Mechel Steel Group OAO
Form 20-F
June 29, 2005

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# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

# Form 20-F

o **Registration Statement pursuant to Section 12(b) or (g) of the Securities Exchange Act of 1934**

**or**

ý **Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended December 31, 2004**

**or**

o **Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**Commission file number 333-119497**

# MECHEL STEEL GROUP OAO

(Exact name of Registrant as specified in its charter)

**Russian Federation**
(Jurisdiction of incorporation or organization)

**Krasnopresnenskaya Naberezhnaya 12, Moscow 123610, Russian Federation**
(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

| Title of Each Class | Name of Each Exchange on Which Registered |
|---|---|
| **AMERICAN DEPOSITARY SHARES, EACH ADS REPRESENTING THREE COMMON SHARES** | **NEW YORK STOCK EXCHANGE** |
| **COMMON SHARES, PAR VALUE 10 RUSSIAN RUBLES PER SHARE** | **NEW YORK STOCK EXCHANGE**[(1)] |

Securities registered or to be registered pursuant to Section 12(g) of the Act:

**NONE**
(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

**NONE**
(Title of Class)

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.

15,957,045 ADSs

403,118,680 common shares

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

| | |
|---|---|
| Yes: ý | No: o |

Indicate by check mark which financial statement item the Registrant has elected to follow:

| | |
|---|---|
| Item 17 o | Item 18 ý |

(1) Listed, not for trading or quotation purposes, but only in connection with the registration of ADSs pursuant to the requirements of the Securities and Exchange Commission.

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Unless the context otherwise requires, references to "Mechel", "Company", "us" and "our" refer to Mechel Steel Group OAO and its subsidiaries. Our annual general shareholders' meeting, held on June 28, 2005, approved an amendment to our charter to change our name to Mechel OAO. This change will become effective upon government registration of this amendment, expected in July 2005.

Our business consists of two segments: mining and steel. References in this document 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 document, we include Izhstal's market shares.

In this document, references to "U.S. dollars," "$" or "cents" are to the currency of the United States, references to "rubles" are to the currency of the Russian Federation and references to "euro" or "€" are to the currency of the member states of the European Union, or EU, participating in the European Monetary Union.

The term "tonne" as used herein means a metric tonne. A metric tonne is equal to 1,000 kilograms or 2,204.62 pounds.

**CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS**

Matters discussed in this document may constitute forward-looking statements, as defined in the safe harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. We wish to caution you that these statements are only predictions and that actual events or results may differ materially. 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 similar expressions identify forward-looking statements. Forward-looking statements appear in a number of places including, without limitation, "Item 3. Key Information Risk Factors," "Item 4. Information on the Company" and "Item 5. Operating and Financial Review and Prospects," 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 document 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, volatility in stock markets or in the price of our shares or ADRs, financial risk management, 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 document.

## PART I

*Item 1.* **Identity of Directors, Senior Management and Advisors**

Not applicable.

*Item 2.* **Offer Statistics and Expected Timetable**

Not applicable.

*Item 3.* **Key Information**

**Selected Financial Data**

The financial data set forth below as of December 31, 2004, 2003, 2002 and 2001, and for the years then ended, have been derived from our audited consolidated financial statements. Our reporting currency is the U.S. dollar and we prepare our consolidated financial statements in accordance with U.S. GAAP.[1] The financial data for 2000 are not presented, as financial statements for this year 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 under "Item 18. Financial Statements" and "Item 5. Operating and Financial Review and Prospects."

| | Year ended December 31, | | | |
|---|---|---|---|---|
| | 2004 | 2003 | 2002 | 2001 |
| | (in thousands of U.S. dollars, except per share data) | | | |
| **Consolidated income statement data:** | | | | |
| Revenue, net | 3,635,955 | 2,028,051 | 1,314,149 | 1,019,726 |
| Costs of goods sold | (2,225,088) | (1,422,987) | (947,527) | (721,089) |
| Gross margin | 1,410,867 | 605,064 | 366,622 | 298,637 |
| Selling, distribution and operating expenses | (660,060) | (407,383) | (277,478) | (193,853) |
| Operating income | 750,807 | 197,681 | 89,144 | 104,784 |
| Other income and expense, net | 794,288 | (21,555) | (18,083) | (12,178) |
| Income before tax, minority interest, discounted operations, extraordinary gain and changes in accounting principle | 1,545,095 | 176,126 | 71,061 | 92,606 |
| Income tax expense | (175,776) | (47,759) | (2,653) | (30,184) |
| Minority interest in loss (income) of subsidiaries | (11,673) | 18,979 | 10,433 | (15,521) |
| Income from continuing operations | 1,357,646 | 147,346 | 78,841 | 46,901 |
| Loss from discounted operations, net of tax | (15,211) | (5,790) | (1,835) | (735) |
| Extraordinary gain, net of tax | 271 | 5,740 | 1,388 | 1,252 |
| Changes in accounting principle, net of tax | | (3,788) | 10,859 | |
| Net income | 1,342,706 | 143,508 | 89,253 | 47,418 |
| Earnings per share from continuing operations | 3.63 | 0.39 | 0.24 | 0.21 |
| Loss per share effect of discontinued operations | (0.04) | (0.01) | (0.01) | (0.01) |
| Earnings per share effect of extraordinary gain | 0.00 | 0.02 | 0.01 | 0.01 |
| Earnings per share effect of changes in accounting principle | 0.00 | (0.01) | 0.03 | 0.00 |
| Net income per share | 3.59 | 0.39 | 0.27 | 0.21 |
| Cash dividends per share(2) | 0.01 | 0.07 | 0.04 | 0.04 |
| Weighted average number shares outstanding | 373,971,312 | 366,178,815 | 333,243,450 | 225,271,391 |
| **Steel segment income statement data:** | | | | |
| Revenue, net(3) | 2,832,189 | 1,656,358 | 1,050,554 | 680,314 |
| Cost of goods sold(3) | (2,065,480) | (1,230,314) | (801,481) | (546,885) |
| Gross margin | 766,709 | 426,044 | 249,073 | 133,429 |
| Selling, distribution and operating expenses | (399,955) | (291,814) | (194,341) | 133,273 |
| Operating income | 366,754 | 134,230 | 54,732 | 155 |
| **Mining segment income statement data:** | | | | |
| Revenue, net(3) | 1,201,409 | 599,756 | 372,216 | 339,971 |
| Cost of goods sold(3) | (557,252) | (420,736) | (254,667) | (174,763) |
| Gross margin | 644,158 | 179,020 | 117,549 | 165,208 |
| Selling, distribution and operating expenses | (260,103) | (115,570) | (83,137) | 60,580) |
| Operating income | 384,055 | 63,450 | 34,412 | 104,672 |

| | Year ended December 31, | | | |
|---|---|---|---|---|
| | | | | |
| **Consolidated balance sheet data (at period end):** | | | | |
| Total assets | 3,678,269 | 1,834,509 | 1,387,378 | 1,116,473 |
| Shareholders' equity | 2,057,629 | 448,826 | 278,051 | 195,122 |
| Long-term debt, net of current portion | 216,113 | 122,311 | 36,496 | 16,525 |
| **Consolidated cash flows data:** | | | | |
| Net cash provided by operating activities | 296,137 | 119,858 | 81,069 | 34,751 |
| Net cash provided by (used in) investing activities | 455,716 | (210,317) | (86,633) | (93,068) |
| Net cash provided by financing activities | 252,269 | 103,079 | 3,422 | 65,701 |
| **Non-U.S. GAAP measures[4]:** | | | | |
| Consolidated EBITDA[5] | 1,707,711 | 341,472 | 207,452 | 105,506 |
| Steel segment EBITDA[5] | 1,249,643 | 245,820 | 133,448 | 2,976 |
| Mining segment EBITDA | 458,068 | 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)
Our annual general shareholders' meeting approved an annual dividend of 5.7 billion rubles (or approximately $203.1 million) for the 2004 fiscal year on June 28, 2005. Mechel Steel Group declared a dividend of 149 million rubles (or approximately $5.1 million) on June 24, 2004, which was paid in October 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.

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 document.

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:

| | **Year ended December 31,** | | | |
|---|---|---|---|---|
| | **2004** | **2003** | **2002** | **2001** |
| **Consolidated EBITDA reconciliation:** | | | | |
| Net income | 1,342,706 | 143,508 | 89,253 | 47,418 |
| Add: | | | | |
| Depreciation, depletion and amortization | 137,820 | 101,689 | 78,773 | 13,378 |
| Interest expense | 51,409 | 48,516 | 36,773 | 14,526 |
| Income taxes | 175,776 | 47,759 | 2,653 | 30,184 |
| Consolidated EBITDA | 1,707,711 | 341,472 | 207,452 | 105,506 |
| **Steel segment EBITDA reconciliation:** | | | | |
| Net income | 1,014,356 | 114,011 | 57,977 | (16,924) |
| Add: | | | | |
| Depreciation, depletion and amortization | 81,052 | 67,272 | 49,728 | 154 |
| Interest expense | 36,058 | 38,351 | 30,416 | 11,708 |
| Income taxes | 118,177 | 26,186 | (4,673) | 8,038 |
| Consolidated EBITDA | 1,249,643 | 245,820 | 133,448 | 2,976 |

| | Year ended December 31, | | | |
|---|---|---|---|---|
| **Mining segment EBITDA reconciliation:** | | | | |
| Net income | 328,350 | 29,497 | 31,274 | 64,341 |
| Add: | | | | |
| Depreciation, depletion and amortization | 56,768 | 34,417 | 29,045 | 13,224 |
| Interest expense | 15,351 | 10,165 | 6,357 | 2,818 |
| Income taxes | 57,599 | 21,573 | 7,328 | 22,146 |
| Consolidated EBITDA | 458,068 | 95,652 | 74,004 | 102,529 |

(5)
The 2004 amount includes a gain of $800.0 million from the sale of our stake in MMK.

**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 | | | |
|---|---|---|---|---|
| Year ended December 31, | High | Low | Average(1) | Period End |
| 2004 | 29.45 | 27.75 | 28.82 | 27.75 |
| 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 |

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

| | Rubles per U.S. dollar | |
|---|---|---|
| | High | Low |
| May 2005 | 28.09 | 27.78 |
| April 2005 | 27.94 | 27.71 |
| March 2005 | 27.83 | 27.46 |
| February 2005 | 28.19 | 27.75 |
| January 2005 | 28.16 | 27.75 |
| December 2004 | 28.15 | 27.75 |

The exchange rate between the ruble and the U.S. dollar on June 27, 2005 was 28.68 rubles per one U.S. dollar.

No representation is made that the ruble or U.S. dollar amounts in this document 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.

**Risk Factors**

*An investment in our securities involves a high degree of risk. You should carefully consider the risks described below and the other information contained in this document before making a decision to invest in our securities. Any of the following risks could adversely affect our business, financial condition and results of operations, in which case the trading price of our securities 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 mining or 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, 7

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 2004 and 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 4.9% per year; after the Russian crisis in 1998, the economy recovered and grew in real terms at an average rate of 6.3% per year from 1999 to 2004. 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 64.3 million tonnes in 2004. Further, our products in Russia are mainly used in the construction, engineering 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.***

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.

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 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 $1.25 billion. Most of our current borrowing is from Russian institutions. 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 securities to suffer" and " Risks 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 mining and steel group, which allows us to benefit from economies of scale, realize synergies, better satisfy the needs of our domestic and international mining and steel customers and compete effectively against other mining and 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:

- 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;
- 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 regarding these subsidiaries 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 over financial reporting and we may not be able to remedy these material weaknesses or prevent future weaknesses. If we fail to do so, there is a more than remote likelihood that a material misstatement of the annual or interim statements will not be prevented or detected.***

In connection with the audit of our consolidated financial statements for the year ended December 31, 2004, management and our independent registered public accounting firm identified material weaknesses in our internal control over financial reporting as defined in the standards established by the Public Company Accounting Oversight Board's Auditing Standard No. 2 that affected our financial statements for the year ended December 31, 2004. The material weaknesses in our internal control over financial reporting are summarized below:

- we do not have an adequate system of internal control over the preparation of our U.S. GAAP consolidated financial statements to ensure that material errors do not occur in their preparation;

- we do not have an adequate financial reporting system for certain disclosure information to be submitted by our subsidiaries in the preparation of our U.S. GAAP consolidated financial statements;

- we do not have a unified, comprehensive accounting and financial reporting system for U.S. GAAP reporting purposes; and

- we do not have adequate accounting resources and expertise in respect of the preparation of our U.S. GAAP consolidated financial statements.

Notwithstanding the steps we have taken and continue to take that are designed to remedy each material weakness identified above, we may not be successful in remediating these material weaknesses in the near or long term and we may not be able to prevent other material weaknesses in the future. Any failure to maintain or implement required new or improved internal control over financial reporting, or any difficulties we encounter in their implementation, could result in significant deficiencies or additional material weaknesses, cause us to fail to meet our periodic reporting obligations or result in material misstatements in our financial statements. Any such failure could also adversely affect the results of periodic management evaluations and annual auditor attestation reports regarding the effectiveness of our internal control over financial reporting that will be required when the SEC's rules under Section 404 of the Sarbanes-Oxley Act of 2002 become applicable to us beginning with our annual report for the year ending December 31, 2006, to be filed in 2007. The existence of a material weakness could result in errors in our financial statements that could result in a restatement of financial statements, cause us to fail to meet our reporting obligations and cause investors to lose confidence in our reported financial information, leading to a decline in the price of our securities. See "Item 15. Controls and Procedures" for additional information.

***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 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 Land Code of the Russian Federation of October 25, 2001, as amended, or the Land Code, requires privatized Russian companies to purchase or lease the land on which they operate. The purchase price and lease terms are to be determined in accordance with legislation enacted by governmental authorities, however, the current government land owners have broad discretion in making these determinations. 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 $155 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 2004, our Russian operations purchased approximately 3.9 billion kWh of electricity, representing 69% 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 2004, our average cost of electricity was 3.0 cents per kWh. Assuming a price of 3.6 cents per kWh in 2004, our Russian operations would have incurred approximately $23 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.

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 $28 per thousand cubic meters ($0.79 per thousand cubic feet) in 2004, and increased by 27% to approximately $36 per thousand cubic meters ($1.01 per thousand cubic feet) as of January 1, 2005. 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 2004, 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 reorganization of the Russian railways transportation sector 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 accordance with legislation enacted in 2003, the Russian Railways Ministry was privatized and its assets are now owned by OAO Russian Railroads, an open joint stock company wholly-owned by the Russian government. Russian Railroads is responsible for the management of all Russian railroads. The Russian government, through the Federal Tariff Service, continues to set rail tariffs and pursue its policy of maintaining international transportation tariffs and possibly increasing domestic tariffs. Factors which may lead to an increase in domestic tariffs include the insufficient financial transparency of Russian Railroads, the poor state of repair of Russia's rolling stock and the cross-subsidization of unprofitable passenger transportation sectors. Failure of Russian Railroads to upgrade its rolling stock within the next few years could also result in a shortage of available working rolling stock and a disruption in transportation of our materials and products. If these or other factors result in increased railway transport costs, our results of operations could be materially adversely affected.

***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, which affected our exports to ten countries in Central and Eastern Europe and the Baltic States that joined the EU on May 1, 2004. Our sales into the EU constituted approximately 16.9% of our steel segment revenues in 2004, and we used 92.9% of our EU steel import quota allocation during 2004. 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 imports of hot-rolled coil and thick steel plate. It previously had a quota system in place with respect to imports of pig-iron, slabs, zinc-plated steel products, hot-rolled bars, cold-processed bars, wire-rod 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 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 steel exports to the United States after the WTO's Appellate Body had determined them to be inconsistent with the requirements of the WTO. 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. These duties, however, have been temporarily suspended. In 2004, approximately 77.4% of our steel segment revenues were derived from sales of steel products that were subject to import restrictions. We also expect that an anti-dumping investigation with respect to Russian exports of steel ropes and cables will be initiated in the United States. There are also risks of anti-dumping investigations against Russian steel exports in other markets. See "Item 4. Information on the Company Steel Business Trade Restrictions."

***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 imported steel products. 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 steel bars, which expires in August 2005. Our Russian sales of steel products that are protected by these tariffs and duties accounted for approximately 100% of our steel segment revenues in 2004. 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.

In May 2004, 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 by the end of 2005. 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 and exporters. 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 revenues, adversely affecting our results of operations. In 2004, the ruble appreciated in real terms against the U.S. dollar by 15.1% 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.

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

The estimates concerning our reserves contained in this document 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.***

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 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 news article in 2004 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 December 31, 2004, we have not created any reserves for environmental liabilities and compliance costs, other than an accrual in the amount of $75.0 million for asset retirement obligations (ARO), consistent with U.S. GAAP requirements. In addition, upon our acquisitions of Mechel Targoviste and Mechel Campia Turzii, as part of the purchase agreements, we committed to the Romanian government to invest $7.3 million and

$4.6 million, respectively, into environmental protection