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TRANSCRIPT: Q3 2020 NLMK Earnings Call (IFRS)

Corporate participants

Grigory Fedorishin - CEO

Shamil Kurmashov - CFO

Dmitriy Kolomytsyn - Director for Corporate Finance, IR

Dmitriy Kolomytsyn

Good morning, and good afternoon, ladies and gentlemen. This is Dmitriy Kolomytsyn from NLMK's Corporate Finance and Investor Relations team. Thank you for joining us today on our conference call to discuss our operating and financial performance in the third quarter of 2020. As always, the elements of our presentation are forward-looking and based on our best view of the market. The company's Chief Executive Officer, Grigory Fedorishin, will provide market overview and key highlights of Strategy 2022, among other things. And following that, our CFO, Shamil Kurmashov, will discuss our financial results in more details. We'll then be happy to answer your questions. That's all on my side. And I hand this over to Grigory Fedorishin.

Grigory Fedorishin

Thank you, Dmitriy. Dear ladies and gentlemen, welcome to everyone who joined our conference call today. I hope that you and your families are well and safe as we continue to navigate through the COVID-19 pandemic.
Before we start moving through the presentation, I would like to highlight that today NLMK's Board of Directors approved the recommendation of the third quarter dividends in the amount of $500 million.

This sum includes one-off dividend of $250 million on top of our dividend policy. It's to compensate for the reduction in Q4'19 dividends following the shareholders' resolution back in April in the middle of the first wave of pandemic. We continue to be grateful to our shareholders who kept their trust in our investment story during this difficult period.

And now let's please move to the main part of the call. As always, I will start with the key macro trends that set the scene during the third quarter. I will then briefly take you through our operational results and the outlook for the fourth quarter. After that Shamil will present the details of NLMK’s financial results and discuss our debt and liquidity position.

Let's please go to Page 4 to discuss the market situation. Demand for steel increased backed by gradual recovery in global business activity. However, new outbreaks are casting shadow on the pace of sequential improvement. Thanks to the state support program, China became a net importer of steel products for the first time in many years, as a result of strong growth in domestic steel consumption.

Market conditions improved in the U.S. and the EU with easing restrictions across the production chains. According to preliminary estimates, demand growth quarter-on-quarter in both regions exceeded 5%.

Consumption of steel products in Russia increased by 15-20%, practically reaching the Q3 last year level, supported strongly by the recovery in seasonal demand from the construction sector.

It is worth noting that demand for rebar, for example, was up 30% comparing to the previous quarter. More importantly, consumption of rebar during 9 months of 2020 was flat year-on-year. And you may remember that we had rather strong construction market in 2019.

Alongside the recovery in steel demand, manufacturers around the world began to resume previously suspended operations. That pushed the average utilization rate for the global steel industry above 80%, or back to pre-COVID levels. Iron ore prices remained elevated as a result of strong demand from Chinese mills and other regions, underpinned by speculations of potential supply disruptions at major exporters.

Coking coal prices remained range bound at around $110 per tonne until late September when they spiked to $135 per tonne amid expectations of worsening weather conditions in Australia. Abnormal rainfalls during winter season were expected to disrupt mine operations as well as to impact transportation. In mid-October, the prices retraced to $120 on the news that China could again tighten coal imports from Australia.

Let's now turn to Page 5 to discuss steel prices and spreads across various regions. HRC and slab prices gained momentum in the third quarter across key regions where we sell our products. In China, prices were rising until September when the anticipation of tighter monetary supply as well as slowdown in the real estate market affected market sentiment.

In the EU and U.S. steel prices remained largely flat. We started seeing some upward movement in late September, which resulted in 15% to 30% increase in mid-October compared to last quarter average. Such trend was supported by low production rates and tight inventories of finished steel.

In Russia, export prices were up quarter-on-quarter, also due to stronger demand. Local Russian prices declined slightly in dollar terms, however, as a result of rouble devaluation. Current steel prices in the U.S. and EU as well as export prices in Russia are now solidly above the levels we saw before COVID.

Overall steel spreads remain robust as strong iron ore prices are offset by weaker coking coal and higher steel prices.

Let's now please switch to Page 6 to discuss utilization rates at our assets. In Russia, our flagship Lipetsk site is running at full capacity. In the long products division, the shift in the construction season in Russia coupled with government stimulus for the real estate market resulted in sequential improvement of the segment's utilization rate. We reached almost 100% in September, while average quarterly utilization rate improved by 20 percentage points quarter-on-quarter.

NLMK's European companies were running at lower rates. This was especially evident during the summer months. However, already in September, utilization rates recovered to 85%. The share of NLMK's domestic sales has been steadily rising during the quarter, and we now see almost 50% of shipments staying in Russia with 50% going abroad. This is partly due to lower slab sales as a result of large-scale capital repairs at NLMK Lipetsk. On a separate note, I wanted to highlight that our Stoilensky plant resumed its operations on September 22nd following the collapse of an ore transportation conveyor gallery. During the 12-day restoration period, we carried out additional repairs, originally planned for the end of 2020 and next year. Optimization of repair works will help reduce concentrate production loads in 2020 and boost production volumes next year.

Let's now turn to Page 7 to discuss our Group's sales results in the third quarter. The third quarter sales were up 2% quarter-on-quarter to 4.4 million tonnes. Sales of finished products increased by 14% to 2.8 million tonnes, driven by solid recovery in demand for steel products on the Russian market.

The share of finished products in our portfolio increased as well due to the start of capital repairs at Lipetsk hot-end operations, which I mentioned before. This also drove down our sales of semi-finished products to third parties by 5% to 1.4 million tonnes.

Sales at our home markets grew by almost 20% due to a gradual recovery in steel consumption on the markets where the Group operates, especially in Russia.

On Slide 8, you can see the effects from Strategy 2022 implementation. The total gains during 9 months of this year reached $170 million. Our operational efficiency program continues to roll out. We already exceeded our annual target of $100 million by 20%.

Investment projects brought additional $46 million. Those include the growth in iron ore concentrate production and recycling of previously accumulated waste at newly-built briquetting plant at Lipetsk.

In Q3, we launched a number of key development projects aimed at low-cost steel output expansion. The start-up of these facilities is under way. Just to remind you, most of the gains related to investment projects in context of Strategy 2022 will start materializing next year.

Let's now turn to Page 9 to discuss short-term outlook. The Russian market surprised on the upside in October owing to good weather conditions and postponed demand. For the rest of the quarter, seasonal slowdown coupled with restrictions related to COVID-19 could drive prices lower.

The market activity in China hasn't gained momentum yet after the golden week holidays in early October. We expect the country to continue demonstrating strong performance going forward. However, during Q4 supply may outpace demand, which could in turn affect local pricing environment.

In Europe, we expect the supply and demand to be balanced with some of the capacity slowly coming back to the market. Local authorities are trying to avoid the virus confinement measures in the manufacturing sector, but the overall uncertainty may cap further growth in steel prices.

Despite traditional seasonal factors typical for the fourth quarter, consumption in the U.S. seems to recover at a higher speed compared to supply. That could support prices into year-end as inventories remain tight.

The sustainability of recovery in economic activity around the globe will largely depend on the magnitude of renewing restrictions related to COVID.

As for our company, we expect to reach an important milestone in Q4. By the end of the year, we plan to complete the 2-year capital maintenance program in our blast furnace and steelmaking operations at NLMK Lipetsk.

We are going to reach our previously announced 2020 steel production target of 12.2 - 12.3 million at this particular site. These projects are the backbone of the modernization program that will enable us to increase steel output at NLMK Lipetsk to 14.2 million tonnes starting already next year.

Now let me hand over to our CFO, Shamil Kurmashov. He will give you some further details on our third quarter performance. Thank you.

Shamil Kurmashov

Thank you, Grigory. Good day, everyone. Let me now discuss our third quarter 2020 operating and financial results. Please turn to Page 11 of our presentation. Our revenue advanced by 3% quarter-on-quarter to $2.2 billion, supported by higher sales volumes and improved product mix.

The share of the Russian market in the revenue mix recovered to 46% compared to 37% in the previous quarter. The share of Asian countries stood at 14% while the EU and the US share was down to about 11% and 14% accordingly.

During the third quarter, we experienced some cost headwinds due to the incident at Stoilensky and our EBITDA declined only by 1% quarter-on-quarter to $579 million.

The widening of price spreads, higher sales volumes, improved portfolio structure and the devaluation of the ruble enabled offsetting the corresponding impact. Without these one-off effects related to the incident at Stoilensky our Q3 EBITDA would have been $640 million.

Our commercial expenses declined by 8% quarter-on-quarter to $208 million, due to lower transport costs associated with the normalization of the export sales from our Russian operations.

Q3 net profit recovered to $312 million (4 times growth quarter-on-quarter) due to the low base effect of the previous period when we recognized the impairment of a $120 million investment in NBH.

Total debt at the end of the third quarter declined by 5% to $3.2 billion. Our net debt to EBITDA ratio stood at 0.87, still below 1x, which means that we continue to distribute 100% of our adjusted free cash flow in form of dividends to our shareholders.

Now let me give you a brief overview of our performance by business segments at Page 12. EBITDA at the Russian flat products division went up by 1% quarter-on-quarter to $306 million, as the sales mix improved and the ruble weakened. These factors allowed us to offset lower shipments due to the start of the second phase of repairs at our Lipetsk site as well as reduced share of captive iron ore.

And our Russian Long Product division recorded $37 million of EBITDA. This is almost 4 times higher than in the previous quarter. Higher sales volume, lower share of billets in the sales mix as well as wider spreads between rebar and scrap contributed positively to the result as well as the deferred demand, which realized in the third quarter.

In the Mining segment, EBITDA went up by 1% to $250 million, driven by higher prices as well as operational efficiency and investment projects. Total sales as a result of an incident decreased by 16% quarter-on-quarter, while external sales of iron ore concentrate declined to almost 160,000 tonnes from 450,000 tonnes in the second quarter.

At NLMK USA shipments increased by 11% following gradual market recovery and the completion of planned routine repairs at NLMK Indiana. EBITDA fell to minus $12 million compared to $3 million in the second quarter due to narrower spreads between rolled steel and slabs. The negative trend was partially offset by higher sales and operational efficiency program gains.

EBITDA at Dansteel stood at the same level as last quarter, that is minus $3 million, as lower demand due to the COVID pandemic drove sales down by 21%. But the performance was underpinned by the Strategy 2022 projects.

And finally, at NBH level, deliveries remained almost flat quarter-on-quarter. EBITDA decreased to minus $32 million. On the back of lower prices of finished products as well as reduced capacity utilization rates.

Now let me drive you through liquidity and free cash flow on Page 13. Our free cash flow reached $239 million in the third quarter. Capital expenditures increased by 57% to $344 million on the back of repairs at hot-end operations at the Lipetsk site as well as active realization of the Strategy 2022 projects.

Cash inflow from working capital totaled $98 million driven by the combination of the following factors: first of all, this was due to an increase in payables of almost $100 million related to higher purchases of third-party raw materials: iron ore and scrap. Secondly, we saw an inflow of almost $50 million related to reduction of slab inventories at NLMK USA as well as overall finished products inventories. The latter was mainly supported by strong demand recovery in Russia and shorter transportation leg associated with lower exports.

On the other hand, there was a negative impact of $37 million outflow which was caused by an increase in receivables due to higher realized sales prices.

Now let's move to Page 14, where we demonstrate our solid debt portfolio and liquidity position. The Group benefits from a strong financial position with low leverage and significant liquidity. As of September 2020, our cash on hands was $1.3 billion and available unutilized credit facilities at the level of $1.5 billion, exceeding our short-term loans by $630 million, a significant headroom possibility.

As discussed earlier, our total debt decreased by 5% to $3.2 billion due to the repayment of a part of short-term debt. Another portion of short-term debt in the amount of $340 million was restructured or rolled over to the later periods.

In addition to that, at least half of working capital lines maturing in 2021 could be rolled over or refinanced to later periods. While net debt rose by 6% to $1.9 million our net debt/EBITDA stood at 0.87 or below our long-term target of 1x.

The Group's liquidity fully covers our short-term debt needs.

To conclude, NLMK's average cost of debt remains at historically low level of only 3%.

This is it for my part. We would like to thank you for your attention, and we'll be happy to take your questions. Thank you.

Questions and answers session

Dan Shaw - Morgan Stanley

Just a couple from me. Just the first one on the demand side, typically, Q4 is a bit of a weaker quarter seasonally at least. Given sort of the level of stimulus and possible, I guess, catch up in demand from earlier in the year, could we see demand up year-on-year? Or do you think there's the best that we can hope for is that demand is flat year-on-year? That's the first question.

Then I have one on the domestic premium for HRC. Where do you see that at the moment? On my numbers, there's no premium at the moment. Is that right? And how quickly do you think that could be restored? And can your customers absorb a price increase?

And then the last question, just on CapEx, can you remind us what your latest expectations are for your CapEx spend for 2020?

Grigory Fedorishin

Thank you, Dan. So I'll take those. For Q4, well, it's a bunch of factors, as usual, influencing the demand, right? So in the U.S., for example, as I said, seasonally, it's usually weaker quarter, but the combination of improving demand and tight inventories makes us sort of optimistic on the consumption side. In Russia October looks good. The weather is mild. So construction season continues. Thus, should also be okay. I wouldn't exclude the consumption this year exceeding the last year, at least on the Russian side, quarter-on-quarter.

Talking about premium. Now we see the discount driven both by strong export benchmarks and weak ruble. Historically, it strongly depends on seasonality, how quickly the premium recovers. Given that we are entering weak season in terms of steel consumption, I wouldn't expect the premium to fully recover before next season, which is March next year. By then, we should see premium coming back to historic average of $40-50 per tonne, but , before that, it should stay roughly 0, maybe slightly positive. That's how we see this.

For CapEx, we reconfirm our plans for this year, we should stay in the range of $1 billion to 1.1 billion all in for year 2020.

Nina Dergunova - Goldman Sachs

I have 2 questions. Firstly, on efficiency gains. Can you speak, please in detail what is driving efficiencies ahead of your initial plan? You were expecting about $100 million and contributions from operational efficiency program for this year is already realized an amount of $124 million.

Can you name what projects are running better and for what reason? And then we'll ask the last after those.

Grigory Fedorishin

Thank you, Nina. The $100 million target, this is sort of a minimum boundary we keep for ourselves. But you can see it for the last several quarters, we actually move faster than that. So I would say we move at the average rate of $150 million run rate per year.

This particular quarter, and actually that applies also for 9 months, it was driven by increased volumes in steel production and increased volumes on the mining side.

By debottlenecking, by leveraging the maintenance in a better way, we were able to get more volumes at the existing equipment that helped us to compensate for some of their losses we had either because of the incident at Stoilensky or at large-scale capital repairs at Lipetsk site.

So you don't see this as a sort of improvement to the baseline. All these effects to be fully realized, we should run at full scale, and that will happen next year, and then we will see that the 100% of the effects realized. But those help us this year to compensate for some of the temporary losses we had.

Nina Dergunova

And the short follow-up from my side. What are the target efficiency gains in 2021 that you expect?

Grigory Fedorishin

We expect to run at the rate of $100 million to $150 million per year, but it's coming from completely different sources and all of our divisions. That's the very general average target that I'm giving you.

Nina Dergunova

That is clear. And given that we touched on 2021, my second question relates to your next year major projects that you plan to undertake. What amount of capital expenditures do you expect for next year? And what will be the key projects the company will be working on during 2021?

Grigory Fedorishin

Talking about CapEx we are still in the process of setting up the detailed CapEx plan for the next year. But for now, I can comment, it's going to be roughly the same level you see this year.

We have some carryovers coming from this year in terms of the capital repairs at Lipetsk site. And also some of our big projects like expansion of concentrate production at Stoilensky and coal stamping at Altai skewed in the second half of the year. So some of the payments will be transferred to the next year.

As for new projects, we'll be seriously handling our captive power plant project at Lipetsk so that will be the first year. This year, we are focused on the project works. But next year, the execution will really start. We'll be doing electrical steel production upgrades, both on GO and NGO electrical steel.
And we'll start our galvanizer project at Lipetsk site. On top of these bits and pieces, different projects on the Russian side in long products and also Europe, we'll continue modernization of our hot strip mill in Belgium. Additional capacity will come with the second furnace at Dansteel that should help us to increase the production from 500,000 to 700,000.

So it's still a bunch of investment projects to do. But in terms of the effects, the first effects will start to materialize next year because the core of the strategy, which is increasing steel production by 1 million tonne, accompanied by 100% integration in iron ore, that's already under ramp up and should be fully on stream starting next year.

Nina Dergunova

In general, in 2021, we will be moving towards downstream, high value-added section of your strategy as opposed to upstream and more cost base in the previous years, correct?

Grigory Fedorishin

As a general rule, yes, but we still do have some upstream project spending and some downstream projects as well. But as a general rule, you are right.

Artyom Bagdasaryan - BCS Global Markets

I have a short question concerning the upcoming increase in the mineral extraction tax into 2021. So what are your estimates or how much the tax would increase for you and how it affect your bottom line?

Shamil Kurmashov

We expect that the influence of this mineral extraction tax would not be significant on our P&L. It would be in ruble terms 1.2 billion for the full year. The 3.5x increase in the tax. And in an absolute amount, that will be RUB 1.2 billion for the full year. If it's enforced from 2021.

Artyom Bagdasarian

So you are meaning that RUB 1.2 billion is incremental?

Grigory Fedorishin

Right. It's incremental. So it gives you about $17-18 million per year of additional tax or additional costs in the P&L, in terms of the cash flow, it should be 20% less because this is sort of a cost base for the income tax as well.

Anton Fedotov - BofA

I have two questions. First question. Do you expect still any impact from the Stoilensky plant accident on the fourth quarter performance of the company? And the second question relates to your full year dividend. Your dividend policy implies that you should pay out 100% of the free cash flow for the full year. Should we strip out the special dividend that you just announced for the third quarter from the dividend calculation? In other words, the effective dividend may increase 100% free cash flow if we add a special dividend. Is it correct?

Grigory Fedorishin

Thank you, Anton. Concerning Stoilensky, the main effect was posted in Q3, and that consisted of 2 big parts. One, they had to buy temporarily external iron ore at market prices versus cost at our own mine. And the second, we lost some volumes, so we couldn't sell those to the third parties to the merchant market, primarily China. There are some bits and pieces, but we are ramping up production. And again, as I said, some of the repairs initially planned for the fourth quarter were done in that period in September. So you will not see an effect in the fourth quarter on the Group results.

On the dividend, this $250 million one-off dividend is to compensate for the cut in a dividend done by the shareholders on the Q4 dividend last year. So this is the one-off thing that comes on top of our dividend policy.

We commit to the dividend policy. You should consider this as a separate one-off event. For the full year, we are going to pay 100% of our free cash flow. And as long as the leverage stays at around 1x, I would say, because we don't follow this precisely in arithmetic terms. So if it's even slightly above 1x, but we will see good couple of quarters coming, so we'll still suggest and propose to the Board to pay 100% of the free cash flow on a normalized basis, meaning, you remember, we have this adjustment for normalization. So if the CapEx exceed $700 million we don't include this in the calculation of the dividends. Coming back to your question, $250 million on top of the dividend policy. So it will not be stripped out of the full year dividend.

Sergey Donskoy - Societe Generale

I have one question. Basically, this year, China emerged as a major importer of steel for the first time, and they're also importing significant quantities of semis. I wonder if you are exporting any slabs to China yourself. And if you do, how do you see these patterns changing? Do you see demand staying strong into the final months of the year? Do you see it cooling down? And how do you think the situation may develop into 2021 in terms of their presence on international market as a buyer.

Grigory Fedorishin

Thank you, Sergey. Yes, you're right. We sold quite a lot of steel this year to China. Most of it came in a form of slabs. Now in the fourth quarter, we keep seeing quite a strong demand. So we're happy that we developed the customer base there. Longer term, we believe it's probably abnormal, and we don't plan to sell that much steel and that much slabs to China next year. But for at least next 6 months, we see demand there as quite strong.

Sergey Donskoy

I see. And what is the freight disadvantage that you have selling to China compared to Europe or North America?

Grigory Fedorishin

Dmitriy, you can help me?

Dmitriy Kolomytsyn

Yes. It's about $20-30 difference between selling shipment slabs to China versus shipping to Europe.

Boris Sinitsyn - VTB Capital

One question from my side, please. So it looks like next year, you are planning quite a sharp increase in steel production. The question is, do you match your requirements and plans actually in terms of iron ore production increase with it next year? If I'm not mistaken, you are planning to raise iron ore production slightly below 20 million tonnes.

Grigory Fedorishin

Yes, Boris. Thank you for the question. You're right. We stick to our plan. We want all the steel volumes that we produce next year to come 100% integrated with the captive iron ore. And we plan for slightly above 20 million iron ore concentrate production at Stoilensky. In parallel, 8 million tonnes of pellets. That was the strategy, and that's the plan for the next year. So we will be fully integrated.

Dmitriy Kolomytsyn

Thank you very much to everyone who joined this call. And we'll be very happy to see you again in about 3 months' time.