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TRANSCRIPT: Q2 2021 NLMK Earnings Call (IFRS)

Corporate participants

Grigory Fedorishin - CEO

Shamil Kurmashov - CFO

Dmitriy Kolomytsyn - Director for Corporate Finance, IR

Dmitriy Kolomytsyn

Yes. 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 for our conference call to discuss our operating and financial performance in the second quarter of 2021. As always, the elements of our presentation are forward-looking and based on our best view of the market. The Company's CEO, Grigory Fedorishin, will provide market overview and present key operating highlights as well as the midyear Strategy 2022 progress. And following that, our CFO, Shamil Kurmashov, will discuss our financial results in more detail, and we'll then be happy to answer your questions. With this, I hand it over to Grigory Fedorishin.

Grigory Fedorishin

Thank you, Dmitriy. Good day, everyone. Let's start with Page 4 to discuss key macro trends. Unprecedented market conditions were prevailing in the second quarter of this year. Business sentiment across all key markets remained robust delivering positive impact on our results. Demand for steel in international markets continue to recover, coupled with a seasonal uptick in activity and the realization of deferred consumption. Capacity utilization rates fully recovered to pre-pandemic levels. Consumption in Russia seasonally improved by 8% quarter-on-quarter. Demand in China posted another quarter of growth, backed by state incentives and strong local consumption. This was actually despite relatively weak numbers for June on the back of adverse weather conditions and limited construction activity.

Iron ore and coking coal prices were up 18% and 6% quarter-on-quarter, respectively, due to increasing steel output as well as sluggish supply response. Let's now turn to Page 5 to discuss prices and demand for steel products. Steel prices improved globally during the second quarter backed by strong demand and reached new record levels in some developed markets. In China, steel prices advanced 20% quarter-on-quarter, driven by resilient construction sector. Prices dipped slightly in the end of June on the back of government's aspirations to constrain inflation, but rebounded since then. In the US and EU, the pricing environment was quite strong fueled by shortage of steel. This trend, however, was less pronounced towards the end of the second quarter as we're entering holiday season. In Russia prices rose in line with key export markets, adding about 30% quarter-on-quarter.

Let's now turn to Page 6 where we will discuss the Company sales. During the second quarter, NLMK Group's steel output rose by 5% quarter-on-quarter to 4.6 million tonnes fueled by the ramp-up after the steelmaking capacities' upgrade at the Lipetsk site. Consolidated sales increased by 11%, reaching 4.3 million tonnes. Higher shipments of slabs and pig iron to the markets of the Middle East and the EU contributed to that result. The intragroup slab sales to NLMK USA more than doubled following a strong consumption trend in the region. This factor actually contributed negatively to Q2 consolidated shipments and led to additional working capital build-up. However, it will support consolidated sales and results of the Company in the second half of this year.

Please turn to Page 7. Strategy 2022 delivered more than $100 million of positive EBITDA effect during the first half of this year. Contributions from the operational efficiency programs came at $68 million or roughly 70% of the annual target, almost evenly split between Russia Flat, Long and Mining divisions. Gains from the investment projects amounted to $44 million. They include the ramp-up of the new benefication section at Stoilensky and additional volumes coming as a result of steelmaking production upgrades at NLMK Lipetsk. Investment gains were twice higher, $86 million, excluding one-off negative effect of volumes lost during the period the hot strip mill at La Louvière was idled for modernization. So you will see higher numbers coming in the second half of this year.

Let's now please move to Page 8. Here we showed the status update of the investment projects. This year, we successfully progressed on several projects aiming both at reducing costs and expanding our product portfolio. In May, we started the assembly of the main process equipment for our new captive power plant at the Lipetsk site. Once the plant is put into operation, the share of captive generation will reach 95% at Lipetsk, while CO_2 emissions will decline by 0.65 million tonnes per year. The launch of the new power station is scheduled for late 2023. In June, we started the installation of metal structures for a new GO steel plant in India. Main process equipment is currently being delivered to the site. The commissioning works and the launch of production are scheduled for the first half of 2022. On top of that, we continued the construction of a new hot-dip galvanizing line at the Lipetsk site. The new line will enable us to produce premium coatings and high strength grades. The start-up of the line is planned for the second half of 2022.

Finally, in Europe, we completed the first phase of hot strip mill modernization at our La Louvière plant, the one I have already mentioned. The second phase of the upgrade will take place in 2022. This project will enable the Company to expand the production of thin and high strength steel for customers in Europe.

Let's move to the third quarter outlook presented on Page 9. In the US, we expect prices to stay at high levels due to supply deficit, which, however, may gradually decline with surging imports and new capacity restarts towards the end of the year. In Europe, we expect prices to stay elevated as well, but with some moderation in the middle of Q3, mainly due to seasonal slowdown in manufacturing activity and gradual normalization of steel inventories. In Russia, we anticipate the pricing environment to remain stable, supported by seasonally high demand in infrastructure projects.

Let me now hand it over to our CFO, Shamil Kurmashov. He will provide further details on our second quarter performance. Thank you.

Shamil Kurmashov

Thank you, Grigory. Good day, everyone. Let me introduce financial results of the second quarter of 2021.

Let's please move to Page 11. Revenue for the second quarter jumped 44% quarter-on-quarter to $4.1 billion. The share of the Russian market in our revenue declined by 3 percentage points to 43% versus the previous quarter. And at the same time, the share of North America was up by 4 percentage points to 19% following the growth of slab experts. Strong revenue and resilient price spreads during the quarter resulted in EBITDA of $2.1 billion, that is 76% more than what we generated in the first quarter of 2021 and EBITDA margin reached 50%.

Let's now move to Page 12 to discuss Q2 EBITDA and EBITDA margin dynamics by divisions. Almost all of our divisions demonstrated high double-digit growth in profitability as compared to the previous quarter. EBITDA at the Russian Flat division grew by 80% to 1.4 billion. The Russian Long Products division's EBITDA gained 74% quarter-on-quarter, amounting to $157 million on the back of the expansion of the spreads and as well as high sales volumes. In the Mining segment, EBITDA increased by 35% to $585 million as a result of rising prices. EBITDA at NLMK USA jumped more than three-fold quarter-on-quarter to $213 million amid the wider spread between flat steel and slab prices as well as due to operational efficiency gains.

EBITDA at DanSteel slipped to minus $13 million from minus $4 million in the previous quarter due to long-term contracts concluded before the surge in local steel prices began. As a result, the rally in slab prices, which is the main raw material for DanSteel, affected the segment's profitability. But we expect the effect of these long-term contracts to become much less pronounced towards the end 2021.

Finally, at NBH level, EBITDA was negative, minus $7 million, compared to a positive $8 million in the previous quarter amid decreased production of strip products at NLMK La Louvière, which was partially offset by improved price spreads between flat steel products and slabs. We successfully concluded the first stage of the modernized project and expect the volumes to be up quarter-on-quarter in the third quarter.

Let us now discuss cash flow dynamics on Page 13. Free cash flow increased by 91% to $864 million, driven by EBITDA expansion. Working capital build-up totaled $430 million, which can be described, first of all, by the receivables, which increased due to higher prices for steel products. The input of this factor reached $290 million out of $430 million. The second largest factor is growing prices, which resulted in higher cost of raw materials and finished products in stock. At NLMK USA the replenishment of inventories occurred ahead of production growth in the second and third quarter. In total, this resulted in almost $400 million outflow. On the other hand, the positive contribution was made in the amount of $252 million by the growth in payables due to rising purchases of raw materials and slabs at NLMK USA, the increase in advanced payments received and an uptick in VAT arrears amid higher sales prices in Russia.

I also would like to highlight that net working capital as a percentage of revenue decreased to 13.4% versus 15.2% in the previous quarter, which reflects rather efficient working capital management. At the moment, we will continue to see quite high prices in the main markets of our presence, and will continue to contract volumes for August, September at today's price levels. Therefore, we do not expect a significant release of working capital in the third quarter, except for the US, where we forecast a decrease in slab inventories by at least $100 million.

The Group's capital expenditure in the third quarter rose by 54% to almost $360 million, in line with our budget assumptions. Please take a look at Slide 14 with some of the key metrics showing our balance sheet strength. We ended the quarter with a robust liquidity position of circa $870 million of cash and short-term equivalents and additional $2.2 billion of undrawn credit lines remain at our disposal, including the revolving credit facility of EUR 600 million and ESG-rating-linked facility of EUR 250 million. It will be used to refinance existing working capital lines, that have not been drawn yet.

We were able to improve the interest rate on the latter following the most recent upgrade of our ESG rating with Sustainalytics. I also want to highlight some liability management initiatives conducted during the second quarter. In May, we issued our inaugural Eurobonds in euro for the total amount of EUR 500 million, with a 5-year maturity and a very low coupon of only 1.45%. The proceeds were mainly used for the buyback of our 2023 and 2024 dollar-denominated Eurobonds with the average coupon rate of 4.25%.

We were able to achieve the lowest coupon ever by a Russian privately-owned corporate issuer, which affirms the strength of NLMK's investment story. NLMK’s average cost of debt, as a result, dropped to 2.7%, which is all-time low, reflecting this liability management exercise. Net debt also decreased by 6% quarter-on-quarter to $2 billion with net debt to 12 months EBITDA ratio declining to 0.42x.

This is it for my part. Thank you, and we are now ready to take your questions.

Questions and answers session

Timothy Riminton - Barclays Bank

My question is on your first inaugural euro-denominated Eurobond issue. I was wondering if you could just tell us a little bit about your thinking on why you opted for euros over US dollars and whether this is something we might see more of in the future? And just sort of related to that, there were some comments from politicians in Russia that companies should move some contracts away from dollars. Could you add any details on whether that is something you are doing with your clients in Europe already?

Shamil Kurmashov

Thank you for the question. So the rationale for issuing of the new instrument in Euro was, first of all, it’s a natural hedging for our geographical distribution of our revenues. As you know, we have extended presence in the European Union, and we have rolling facilities there. Therefore, the part of our revenue is denominated in euro, which makes natural issue of the instrument, the debt instrument also in euro. The second factor was at the moment of the issuance, the euro was fully valued, like the cross currency rate between euro and dollar was favorable in order that if we convert euro into dollars and finance our dollar expenses that would make additional positive influence on our P&L. We are not going to redenominate our contracts somewhere in our geographical presence from the existing currencies. We think that our balance of our sales portfolio is very balanced and stable. We are not going to change it in the near future.

Grigory Fedorishin

Yes. And answering your question on whether you can see us more on this market, yes, we are going to come back to that when the opportunity persists.

Timothy Riminton

Okay. Great. And just to follow up quickly. What share roughly of your revenue is already denominated in euros?

Shamil Kurmashov

Approximately 22-23% of our revenues are denominated in euro.

Anton Fedotov - BofA

I have a question relating to your working capital increase, which was quite significant in the second quarter, as I understand. It was related mostly to the price increase for steel, would you expect some normalization of the working capital and some working capital release in the following quarters?

Grigory Fedorishin

Anton, thank you for the question. I will start and Shamil will help me with the details. The price growth was obviously one of the main factors influencing both receivables and inventories. I would mention actually two more that are company-specific. There was quite a significant working capital build-up because we resumed our supply chain of slabs to US. And because we were starting from the low base to bring it to the normalized levels and help them to achieve actually a level of utilization they have now, which is more than 75%. We had to bring a lot of material there. So, roughly $200 million of this working capital outflow is attributed exactly to this one.

It was partly compensated by the payables they have in the local market for scrap and other materials, but that is still a very significant factor. And another one is, we have accumulated slab stock in Europe in anticipation of a hot strip mill recovering and ramping up after modernization with increased volumes. All of this sits now in inventories with profit unrealized and should be rerolled in the third quarter. Other than that, you are right to point that it is mainly pricing effect.

Talking about the third quarter, company-specific, the slab stock in the US should normalize. That is probably one factor that I should be able to quantify. We expect about $1 million release there in the US. The rest of it purely depends on the pricing environment. If the prices continue growing, in the third quarter - the end of the third quarter, we will see further working capital build-up. But that should actually help us to smooth free cash flow generation when we see prices sliding finally.

Andrew Jones - UBS Investment Bank

I have got a couple of questions. First of all, on the export duty and so forth. Could you just give us an estimate, a range, of what you expect that to be in terms of millions of dollars? I mean, obviously, price dependent, but what's the ballpark are you thinking of all be? Could you give us an idea how much you could change your sales mix in order to kind of get that number down? And then do you have much flexibility to change the export share much? And then just further to my question on tax. What are your thoughts at the moment on potential higher taxation in Russia on the sector? I mean, obviously, that has been talked about. I mean what are you expecting going forward? Based on your discussions with various government bodies, do you have any sense of how that could look?

Grigory Fedorishin

Thank you, Andrew, for the questions. As for the export duties, I do not think I am in a position to give you a number because that is purely subject to the price forecast, right? The formula is clear. And that depends on the pricing that you have in your models for the rest of this year. But obviously, it is a material amount. What concerns us is the minimum threshold that they have for the duties because it is not only 15%. As you know, they also have some 25 fixed limits. For example, for slab, it is 1.15, which uses the pricing of slab of 750. If you think how often we sale 750 per slabs in the last 10 years, not very often, right? That means that if the prices and when the prices start sliding, the effective rate of the duty may easily jump higher than 15%, which was not the intention. This is something we monitor carefully. That was the consideration on the reducing this fixed boundary for the pig iron. But here, we have to wait until August and September and look at the numbers. So that is on the effect. On the sales mix, we do have some degree of flexibility, but it is influenced by different factors, and the duty is not the major factor there. We have established the portfolio of our sales domestically. And on the export markets, we are not selling commodity. It is not like iron ore concentrate that you can easily sell to China at any point of time and purely based on the netback prices. That is long-term established relationships. So I would not expect the significant change in the sales mix because it is more subject to seasonality and the demand on specific markets rather than on this specific duty. And the last one, again, I am probably not in a position to comment on the government initiatives. What we know is the export duty is considered to be a temporary solution. But then the government has made it clear that they think of longer-term structural instruments to regulate the tax environment in the periods of the high commodity pricing like this one. And yes, we are in discussions and we expect and looking forward for a discussion like this, but it will probably happen later during the year and how the pricing cycle behaves will have an impact on that.

Andrew Jones

Just a follow-up on that. I mean you have mentioned that they are looking at mechanisms for taxation at times of very high commodity prices. Is that your understanding what they are trying to achieve? Or if we assume the prices normalize by next year, do you expect to have that further tax burden as a sort of percentage of sales or something like that? Or do you think they are just looking at something which will effectively kick in a certain tax rate above a certain price level?

Grigory Fedorishin

Andrew, I do appreciate the question, but as I have said, I am not in a position to comment on that.

Andrew Jones

Okay. And just as was asking a question. It is just a third one for me on the carbon border idea. Obviously, we have had some announcement on that whether it is implemented or not we are not sure. But if that does come into effect, how do you see that changing your potential investment plans and your strategy towards Europe going forward?

Grigory Fedorishin

As you know, we are not only Russian producers, but also a European producer with a big presence in Europe. So we have been following these developments for the last two years. We were participating in the discussions on the country and the European commission levels quite actively. What came as a final package was actually quite fair. Also there is not enough details to make a final quantified estimate on the impact. But one of the good things is the package looks for individual adjustments means that the tax whatever number it is going to be, it is not going to be calculated on the average country level or, let's say, worst producers' levels. So it will take into account the actual emissions. For us, it is extremely important because we have invested into decarbonization for quite some time, and we are measuring, benchmark ourselves versus the best European producers. I can tell you that we are in the best 20% comparing to the European producers if you talk about CO_2 emissions. That means that the tax burden will be lower for the leading companies like us. That is a good thing. Another good thing is that the introduction of the tax will come in parallel and will be synchronized with free quota allocation for the European producers. It gives a sort of a fair play ground for importers and the local producers because the tax will be synchronized with the free allocation. That is another good thing. The rest will have to wait and see. It will depend on the benchmark versus the tax going to be calculated. But we have time for that, right? There is a time period for where you just report, but no tax is calculated. Based on the current text of the document, our calculation says that the impact for us as a company for the slab supply, which is the major supply chain to Europe is not going to be material. But again, it is subject to CO_2 price, which may double easily during this period and some subject to the benchmark level that may become higher.

Sergey Donskoy - Societe Generale

Some of the questions have been answered already, but I have two follow-ups on things touched upon just before me that is export duty mechanism introduced by the Russian government. I have two questions here, basically. One is, speaking about these consultations with the government, if I understand it correctly, you have said you are in touch with authorities. How is this discussion structured? Is this some sort of bilateral negotiations or meetings between you as a company and some ministries officials or is this channel through, for instance, Russian Steel and you are pulling your efforts with other steelmakers. Is there any common ground that is defended by all steelmakers in Russia or are you all acting independently? That is one question.

Grigory Fedorishin

There is no particular structure under these discussions now because, as I have said, these discussions are not active. It is difficult to discuss a topic like this based on the forecast numbers in such volatile markets. It really depends on how the pricing is going to evolve in August-September. We believe we should wait till August and September come and see how these duties will affect in real life the level of shipments, production in some cases, and then we will have the active discussion. That will be the time we will ask our counterparts and the government to structure this to find a common ground. Now the only discussions that are happening are for the products that are already under concern for some of the producers. You probably have heard of pig iron discussions because some of the producers said: “Look, we are going to lose part of the production”. And there was a government response to that. We as a producer also do have some volumes lost because of that. I would not call them material in the perimeter of the Company, but for the Long products, some streams of exports are going to be reduced due to the profitability reduced significantly. Another concern was pig iron, but with the minimum rate already reduced, it is less of a concern now. Anyway, most of our pig iron this year is consumed into the steelmaking. So, I guess as for the active phase of discussions, we should just wait for a month or two for at least to have more info on that.

Sergey Donskoy

Understood. And second question is this, I have been trying to remember if there are any cases in the world where such duties on super profits and would be levied on steel makers. There are a number of countries that have progressive taxation in respect of, say, base metals, copper or other metals. We know these examples very well. But personally, I am struggling to remember any single country that would tax steel in this manner? Do you have any examples that you maybe know?

Grigory Fedorishin

Nothing we can share with you right now. You are right, I mean, steel is quite a complicated industry given different production routes and a lot of elements of the value chain, right? As an integrated company, we are moving from pure commodity raw materials to quite advanced multistage production products. So to create a system that covers all of it and gives the fair taxation. That is a pretty difficult task to do.

Anna Antonova - JPMorgan Chase & Co

A quick follow-up question from our side. So on the resumption of captive slab supply to the US, does this imply that you expect US steel import duties to be removed any time soon?

Grigory Fedorishin

No, we do not expect it to be removed in the short term. Now just there is a high market that allows us to supply with the duty, actually with the two duties, right? Now we are taxed 25% on that side and another 15% on this side, starting from August. But currently, with hot rolled prices in the US, reaching and exceeding $2000 per tonne is something that we can do. But as we said numerous times, it is not sustainable as a business model. That answers your question, right?

Anna Antonova

Yes, absolutely.

Dmitriy Kolomytsyn

We actually have one more question from one of the analysts, and we would like to have this question answered as well. The question was what are your investment plans for 2022? And whether we see any additional projects that we can announce in the near term that could make our CapEx higher?

Grigory Fedorishin

We stick to our guidance that we g gave to the investment community before. We are still operating on the framework of Strategy 2022 and that is going to be another active year of implementation of the projects that we have already announced. We have started to work on the new strategy again, as promised by the end of this year. Probably in context of Capital Markets Day we should announce some of the ideas that we have. But you should not expect additional CapEx burden coming within the frame of the current strategy.

Dmitriy Kolomytsyn

That is all we have in terms of questions that were not answered online. I think we are done now with the Q&A. We would like to thank you for your attention, and we will be happy to see you again in about three months' time on the same call to discuss our third quarter results. Have a good rest of the day. Bye.