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TRANSCRIPT: Q2 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 second 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 present key highlights of Strategy 2022, among other things. Following that, our CFO, Shamil Kurmashov, will discuss our operational and 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 will start with market overview, recent market trends and steel prices dynamics, and then I will provide key highlights related to Strategy 2022 implementation and the outlook for the third quarter. Our CFO will then present the details of the company's operating and financial results for the second quarter and discuss our better liquidity position.

Market volatility and uncertainty the company faced in the second quarter were unprecedented. I would like to thank all our employees for their support, diligence, hard work and patience. This is more than reflected in the quality of the results we are presenting today.

Let's please go to Page 4 to discuss the market situation. China has been setting some major trends so far this year. The first country that was hit hard by coronavirus, it showed a significant slump in economic activity in February. However, China's PMI quickly rebounded already in March, backed by government stimulus and has remained above 50 up until now. Unexpectedly robust economic growth in China resulted in record high domestic steel production. Combined with reduced supply from Brazil in the second quarter, iron ore prices have increased, adding more than $20 per tonne since April. Coking coal prices, on the other hand, dropped from $144 in April to $108 per tonne in June due to concerns over tightening import quotas in China as well as low demand during the pandemic in key seaborne core consumer regions such as Japan, India and Europe. Slowdown of the Russian, the U.S. and the EU economies showed somewhat similar dynamics as in China, but with a 2- to 3-month delay. Economic recovery, however, has been much slower when compared to China. The U.S. continues to suffer from the new outbreaks, and it remains to be seen how long it will take for the world's largest economy to combat the disease. Needless to say that the spread of the COVID-19 has resulted in a significant decline in steel demand in our home regions: Russia, EU and U.S. While demand in Europe and the States remains weak, business activity in Russia recovered strongly already at the end of June, supported by government measures, including interest rate cuts by the Central Bank and delayed demand coming from the construction sector that was backed by falling mortgage rates.

Let's now turn to Page 5 to discuss steel prices and spreads across various regions. HRC and slab prices declined sequentially in the second quarter across key regions where we sell our products. Chinese steel prices were the first to start showing the signs of recovery in late April, backed by healthy demand. Both domestic and export prices continued to demonstrate solid growth versus Q2 average. In the EU, prices have been steadily declining since late March. And in the U.S., the June price hikes were short-lived as the economy is still recovering at slower than expected pace. Prices in the EU and the U.S. are still 15% to 20% below the pre-lockdown levels. Steel prices in Russia are holding up well due to the factors that I've just highlighted. In fact, prices are currently close to mid-March 2020 levels or before the lockdown. Steel spreads have been slowly improving as lower coking coal prices and increase in steel quotations offset elevated iron ore prices.

Let's now please switch to Page 6, and talk about Strategy 2022 implementation.

Despite the pandemic, the company continued to work on its strategy. During the 6 months of this year, total effects amounted to $113 million in annual terms. Contributions from the operational efficiency programs during the first half of the year already approached our annual target of $100 million. Most of the effect came from the Mining and Russia Flat divisions. Gains from the investment projects were $16 million, as you can see on the slide. They include projects targeting iron ore concentrate production growth and recycling of previously accumulated waste at the briquetting plant in Lipetsk. As we guided before, most of the gains related to the investment projects will start materializing in 2021, with some appearing later this year.

Let's move to Page 7 to talk about some of the investment projects in more details.

While we are on track to deliver additional 1 million tonnes of steel next year at Lipetsk site, we have concluded several major phases of this program in the second quarter of 2020. In downstream, we recently launched a new continuous casting machine. Its productivity increased by 80% to 1.8 million tonnes per annum. The upgraded machine will enable us to fully master the production of the so-called 'heavy' slabs, with higher chemical purity, offering one of a kind product mix in Russia. In upstream, we have commissioned additional iron ore concentrate production equipment at Stoilensky, targeting the increase in the output from 17.5 million tonnes to 20 million tonnes of concentrate per annum by next year. We have already started testing new coal charge stamping treatment at Altai-Koks, which aims to improve coal quality and reduce its production costs. It would also decrease our dependence on premium grades of coking coal. We are also keen to enhance our customers' experience by increasing flexibility and the speed of deliveries. The new logistics complex at NLMK Lipetsk site that we opened in June with an ability to ship over 1 million tonnes of flat products per year by auto is designed to fulfill this target.

Let me now take you to Slide 8 to go through our current utilization rates at various divisions.

In Russia, our flagship Lipetsk site continues to run at 100% utilization. Currently, we are booking sales of flat products for the month of September. In the Long Products division, the delayed launch of the construction season in Russia, coupled with government stimulus for the real estate market, resulted in quick rebound of the segment's utilization rate. The share of our sales to Russian market, flat and long products combined, has been steadily rising, and we are now almost back to normal level, with roughly 45% of shipments staying in Russia and 55% going abroad. The run rate at our European and U.S. plants, however, remained low, 66% and 50% correspondingly.

Let's please move to Page 9 for the third quarter outlook.

We expect China to continue performing well, posting sequential demand improvement in manufacturing and automotive sectors. We also anticipate rather strong infrastructure activity that should provide ongoing support for steel demand in the country. The Russian market also appears robust. The ease of the restrictions, monetary policy support, preferential mortgages rate as well as upbeat construction markets should keep domestic steel demand stable. In Europe and the U.S., we expect steel consumption to be depressed in the third quarter as the pace of recovery continues to be sluggish in both regions. Further recovery in business activity will heavily depend on whether we'll see the second wave of COVID-19 and related economic disruptions.

As for our company, we expect steel production at NLMK Lipetsk to be flat year-on-year in the third quarter due to the second stage of the major maintenance works at blast furnace and steelmaking operations aim to increase steel production by 1 million tonnes, starting from 2021.

This is it for my part. Now I would like to hand this over to our CFO, Shamil Kurmashov. Please go ahead, Shamil.

Shamil Kurmashov

Thank you, Grigory. Good day, everyone.

Let me now discuss our second quarter operating and financial results, and I propose to start with Page 11.

Our steel shipments decreased by 3% quarter-on-quarter to 4.4 million tonnes, mostly due to lower sales at NLMK U.S.A. and NLMK DanSteel, our overseas divisions. Compared to the same period last year, sales increased by 2% year-on-year, driven by the increase in production at NLMK Lipetsk. Sales of semi-finished steel rose significantly to 1.9 million tonnes and were up 27% year-on-year, driven by high pig iron and billet exports. Slab deliveries almost remained flat. They rose by 1% quarter-on-quarter to 1.4 million tonnes. Finished product sales dropped by 12% quarter-on-quarter to 2.4 million tonnes, followed by weaker demand and a corresponding redistribution of a part of the portfolio to semi-finished products. Sales outside Russia were up by 6% quarter-on-quarter as a result of higher level of shipments to the Asian markets from Russian Flat and Long divisions.

Let's now move to Page 12. Our revenue declined 12% quarter-on-quarter to $2.2 billion due to lower sales volumes and steel prices. Increase in the share of semi-finished products in the sales mix also contributed to the drop in revenue. The share of the Russian market in total revenue dropped to

37% compared to 41% in the previous quarter as a result of higher export deliveries from NLMK's Russian facilities, which grew by 14%, and changes in the regional breakdown. The share of Asian countries increased to 15% from almost 0% in the first quarter and the same period last year, while the EU and the U.S. share was down to about 30% compared to a little bit more than 41-44% last quarter and a year ago. So a little bit away from the normalized levels.

Despite the 12% drop in revenue, EBITDA declined only slightly or 2% quarter-on-quarter to $582 million. This is because lower shipments in steel prices were almost fully offset by ruble depreciation and operational efficiency gains. Our commercial expenses increased by 7% quarter-on-quarter to $227 million, with higher transport expenses driven by an increase in exports to remote destinations. General and administrative expenses, on the other hand, decreased by 5% quarter-on-quarter to $82 million, driven by managed cost optimization efforts. Our net profit for the second quarter decreased by 73% to $77 million, and it was due mainly to the impairment of $120 million investment in NBH. The recognition of $70 million loss from foreign exchange differences served as an additional factor. Apart of this impairment, our income would have decreased by 24% only. Total debt during the second quarter 2020 declined by 3% to $3.4 billion due to the repayment of our short-term portion of debt. Net debt-to-EBITDA ratio remained at a comfortable level of 0.79x.

Let us now move to Page 13 to discuss quarter 2 EBITDA and EBITDA margin dynamic by divisions. EBITDA at the Russian Flat Products division totaled $303 million, down 15% quarter-on-quarter due to lower sales and changes in the product mix, which was partially offset by a weaker ruble and gains from operational efficiency program. The Russian Long Product division recorded EBITDA of $10 million in the second quarter. This is 29% lower sequentially as the share of billets in the sales portfolio increased following a decline in the rebar demand on the Russian market. It's important to mention that we currently see the effect of postponed demand on the domestic market and active destocking, as customer activity picked up significantly following the easing of lockdown constraints.

In the Mining segment, sales increased by 6% quarter-on-quarter to 4.9 million tonnes, following production growth. External sales of iron ore jumped to 450,000 tonnes. Revenue grew by 8% to $336 million due to higher sales and almost 15% quarter-on-quarter increase in ruble-denominated prices for concentrated pellets. As a result of all this, EBITDA increased by 9% quarter-on-quarter to $248 million. At NLMK U.S.A., sales fell almost 40% quarter-on-quarter due to the sharp drop in demand on the U.S. market caused by the COVID-19 pandemic. Additionally, planned routine repairs were carried out at NLMK Indiana in June. EBITDA, nevertheless, stood at $3 million compared to minus $22 million the quarter before. Positive dynamics in EBITDA was due to widening of the slabs to rolled product price spread and one-off factors in the first quarter. I would like to remind you that we made the impairment of slab base, slab inventories in the first quarter adjusted to the market conditions. EBITDA at DanSteel was minus $3 million compared to plus $6 million the quarter before. This is because of a narrowing slab to plate price spread and lower sales volumes. Finally, at NBH, sales declined by 23% quarter-on-quarter, mainly due to lower strip sales amid the overall demand drop on the European market. This resulted in revenue falling by 19% to $308 million, and EBITDA declining to minus $14 million versus $19 million in the first quarter.

Let's now discuss cash flow dynamics on Page 14.

Our free cash flow decreased slightly quarter-on-quarter to $304 million, with a decrease in operating cash flow by 11%. This was partially offset by managed Capex reduction. Year-on-year, free cash flow increased by 18% due to the cash inflow from working capital. Cash flow from working capital totaled plus $57 million, mainly due to a combination of the 3 counterbalancing factors: a positive factor of $109 million resulted from a decrease in receivables; and the negative contribution of the fact of minus $76 million, which was due to decrease in payables, driven by lower slab purchasing at NLMK U.S.A. division. NLMK Group's Capex in the second quarter decreased by 24% to $219 million against the backdrop of a managed optimization, which has meant as the slowdown of Capex projects and payment schedule optimization.

Let's move to Page 15 for a brief overview of our debt portfolio and liquidity.

As discussed earlier, our total debt decreased by 3% to $3.4 billion due to scheduled repayments of working capital lines. While net debt rose by 3% to $1.8 billion and net debt-to-EBITDA stood at 0.79x or below our long-term target of 1x, the group's liquidity of $1.5 billion fully covers our short-term debt needs, with about $900 million further available through undrawn credit lines. This is almost our cash at hand. NLMK's average cost of debt remains at historically low level of just above 3%. Our working capital lines maturing in 2020 could be rolled over or refinanced. It depends upon our needs, which will be clarified further. I also would like to remind that NLMK has recently signed a 4-year syndicated revolving credit line with a group of international banks in the amount of €600 million, with an accordion option, allowing the company to raise the funding limit to €1 billion. This facility further helps to ensure optimal liquidity and without additional costs.

Finally, today, NLMK's Board of Directors approved the recommendation of the second quarter dividends in the amount of $400 million or 132% of free cash flow, which is in line with our dividend policy.

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

Questions and answers session

Sergey Donskoy –Societe Generale Cross Asset Research

I have 2 very short questions. One, do you have any estimates as to what additional working capital release or any increase in working capital you might see in the second half of the year? And also, if you have any estimates as to where you see your net debt to EBITDA by end of the year, ballpark.

Shamil Kurmashov

Thank you for the questions, I would like to begin with the first one. It's very difficult to forecast working capital release buildup in such a volatile environment. But for the second half and mainly for the third quarter, we expect a certain buildup of working capital due to the realization of the 3 factors: first, increasing prices by the end of the third quarter; second - stockpiling of scrap ahead of the winter season; and the third factor is the increase in iron ore inventory due to maintenance works at the pelletizer. All this is going to result in from $50 million to $100 million working capital buildup. Regarding to your second question, that was our net debt to EBITDA, we expect to be around our long-term target, 1.0x. That's our target. We would like to keep close to that.

Alexandra Symeonidi - William Blair

I wanted to ask about your Capex guidance. I remember you revised it to $900 million for this year. Does it still fund the $900 million? Or did you revise it back to $1.2 billion?

Grigory Fedorishin

Thank you for the question. Our target is $1 billion to $1.1 billion for the full year. So we just leave it like for the unchanged target for the whole year.

Anton Fedotov - BofA M errill Lynch, Research Division

I have two questions. My first question relates to your dividend. I noticed that the free cash flow payout for dividends for the second quarter was materially higher than the 100% of FCF versus 75% for the first quarter. Does it mean that you have much more confidence in the markets right now in the current situation? And what free cash flow payouts should we expect in the second half? That's my first question. And my second question relates to the situation in the Russian domestic market. As I understand, you expect some improvement. Does it mean that we should expect you to sell more in the Russian domestic market in the second half to go to better some of the efforts going to the Russian market?

Grigory Fedorishin

Thank you for the questions. I'll take both of them. So on dividends, we are coming back to our dividend policy. The payout for the first half of the year is slightly higher than 100% of the free cash flow, in accordance, again, with the dividend policy. As you remember, we committed to pay 100% of the free cash flow, plus adjustment for normalization of Capex if the leverage stays below 1. That's what we are doing now. And we are going to stick to the policy going forward. So we can go beyond 100% of the free cash flow if we see strong economic recovery. Otherwise, it's 100% of the free cash flow as a guidance.

On the Russian domestic market, we do see the market recovering pretty quickly, driven by: first, government stimulus; and second, the postponed demand, the volumes lost, the time lost in the second quarter is now coming back. And construction, in particular, construction companies, the rush for the new projects. Demand for the construction already approximate the normal seasonality we saw in the last years and keeps improving. So in the third quarter, we expect to come back to our normal mix of 45% sold in Russian market, 55% exports. I'm now talking about Russian assets, both flat and long products. And we see interesting dynamics. Construction activity is pushing up not only rebar and other long products, but coated products, which is a part of the residential construction, also enjoy quite a high demand levels. I hope that answers your question. Thank you.

Anna Antonova – JPM organ Chase & Co, Research Division

Just two questions from our side. First, on your Capex guidance for this year. As I remember, in the end of April, with Q1 results, you have cut your original Capex guidance to around $0.9 billion/$0.95 billion. But according to your previous comments, correct me if I'm wrong, the line was a bit bad, you commented that you plan to spend around $1 billion of Capex for this year. So does it mean that you're returning to your original Capex plan this year in light of improving market conditions in the second half of this year? That's the first question. And the second question is on NLMK U.S. division's performance. So on spot prices, what are your expectations for earnings of this division in the second half of this year? i.e., do you think that the positive performance that we have observed in Q2 is sustainable into year-end?

Grigory Fedorishin

Thank you, Anna. Again, I'll probably take both of the questions. On Capex, so again, our guidance for this year is a range. It's $1.0 billion to $1.1 billion. And the main reason we're providing a range and the main reason it deviates from $0.95 billion that you mentioned of April guidance is FX rates. 70% of our Capex is ruble denominated, which means when ruble gets stronger, and obviously, it has got stronger comparing to April levels, we see an increase in the Capex number. But in terms of the projects and the portfolio, in terms of the volumes of the work we want to do this year, it's more or less the same we forecasted in April. We limited ourselves, so it was a high Capex discipline in the second quarter, and this time is already lost. Some of the projects were postponed by quarter. So we are not going to catch up with our initial guidance of $1.2 billion that we provided at the very beginning of the year. That's on Capex.

On U.S., the reason of the difference between the first and the second quarter, as Shamil said, is this nonmonetary reserve on the stock revaluation. If you take those 2 quarters on average, what I would do, you have breakeven or slightly negative performance. This is something I would expect in the third quarter. Pricing remains rather low in the U.S., and recovery of the economy is slow. Construction is okay, but energy and automotive is completely out of the markets. Again, breakeven or slightly negative for the second half of the year.
But on our side, we reduced the costs there, including the fixed costs, quite considerably for this period. So we accommodate to the markets. Does it answer your questions?

Nikanor Khalin - VTB Capital
Actually, one question from my side. I see $131 million also as a contribution to share capital joint ventures in the first half. As I reckon, this is NBH.
And could you elaborate what should we expect for the second half of this year because the amount is already above the original plan, is higher again?

Grigory Fedorishin

I'll take this one. The most of this amounts relates to the new shareholder agreement signed end of last year. More details can be found in our financials. Since then, we follow the new shareholder agreement. So there was no more developments in this area since then. It's still the same financing dedicated to the investment program on European side, mostly modernization of assets strictly in Belgium. The first phase should be completed later this year, the second phase next year. That should push our orders up by 600,000 tonnes and bring new products to our portfolio.

Nikanor Khalin - VTB Capital

As far as I see in the note, execution of group strategy, investment projects assumes about EUR 50 million in 2020 and already higher than $30 million in the first half. So maybe you could elaborate why?

Grigory Fedorishin

Yes. As I cannot immediately see the numbers, I suggest you take this question offline with our IR team, and I will be involved it requires. Okay?

Anna Antonova – JP M organ Chase & Co, Research Division

Yes. Just a brief maybe a technical follow-up question. Could you please comment what was the nature of the $31 million expenses on operations with financial instruments in Q2?

Grigory Fedorishin

May I ask you to repeat the question? So you're talking about the financial expenses in the second quarter?

Anna Antonova - JPM organ Chase & Co, Research Division

Yes. If I look at your P&L for Q2, I see expenses on operations with financial instruments amounting to $31 million, and there is no note in the financial statements regarding the nature of this expense.

Grigory Fedorishin

Shamil, can you follow with that, please?

Shamil Kurmashov

Yes. So as you know, we have used the natural hedge in the first quarter, which allowed us just to reflect the deviation in foreign currency in our capital. But part of it is recognized in the P&L. So part of this natural hedge which hadn't been recognized in the first quarter in our P&L, there's a certain amortization schedule, according to which, a part of this result comes from the capital to the P&L. We could provide to you with the more detailed structure in order to let you understand the structure of this $30 million. But mainly, the effect is like that.

Grigory Fedorishin
Just a small comment from my side. So you can consider this as a Forex loss. The nature of this is a Forex loss on our currency position.

Anna Antonova - JPMorgan Chase & Co, Research Division - Analyst

Okay, understood. So it is kind of a recurring expense, but FX - noncash recurring FX charge? Is that correct?

Shamil Kurmashov

Yes.

Dmitriy Kolomytsyn

Okay. With this, we would like to thank you for your questions and attention. And we are looking forward to seeing you again in about 3 months. Thank you, and have a good day.