Risk management

This section of the annual report describes key risks that may have a negative impact on companies' activities, operational and financial results.

NLMK recognises that like any other business the Company faces risks in the course of its operations. The Company therefore is strongly focused on risk management for the purposes of mitigating the potential negative impact on its business.

In 2008 the parent Company, OJSC NLMK (Lipetsk site), launched a project to implement a comprehensive risk management system and completed phase one of the project. MARSH, a leading risk management international consultant, was engaged in phase one and assisted in the implementation of the following actions:

- Analysis of the Company's existing risk management system;
- Appraisal of the Company's risk-tolerance levels;
- Risk ranking and mapping;
- Design of the internal regulations governing risk management;

NLMK's management, working with the MARSH consultants, devised specific measures to manage the principal risks the Company faces.

In 2009 further action will be taken to implement a comprehensive risk management system for OJSC NLMK. It is expected that a first annual risk management cycle will be completed by the Company on its own.

Key Group risks

Market risks

Market risks arise from changes in prices for raw materials, finished products, natural monopolies' services and logistics services. The initiative of authorities with respect to the market in which the Company operates is also considered to be a market risk.

Commercial Risks

1. Raw Materials and Supplies

The risks related to raw materials and supplies are of particular importance for the Company. Raw materials supplies are subject to specific sector risks.

In order to mitigate this risk, NLMK is pursuing a policy of developing into a vertically integrated holding Company by including businesses which provide a reliable source of raw materials for steel-making. Today, the Group is self-sufficient in iron ore, fluxing materials, coke and largely in scrap.

NLMK applies a balanced approach to working capital management:

- Certain limits and norms applied to manage current assets (inventory, semi-finished products). The control of non-production expenditures is performed by the appropriate body.
- The respective commission is involved in receivables/payables management in order to avoid bad debt risks and risks related to counterparties' obligations fulfilment.

In recent years the Company has maintained its consecutive policy toward diversifying supplies. Our compulsory practice in supply chain considers analysis of the market, and negotiations with suppliers towards the conclusion of long term contracts with favourable pricing.

LLC Trade House plays a major part in the Group's commercial activities which allows NLMK to reduce its commercial costs and rationalise transport expenses.

2. Finished Products

Sales of finished products constitute the following risks:

- cyclicity of demand for steel products;
- pricing volatility both on internal and external markets;
- macroeconomic risks on external and internal markets (economic growth, inflation and energy resources);
- quotes and other trading barriers on the main export markets;
- increasing competition among steel producers including those from emerging markets (China, India, Brazil).

The second half of 2008 saw an increased impact from the key risk affecting NLMK sales, such as low demand for steel from end consumers. The drop in demand spilled over into all Group businesses, forcing to reduce sales of their products.

To address this risk NLMK and the Russian Government take an active part in elaborating measures towards the stimulation of end user demand and the realisation of steel sensitive infrastructure projects.

A lower ability to pay and deteriorating solvency of several NLMK debtors led to increased credit risks, including higher receivables. The Company strives to mitigate this sales-related risk by quickly engaging clients in cases of overdue accounts, identifying appropriate payment conditions and maximising the collection of sales revenue. To cover this risk, the Company plans to implement a customer ranking system that would reduce non-payments from the clients.

The likelihood of the risk of lower prices, stemming from lower demand remains in the 1st half of 2009.

3. Logistics risks

Railways are used to transport a major part of the NLMK's stock. There are certain risks related to transportation infrastructure, tariffs, and insufficiency of railcars.

The Company successfully addresses the risk by being the 100% owner of NTK, the transportation unit which has its own fleet of railcars. NTK transports a major part of NLMK's stock.

4. Natural monopolies risks

Nearly all energy resources are provided by natural monopolies giving rise to the risk of regulated tariffs rising in the medium term.

To mitigate this risk, the Company actively purchases electricity on the spot market and increases its self-sufficiency in energy resources. NLMK achieved 40% self-sufficiency in electricity in 2008 and aims to increase this share to 60% through the completion of the second stage of the investment programme.

To cover the risk of rising energy tariffs, NLMK's representatives participate in industry consultative bodies and non-profit organisations.

Operational risks (property, environment, project risks)

Property risks

Property risks involve the possibility of losing all or part of a property as a result of industrial accidents, and the risk of reduced earnings due to interruptions in operations. In order to mitigate these risks, NLMK Group take precautionary measures aimed at the prevention of accidents and hazardous events, maintenance of a reasonable stock of work-in-progress and auxiliary supplies in case of an emergency shutdown. Property is safeguarded, and alarm and fire systems have been installed at the production facilities.

Large businesses within the Group take out insurance for their property assets and against production interruptions with priority reinsurance in major western markets. Prominent international brokers are invited to participate in tenders for the development of the most effective insurance and protection programmes, which provide for the most favourable pricing terms, as well as guaranteed insurance indemnity paid in case of an insured event.

In 2008 NLMK's insurance programme was awarded 'Best Insurance' as part of the 'Best risk management in Russia and CIS 2008', an event organised by the Russian Risk Management Society.

National, regional and administrative risks

National and regional risks

NLMK sales products to export markets. Countries to which NLMK exports products can be subject to risks. The Company has certain opportunities to diversify sales towards the most attractive markets which allows the Company to minimise losses arising as a result of quotes and other protective measures.

Historically, NLMK's priority markets were Europe and the Middle East (most attractive countries in 2008). A large proportion of sales was made to South-East Asian countries.

Administrative risks related to regulating bodies

Together with the Russian Government, NLMK elaborates trading protection instruments directed toward internal market protection from steel imports.

Political risks

Core NLMK Group businesses operate within the Russian Federation. Given the current political situation in Russia, country risks for the Company are insignificant.

Risks associated with potential military conflicts, states of emergency and industrial action are almost non-existent, because NLMK Group operates within regions which enjoy economic and social stability.

Investment risks

Project risks

Given the current financial crisis, the risk of not completing investment programmes has risen as the Group has fewer own sources for projects and the cost of financing has risen as well.

The measures taken by the management to reduce the risk impact are the following:

- review of the technical upgrade programme in order to specify the key and most effective projects, the financing of which will be continued. Currently the projects dedicated to cost reduction, quality and product mix improvement take the highest priority.
- attraction of acceptable low cost financing from western financial markets.

Risks associated with acquisitions, disposals

The Group was active in the mergers and acquisitions market, and risks related to non-completion of these projects may arise. In order to mitigate the risk the Company actively integrates acquired subsidiaries, combines Russian and international management teams, and optimises business processes.

Investment attractiveness decrease risk

Factors:

- a decrease in group profitability as a result high expenditures occurred in recent acquisition;
- increase in debt burden;
- cut in credit agency ratings;
- others.

In order to mitigate risk, the Company regularly organises events with the investor community to enhance understanding of our business. The management team sequentially comments on key decisions made by the Group.

Finance risks

Currency Risks

The Group's export-oriented businesses are affected by currency risks. The financial crisis followed by high volatility in the currency exchange market caused a risk that may have a significant impact on financial performance.

In order to minimise currency risk, the Company considers the expected exchange rate volatility in export planning. Measures are taken to diversify foreign currency revenue. Concluding export contracts the Company hedges its foreign currency operations through matching the currencies of cash inflow and outflow.

About 60% of sales come from exports while a major part of our costs is incurred in rubles. In order to balance sales and the costs budget, in 2008 NLMK entered into forward contracts with maturity in 2009. The rationale for this was based on currency exchange rate forecasts and market expectations given in 2008.

Interest rate risks

The Group applies financing from international financial markets nominated in foreign currency (USD, EUR), hence we are exposed to the risk of interest rates changes. In order to cover this risk, the Company takes measures to balance fixed and floating rate borrowings.

Social risks

Environmental Risks

Environmental risks emerge during the construction and operation of production facilities, wherever there is a probability of causing damage to the natural environment.

For the purposes of mitigating environmental risks we conduct continuous chemical monitoring of air emissions and effluents, and the overall impact on the environment is further reduced with the commissioning of environmentally-friendly technology and by the upgrading of installed equipment.

NLMK Group carries third-party liability insurance against accidents during the operation of hazardous production facilities.

Personnel risks

Personnel risks relate to matters such as the deficit of qualified staff, risk of accidents caused by personnel, illness and others.

In order to address this risk the Company has elaborated its corporate standards which dictate hiring and dismissal, training and assessment of professional skills, staff awards, the hiring of young trainees, and the implementation of other internal programmes aimed at improving the life of employees.

Well balanced social policy applied by NLMK during the period of a downturn allows the Group to maintain a stable social environment in the companies.