ALROSA Q2 and 6M 2018 IFRS results conference call edited transcript

28 August 2018

ALROSA speakers

Sergey Ivanov, Chief Executive Officer – Chairman of the Executive Committee

Igor Sobolev, First Deputy CEO – Chief Operating Officer

Alexey Philippovskiy, Deputy CEO – Chief Financial Officer

Yuri Okoyomov, Deputy CEO for Sales

Sergey Takhiev, Head of Corporate Finance

Participants asking questions

Dan Shaw – Morgan Stanley

Nikolay Sosnovskiy – Prosperity Capital Management

Anna Antonova – J.P. Morgan

Anton Fedotov – Bank of America Merrill Lynch

Presentation

Sergey Takhiev

Good morning and good afternoon ladies and gentlemen. My name is Sergey Takhiev, Head of Corporate Finance at the company ALROSA. I'm honored to conduct the conference call today. Thank you for joining us today on our conference call to discuss financial performance in the second quarter and the first half of 2018. As always, elements of our presentation are forward looking and based on our best view of the market.

Company's CEO Sergey Ivanov will discuss key operating and financial highlights and key developments at the company, and our CFO Alexey Philippovskiy will dive deeper into second quarter financials, and then we'll be happy to take your questions.

Today, senior management team – Igor Sobolev, First Deputy CEO – Chief Operating Officer, and Yuri Okoyomov, Deputy CEO for Sales are joining us and will be happy to answer your questions as well.

That's all on my side, and I hand over the call to Sergey Ivanov.

Sergey Ivanov

Dear colleagues, I am happy to welcome you at our Q2 and six months 2018 results conference call.

You have seen our presentation on ALROSA's performance, and before I hand it over to Alexey Philippovskiy who will discuss it in more detail, I would like to say a few words on the diamond market environment, our outlook and recent developments.

The sentiment in the rough diamond market has been positive year-to-date on the back of growing diamond jewelry sales and diamond prices in the key markets (US and Asia Pacific). The prices have been growing since the beginning of the year, with tighter demand and supply balance driving the diamond price index up over 4% since January 2018. Inventory of rough and polished stones at end-customers – namely polishers and jewelers – are at the last few years' average in value terms. In the second half of the year, we expect traditionally softer demand in the diamond market, but that's been well expected and comes as no news.

As for our outlook – we keep it unchanged – 2018 sales numbers should come at 39–40 million carats, and this including 6 million carats sold from inventories in January-March this year. 2018 production outlook also remains unchanged at 36.6 million carats.

Let me spend some time on recent asset portfolio management efforts. Our strategy focused on core business, which is diamond production and sales, remains unchanged. We sold our gas assets in February this year for RUB 30.3 billion. In July, we completed the acquisition of a 10% stake in our subsidiary ALROSA-Nyurba for RUB 12 billion, bringing our total stake to over 97%.

We are strongly committed to increase shareholder value – allocate prudently our capital and return cash to our shareholders. In August, we paid out the last of its RUB 38.6 billion dividends for 2017.

We previously stated that our dividend policy should be modified to offer better transparency and flexibility on how we return cash to shareholders. In August this year our Board approved financial policy and new dividend policy. That means, according with the new dividend policy we pay dividends twice year, and dividends are calculated based on company's free cash flow. And the payout is defined by level of Company's leverage. The Board, based on the new policy, recommended 6 months dividends of RUB 43 billion, or 70% of free cash flow for the six month ended June 2018. The shareholders are to make their decision by the end of September 2018.

At this, I am handing it over to Alexey Philippovskiy, our Chief Financial Officer. Alexey will walk you through the Company's financials and then we are ready to take your questions, if you still have them. Thank you.

Alexey Philippovskiy

Good day, ladies and gentlemen. First, let's take a look at ALROSA operating performance in the second quarter of 2018. As you recall, in the first quarter of this year, we were able to take advantage of improving market conditions and our Q1 sales came at 13.4 million carats, including 6 million carats out of inventory. This created a high base effect for our sales in the second quarter, which resulted in 32% quarter-on-quarter decrease in terms of carats.

Overall, first half sales volumes in carats were 8% lower versus last year, largely due to the decrease in production volumes. Now I suggest we turn to page seven to view our key financial highlights. Second quarter revenue was down 25% quarter-on-quarter, despite 32% drop in volumes, due to improved product mix and higher prices. Both of these factors, along with the destocking that took place in this first quarter contributed to 8% year-on-year revenue increase for the six months of this year.

Key factors behind our EBITDA dynamics are presented on the slide eight. Given relatively high seasonality of our business, we believe it makes more sense to analyze our EBITDA, costs and free cash flow by comparing the year-to-date numbers with the same period of last year. So our six month EBITDA was 22% up on improved product mix, higher prices and weaker ruble. These factors also explain the increase in our EBITDA margin from 47% to 53%.

Slide nine shows our cost dynamics and cost breakdown in the first half of 2018. The Company's costs excluding the change in mineral extraction tax, which is a function of sales, decreased by 3% year-on-year driven by reductions in payroll, SG&A, energy cost as well as costs of exploration and materials. Unfortunately, some of this decrease in costs is also explained by the closure of Mir mine. The per unit cost, measured in rubles per cubic meter of rock mass was down 4% largely due to our efforts to improve efficiency of operations.

Now let's move to slide 10, our free cash flow increased from RUB 50 million to RUB 62 billion driven mostly by stronger revenues, lower costs and release of cash from the working capital due to diamond inventory reduction, while CAPEX increased just marginally.

Slides 11 and 12 show leverage and net debt change analysis. Net debt fell to RUB 6 billion due to an increase in the free cash flow and the proceeds from the sale of our non-core natural gas business that took place in February of this year.

Just as Sergey Ivanov mentioned the general meeting of our shareholders will convene in September to consider the proposed payout of dividends for the first half of 2018. If their decision is positive, the Company will pay to its shareholders RUB 43 billion in November of this year.

This concludes my presentation and now we are ready to take your questions. Thank you.

Questions and Answers

1. **Dan Shaw** – Morgan Stanley

Hi, thanks for the presentation. Two question from me, the first one is on the dividends. I think it's positive step to have the new policy in place, but can you just talk through some of the reasoning behind why you're paying 70% of free cash flow given the net debt position is extremely low at the moment and the business remains very free cash flow generative going forward and there are minimal increases in CAPEX going forward as well?

And then the second question is on realized prices. Can you give any indication of direction, should we expect the realized prices to increase in the second half versus the first half given the positive market dynamics rather than other mix effects, which will get to offset this? Thank you.

Alexey Philippovskiy (translated)

Now first question, 70% payout ratio based on free cash flow is in line with our new dividend policy given current leverage. Under our dividend policy, there is a respected range from 70% to 100% and this has been, as you know, approved by our Supervisory Board. Now why 70% and not 100%, in our discussion at the Supervisory Board we took a number of drivers into account and one of them, the key one in this respect was CAPEX amount, which is still under a question mark. I mean CAPEX in terms of restoring the Mir mine. This item is pending decision, no final decision is taken yet, but this CAPEX is possible. This is why we opted for the lower end of the range.

Yuri Okoyomov (translated)

Hello. Thanks for your question. Before I address the question about the average sales price for the second half year, let me give a bit of a context explanation. The thing is that there are two key drivers to consider behind the average price level. First, this is seasonality of demand and typically in the second half year we see demand somewhat softer. Secondly, this is expected changes in the supply mix due to the seasonality, in the second half year we produce and sell more diamonds from our alluvial deposits. And the price of these diamonds is typically somewhat lower versus the average. The composition of these 2 drivers actually derive the actual realized price. However, all in all, we do not expect material deviations versus the levels achieved in the first half year going forward.

2. **Nikolay Sosnovskiy** – Prosperity Capital Management

Hello, I've got a couple of questions. First of all on the production numbers you published in the second quarter. As we see on slide number six, alluvials at 2.3 million carats versus 1.9 million carats in the second quarter last year indicate 20% improvement. Is it just quarter-by-quarter fluctuation or we can assume this increased run rate going forward? And what are the sources to increase production next year and substitute some part of missing Mir mine volumes? And maybe you are ready to provide next year guidance in terms of production.

And the second question basically is on dividends, this 70% payout you mentioned, will it remain at this sort of level going forward, if Mir CAPEX kicks off next year, and if not, will it go to 100% already in the next payment? Thank you.

Igor Sobolev (translated)

As for the increase in our production from alluvial deposits the achieved higher level has become possible thanks to relevant steps undertaken by our Company to replace the missing production volumes of the underground Mir mine. In particular, we are running a project to produce from the Ebelyakh alluvial deposit. So the achieved level is something pretty steady that you can expect going forward through 2025. After that, subject to additional geological exploration work, the production level will remain flat or increase.

Sergey Ivanov (translated)

Our full-year production level for 2018 will be at least at the level of 36.6 million carats. Production estimates for 2019 are also unchanged from our previous guidance in the range between 37.5 million to 38 million carats.

Alexey Philippovskiy (translated)

Talking about our dividend policy and payout ratio, I can say the following. As you know, we have sold out a major part of inventory in the first half of 2018 and given the production volume in 2018 is going to be lower than in 2017, most likely in the second half of the year we will see a softer result than in the first half of the year. Besides, as the dividend payout ratio in absolute volume terms is pretty high, at the year-end we expect a net debt to EBTIDA position in the range, allowing us to pay out dividends in the range between 70% to 100% of the free cash flow under our updated dividend policy, but let me stress it that final decision will be subject to the Supervisory Board, who in its tern will be guided by liquidity projections for our business and these liquidity projections will be driven mainly by production volumes and guidance, pricing, the exchange rate of Russian ruble versus US dollar and Mir CAPEX, that will probably come on stage. As yet, there is no precise decision to disclose.

3. **Anna Antonova** – J.P. Morgan

Just two small questions from our side. First on the income from grants in your top line. Could you please specify what is the nature of this income and how should we expect that to evolve over the next quarters and into 2019? That's the first question.

And the second question is on your recent purchase of 16% of Catoca. According to your financial statements, the deal should be closed by this year-end. So how should we think about this stake purchase going forward, will you sell the 8% in Catoca back to Odebrecht by this year-end or perhaps you may decide to keep the stake for yourself? Thank you.

Alexey Philippovskiy (translated)

As for the grants, these mainly relate to the reduction in power generation tariff for the Far Eastern federal district of the Russian Federation. This governmental decision is in force through 2020. So in the respective period, ALROSA will keep receiving grants dedicated to the electric power generated by our in-house power plant which is Viluiskaya hydropower plant number 3. The total amount of grants is expected to be RUB 4 billion. That's the total for year.

Sergey Ivanov (translated)

Let me be more precise on the numbers here. We are talking about 16.4% in Catoca, purchased from Odebrecht. According to our previous agreements with Endiama we are going to sell 8.2% to Endiama. The expected value of the transaction is $70.0 million. Now we are discussing a payment schedule that would be comfortable for Endiama, it's quite likely that we will allow payments in instalments, in return for certain consideration from that side on a fee paid basis. As far as the deal itself is concerned, I can tell you that we are quite happy because since the time the deal was closed the price of rough diamonds produced by Catoca has jumped by some 20% and so the time of pay back on that deal will be additionally reduced on the back of that driver.

4. **Anton Fedotov** – Bank of America Merrill Lynch

Hi. I have a question with regards to the recent agreement achieved last Friday within the Russian metals and mining companies and the Russian state about the new potential investments in number of social projects. It looks like these projects will be finalized within the next two-three months, so what are your expectations with this regard and what can be the impact on your investment program in the next few years? Thank you.

Sergey Ivanov (translated)

Yes, indeed there was meeting and I took part in that myself together with first Deputy Prime Minister Mr. Siluanov who is the Chairman of our Supervisory Board. Generally, the outcome of that meeting is positive, but let me comment on the ALROSA part exclusively, during the meeting I said that ALROSA is no doubt a state-owned company because our major shareholders are the government of the Russian Federation and the Republic of Sakha (Yakutia) holding a 33% equity stake each. And according to our new dividend policy, the profit that is going to be generated by our Company's business going forward in the coming year and years will flow to our shareholders under the improved mechanism and the drivers behind those profits will include favorable foreign exchange rates, good market sentiment and supply and demand balance and so the profits will then flow to relevant public budgets within the Russian Federation.

That said we do not expect any non-core projects to appear in our CAPEX plan. As for our CAPEX plan itself, it has achieved the status of a plateau, which means it will stay within RUB 28 billion to RUB 30 billion before any decision on Mir CAPEX is taken. So we do not expect any additional tax withdrawals or any additional tax burden to pop up for our Company. That meeting also included an interesting discussion on instruments, tools and measures that can be offered by the state to private companies to share risk on certain projects for the Russian companies to start launching new investment projects. This is related to the topic of why invest or not invest into the Russian Federation. This matter is interesting to our Company and as you remember, we are engaged in all sorts of discussions on this matter owned before the August discussions related to taxation started. We wrote a number of public letters in the past periods on a number of projects. One of those projects discussed was the reconstruction and upgrade of the airport in the city of Mirny (Yakutia). It's quite likely that the project will be managed under a public-private partnership framework with the aviation parts of core airport facilities financed and constructed by the state and the surrounding adjacent infrastructure funded and constructed by ALROSA.

Let me emphasize that this project came into the discussion long before the August meetings on taxes started. This is one of the range of interesting opportunities for private companies and the Russian Government to cooperate and increase the attractiveness of investments into the Russian Federation.