5 billion share repurchase. In another interesting development, Uralkali, the top Russian producer of potash, agreed to acquire a 20% stake in smaller rival Silvinit, which could create the world's second biggest manufacturer of the fertilizer ingredient. The deal is significant in the context of the global potash market after BHP Billiton's bid to acquire Canada's Potash Corp. failed.

Source: World Steel Association

Some of the leading steel makers in the country have managed to raise overseas money from their listings on the world's leading stock exchanges. Mechel OAO, one of the major Russian steel makers listed on the New York Stock Exchange, recently said it plans to list shares of its mining division in London or New York in the second half of 2011. The company would take 10 to 25% of its mining unit public and would retain a controlling stake. Mechel's mining unit has a market share of 60% in Russia's coking coal concentrate. The London Stock Exchange remains the favorite listing destination for Russian metals and mining firms. High market liquidity, availability of a GDR program, and a proven IPO track record tilt the balance in favor of the LSE. Besides London, Hong Kong has become a favorite IPO destination for metals companies in recent times, with Metallurgical Corp. of China managing to raise more than US$2 billion. Besides these, UC Rusal, the world's largest producer of aluminum and alumina, has raised more than US$2 billion, at a premium over its peers, by pricing its dual IPO in Hong Kong and Paris in January 2010. Interestingly, Russia's two biggest banks, OAO Sberbank and VTB, both state-controlled, bought shares in the IPO alongside state-run VEB, in a growing affirmation of the Rusal promoter's ties with the Russian administration. Rusal chief executive Oleg Deripaska has gone on record saying the company's shares may start trading in Russia within a year.

In fact, initial public offerings from Russia and China dominated the global IPO market in 2010. Among these, offerings from Chinese companies constituted 67 percent, but UC Rusal IPO is so far the biggest. Companies from the materials sector have taken the lead in going public this year, ahead of energy and power segment companies.

Top 10 Steel Producers in 2009

Rank	**Company**	**Country**	**Production (million metric tons)**
1	Arcelor Mittal	Luxembourg	77.5
2	Baosteel	China	31.3
3	POSCO	South Korea	31.1
4	Nippon Steel	Japan	26.5
5	JFE	Japan	25.8
6	Jiangsu Shagang	China	20.5
7	Tata Steel	India	20.5
8	Ansteel	China	20.1
9	Severstal	Russia	16.7
10	Evraz	Russia	15.3

Source: World Steel Association

If UC Rusal dominated the Russian IPO market last year, some companies from the metals and mining sector are all set to cash in on the improving commodity prices to float their shares in 2011. According to a PwC review on the metals and mining sector in Russia, Russian metals and mining companies are expected to corner a 40% share of the IPO market in 2011, ahead of utilities, infrastructure, and retail firms. Separately, news reports from Reuters indicated that iron and steel miner Metalloinvest, which is majority-owned by Alisher Usmanov, has plans to list up to 20 percent of its shares in an initial public offering this year. Metalloinvest aims to use the IPO proceeds to develop its Udocan copper field. Likewise, there were reports that gold mining firm Kamchatka Gold, controlled by Russian tycoon Viktor Vekselberg, is planning a Hong Kong IPO since the company's business depends to a great extent on demand from China. Moreover, Russian steel and gold producer Severstal has plans to float about one-third of its shares of its gold unit in London in the first half of 2011.

While government investments in the mining sector will be affected by recent changes to legislation, the financial crisis has opened up additional opportunities for foreign investors apart from their existing tie-ups with local companies. Russia's vast mineral wealth has attracted huge investments from major global players in the industry over the years, especially in the coal industry. ArcelorMittal, the world's largest steel maker, acquired three coal mines from its Russian rival Severstal and affiliated parties for US$720 million in western Siberia's Kuzbass basin. Similarly, Australian mining major BHP Billiton and Norilsk Nickel joined hands for the exploration and development of coal in the Arctic region. South Korea's POSCO has inked a five-year deal to purchase one million tons of coking coal and coal products from Sibuglemet, starting in 2010. Gold production in the country received a boost from the launch of Canadian miner Kinross Gold's operations in the Kupol mine in the remote Chukotka region in the northeastern part of Russia, as well as the Karalveyem mine in the same region.

Industry Losing its Sheen

Steel makers in Russia, the world's fourth-largest steel producer, have suffered from a slump in orders from key industrial sectors such as auto production and construction. Badly battered by the fall in demand from these segments, steel makers in Russia have made efforts to boost exports to make up for the shortfall. However, major buyers of Russian steel, such as China, have threatened to impose tariffs and other anti-dumping measures on steel imports. Though the Russian government has pledged support for the sector by increasing demand, industry players are looking for tangible measures. Seeking relief, companies have urged the government to restore a tax break on 50% of profits spent on capital investment.

Despite the moderate recovery in commodity prices after their steep fall in 2009, Russian metals firms have not been able to resolve issues related to their debt obligations. Some of the country's metals firms are in debt in excess of $50 billion, sparking talks of consolidation and capital infusion by the federal government. The companies must have been spurred by the need to ensure a steady supply of raw materials, bring down production costs, and get the state to invest in the beleaguered metals sector. However, concerns persist over whether the government should hold an interest in the proposed enterprise. The metals sector, which has remained relatively independent from the state so far, may lose that distinction if the government intervention becomes a reality.

To make matters worse, a Russian government panel has proposed to introduce a 5% duty on nickel exports. The country had first slapped a duty on raw nickel exports in 2007, but it was withdrawn in early 2009. The government now plans to impose the tariff to support the federal budget. Though government intervention in the metals and mining sector is comparatively less than in the oil and natural gas industry, it exerts indirect control through some of the oligarch-promoters who owe allegiance to the Kremlin.

Challenges Ahead

The gradual improvement in demand for commodities as well as higher prices, thanks to increased infrastructure spending in countries like China, bode well for the country's metals and mining industry. Going by the continued recovery in the sector through 2010, the future appears bright for the industry players. However, as Russian-American Business magazine has pointed out, the country's metals and mining segment is handicapped by the lack of state-of-the-art machinery, which is needed to improve productivity. According to news reports, Russian President Medvedev also echoed this sentiment when he urged mining companies to make better use of new technologies. The World Bank in its Russian Economic Report has observed that the country should adopt a more sustainable growth model by maintaining a competitive exchange rate, improving the investment climate, investing in infrastructure to eliminate key bottlenecks to growth, and curbing corruption to improve the efficiency of the public sector.

After a year of stunted growth, the Russian economy grew about 4.1% in 2010. Deutsche Bank has observed in a research report that while returning to the growth rate achieved during the boom years may remain a dream, raw materials-based exports could provide the basis for the country's economic growth provided commodity prices remain stable. However, there is a consensus that Russia's long-term growth rates will be significantly below those of recent years, as rising commodity prices and strong capital inflows cannot be taken for granted.

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Thomas White International, Ltd.
One Financial Place,
440 South LaSalle Street,
Suite 3900,
Chicago, Illinois 60605.
Email: feedback@thomaswhite.com

Thomas White India Pvt., Ltd.
Suite 300, 3rd Floor
Phoenix Towers
16/1 Museum Road
Bangalore 560001
Tel.: 91-80-40187777

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