

## Russia coking coal in crisis as orders dry up

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By Alfred Kueppers

MOSCOW, Nov 27 (Reuters) - News Russia's second-largest coking coal firm has not been paid for 79 percent of shipments since September, as steel makers slash output, shows the risks again facing an industry that once had to barter to survive.

Coal company Rospadskaya's announcement this month, along with the cutbacks by Russian steel producers as the world financial crisis bites, has seriously dampened expectations for coking coal output and prices in 2009.

"Next year's order books for many steel companies are empty," said Kevin Dougherty, co-manager of the Pharos Russia Fund, which has closed all its positions in coking coal stocks.

"The global crisis caught a lot of people off guard and, in the current environment, most companies will run down whatever stockpiles they have on hand before placing new orders."

Coking coal producers boasted record profits prior to the market downturn, thanks to booming sales of automotive and construction steel in Russia and abroad. The sudden slowdown in Russian manufacturing is now forcing raw materials producers to slash expansion plans hatched in more prosperous times and seek alternative markets.

Russia's major coking coal producers, which supply fuel for blast furnaces, will have to make changes to stay profitable.

Analysts said miners like the biggest coking coal producer Mechel, must diversify their clients to cut dependence on the moribund Russian and Ukrainian markets, although inadequate infrastructure means this cannot be done quickly.

"I do make an assumption that Mechel will increase exports to Asia," said George Buzhenitsa, metals and mining analyst with Unicredit Aton.

"They will be better positioned than Rospadskaya, which mainly works with Russian clients and also exports about 25 percent of production to Ukraine."

Unlike its rivals, Mechel owns a port in Posiet on the Sea of Japan from which it can supply a range of Asian clients.

Russia is the world's fourth-largest steel producer, while Ukraine is number eight on the World Steel Institute rankings.

The World Coal Institute also ranks Russia as the fifth largest coking coal exporter behind Australia, Indonesia, the United States and Canada.

#### HARD LANDING

Morgan Stanley this week issued a report predicting Russian coking coal output would drop by at least 30 percent quarter-on-quarter in the September-December period, followed by a further 10 percent decline in the first quarter of 2009.

Russia produced 70.1 million tonnes of coking coal in 2007. Morgan Stanley expects 2008 output to decline to 66.3 million tonnes this year before dropping to 60 million tonnes next year.

Its analysts expect 2009 Russian semi-hard coking coal prices to average \$107 per tonne, down 53.5 percent from the first half of 2008, and they do not see a recovery until the second half of next year at the earliest.

Coking coal shares have suffered heavy selling in the second half of the year. Mechel, Belon Group and Raspadskaya are on average worth 85 percent less than at their peaks.

Together, they have underperformed the MICEX stock index, which has dropped close to 70 percent from its 2008 high.

About 15 percent of the Pharos Russia Fund was invested in coal and steel during the second quarter before Dougherty closed all his positions.

"Now that demand has collapsed and steel companies are reducing output, coking coal has gone from being among the most attractive to among the least attractive sectors to invest in," Dougherty told Reuters.

#### INVESTMENT CUTBACK

The investor exodus, which accelerated when Prime Minister Vladimir Putin in July criticised Mechel for its domestic coking coal price policy and other issues, has hurt investment plans.

Mechel in August pulled a preferred share issue that could have raised more than \$2.5 billion and last month said it would "significantly" reduce a \$5.5 billion five-year capital spending plan.

Belon, which is listed in Russia, is still preparing for a 2009 secondary offering abroad. A spokeswoman said the company will take a final decision in the first quarter of next year.

Russian coking coal producers cannot operate indefinitely if the payment levels reported by Raspadskaya are experienced by all of the companies into 2009.

For now, industry experts are optimistic the sector will avoid the nightmare of barter trade and wage arrears that plagued the Russian mining industry a decade ago.

"The Russian market is more civilised now," said Alexander Kovalchuk, general director of Russia's Institute for Coal Markets. "Because of what happened in the 1990s, barter trading has a bad reputation and no one wants to see it return."

Morgan Stanley analyst Dmitry Kolomytsyn agreed. If coal miners were to accept steel products for coal, he said, they would face the problem of selling the steel in a weak market.

"They would cut production or export to Asia. That's much more realistic," he said. (Editing by Anthony Barker)

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