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TRANSCRIPT: Q3 2021 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 2021. 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, present key operating highlights as well as Strategy 2022 progress. And following that, our CFO, Shamil Kurmashov, will discuss our financial results in more details, and we'll then be happy to answer your questions.

With this, I hand this over to Grigory Fedorishin.

Grigory Fedorishin

Thank you, Dmitriy, and good day, everyone. Let's please go to Page 4 to discuss key macro trends. Economic recovery started losing momentum towards the end of the quarter. Steel consumption softened in all key regions, except for the US. Demand in China declined as a result of seasonal slowdown as well as property market moderation. Consumption in Russia was lower quarter-on-quarter due to subdued dynamics in the construction and industrial production.

In the EU, steel consumption was affected mainly by the automotive sector suffering from ongoing deficit of semiconductors that may continue into 2022. Iron ore prices fell by half from the summer peak levels on the back of steep decline in Chinese steel output. This trend, by the way, has recently been challenged by rising energy costs and pick up in scrap prices that demotivate EAF producers and put iron ore back in focus.

Coking coal prices reached all-time highs due to restrained coal production in China and supply disruptions from Mongolia as well as due to healthy demand for the material outside of China. As a result, raw materials basket increased by 5% quarter-on-quarter during Q3. Coal prices, especially in China, are extremely unsustainable. Following the restoration of Mongolian supply as well as Australian coal cargoes that managed to get to China could provide some relief.

Let's now turn to Page 5 to zoom in on the steel prices performance. In the US, prices remained abnormally high, reaching new records to meet strong demand and lean inventories. In the EU, prices topped out in June and were gradually sliding due to quiet season, coupled with low demand from the auto sector. That limited the quarter-to-quarter growth at 8%.

In China, the May-June downward trend marginally reversed in July on the back of supply restrictions. In Russia, export benchmarks fell 9% following the demand deceleration in key export markets. Domestic flat prices were marginally lower as a result of subdued activity in the manufacturing and auto sectors. Introduction of export duties amplified the decline as market was expecting increased domestic shipments and reduced prices. Steel margins in the US and EU remained elevated. However, increased raw material costs squeezed the EU margins by 17% in October.

Let's now move to Page 6 to discuss our operating results. During the third quarter, NLMK's steel production fell 15% to 3.9 million tonnes, mainly due to the incident in the oxygen supply infrastructure of the steelmaking production at the Lipetsk site in August and the subsequent repair works. Besides, we were conducting scheduled maintenance at the pig iron and steelmaking facilities. Utilization rates at NLMK Lipetsk recovered once repairs were complete and reached 98% in September. As a result of temporary steel output decline, consolidated sales decreased by 4%, mainly affecting slab shipments to our captive assets. Deliveries of finished products slightly increased amid stable final demand in key markets.

On Page 7, you can see that Strategy 2022 delivered roughly $250 million of positive EBITDA effect during the 9 months of this year. If you remember, $250 million is our average annual target during the Strategy implementation period. Contribution from operational efficiency program came at $120 million, well ahead of our annual target. Gains from investment projects amounted to $130 million. They included the ramp-up of the new additional concentrate production at Stoilensky and steelmaking modernization that comes with additional volumes at NLMK Lipetsk.

Let's move to the fourth quarter outlook presented on Page 8. Overall, we anticipate mixed price dynamics and increased volatility. In the US, we expect prices to moderate towards the end of the year with the gradual ramp-up of new mills and the end of repairs at others. Rising imports won't help much either. In Europe, we anticipate prices to continue trending lower due to weak activity in the auto sector, while rising energy costs could support prices. In China, production cuts as well as higher input costs could positively weigh on prices. Albeit possible property sector turmoil is still a wild card.

In Russia, prices have already marginally rebounded for November orders. Over the last 2 months, buyers remained in the wait-and-see mode consuming inventories. Therefore, we expect noticeable stocks replenishment in the coming months. In terms of production, we expect output of Lipetsk to normalize in

Q4. Lipetsk steel production is expected to increase by 30% quarter-on-quarter, which would correspondingly result in a 10% year-on-year growth for the full 2021 to about 13.5 million tonnes. We anticipate our shipments to the Russian market to show double-digit growth in Q4. That will be driven by postponed demand that was shaped during July-September when the market reduced purchases expecting further price reduction. As I said, we expect some restocking to happen in Q4 in Russia.

We expect a spike in coking coal prices in Russia that we saw recently to translate into incremental $60 per tonne in our slab cash costs in Q4. I would like to highlight that this increase will be partially balanced by other factors, such as lower scrap prices, for example. CapEx this year, 2021, would amount to $1.2 billion, as we guided before.

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

Shamil Kurmashov

Thank you, Grigory. Good day, everyone. Let me take you through our financial results for the third quarter in more details. Let's please move to Page 10.

We delivered a 10% growth in revenues versus the previous quarter. The top line reached $4.6 billion backed by steel prices growth. The share of the Russian market in our revenue declined by 6 percentage points to 47% versus the previous quarter. However, the share of the North American market was up 6 percentage points to 25% amid firm demand and record high prices in the region. Fueled by widened steel price/raw materials spread, NLMK's EBITDA improved to $2.3 billion, that is 11% more than what we generated in the second quarter of 2021. EBITDA margin reached 50%.

Let me briefly stop at Page 11 to discuss EBITDA and EBITDA margin dynamics by division. As we see, EBITDA growth is everywhere, across all the divisions, except Russian Flat, where EBITDA softened by 17% quarter-on-quarter to $1.2 billion, mainly due to temporary production decrease caused by the August incident at the Lipetsk site and introduction of export duties in August 2021. This was partially offset by Strategy 2022 investment project gains.

Let’s discuss cash flow dynamics on Page 12. Free cash flow increased by 29% quarter-on-quarter to $1.1 billion due mainly to EBITDA growth. Working capital build-up totaled $450 million. Let me discuss in details the following factors that caused such increase. The first factor is receivables. They were up by $223 million, mainly due to 4 counterbalancing factors: first, the growth of advanced payments related to export duties in Russia in the amount of $139 million; second, an increase in accrued VAT refund as a result of lower steel prices inside the country, coupled with higher raw material prices for the total amount of $113 million; third factor is higher steel prices, which caused $116 million receivables inflation; and at the same time, advanced payments from clients and decrease in long product sales released close to $180 million.

The second large portion of the working capital build-up is inventories. They consumed additional $262 million, mainly due to higher cost of raw materials and finished products in stock amid growing prices, which added $135 million. And as you know, seasonal increase in scrap inventories caused outflow of $77 million. The positive impact was produced in the amount of $50 million of inflow, underpinned by increase in payables following growth in coking coal prices. The Group's CapEx in the third quarter softened by 24% to $272 million amid the high base of the previous quarter when railcars for pellet transportation were purchased. In addition, the third quarter investment load was partially shifted to NBH where projects for hot strip mill and plate mills are being implemented as part of Strategy 2022.

I would like to refer to Page 13. Please take a look at the slide with some of the key metrics describing our balance sheet strength. We ended the quarter with a healthy liquidity position of almost $700 million of cash and short-term investments. Additional $1.5 billion 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 that will be used to refinance existing working capital lines. NLMK's average cost of debt dropped to all-time-low level of 2.4%, reflecting the utilization of attractive financing instruments that we have access to. So we draw down cheaper financial instruments and diluted our cost of debt. Net debt increased by 40% quarter-on-quarter to $2.7 billion amid cash outflow to pay out dividends for the first 2 quarters of the year and working capital growth on a strong market. At the same time, our net debt to 12 months EBITDA ratio remained flat at 0.43x. So we are very stable.

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

Questions and answers session

Nina Dergunova - Goldman Sachs Group

Congratulations with record best results. Two questions from me, please. First one about the Strategy cycle. As you are nearing completion of the 2022 Strategy cycle, what is your guidance on next year's CapEx? And what are the key projects that will be delivered next year? And what effects do you expect from them?

Grigory Fedorishin

Nina, thank you for the questions. I wouldn't say it's the very end of the strategic cycle. So we still have 2 years ahead of us because part of the effects, like our captive power plant at Lipetsk will be realized in 2023. Speaking on the next year CapEx guidance, we are still in the process of putting together the investment program for next year. But I would say flat to this year level. As for the biggest projects, we are active on electrical steel developments of both GO and NGO steels. That occupies a significant portion of the program. Our steel plant for GO steel that we're putting together now in India is going to start the production sometime second quarter next year. What else? We actively invest into the captive power plant that I have mentioned, that's a big portion of next year CapEx, about $100 million. Galvanizer at the Lipetsk site, which should be put into operation later next year. So these are the main development projects. On top of this, we have a sizable maintenance as well. Does that answer your question?

Nina Dergunova

Understood. And just a short follow-up. You mentioned that '22 guidance is in progress, but likely be stable to this year level. And this year level, you reconfirm the $1.2 billion guidance?

Grigory Fedorishin

Correct.

Nina Dergunova

Understood. And just a small follow-up on the payback that you already mentioned earlier in the presentation. You said that the payback and the effort from the Strategy are running ahead of your expectations this year. And can you comment which projects are driving this outperformance, delivering better results that you initially expected?

Grigory Fedorishin

Well, Nina, I would say with the current level of prices, almost all the projects and the operational efficiency initiatives bring results higher than the ones that we have predicted at the mid-cycle levels. If we come back to the mid-cycle levels, I would say we're generally on track. When we were commenting on us moving ahead of expectations, it was more like the pace because we have said, as you remember, initially $1.2 billion as an overall effect that translates into roughly $250 million per year on average. We're already at $250 million with 9 months of this year. That was the comment related to.

Nikanor Khalin - VTB Capital

Congratulations on great results. A question on capital allocation for me. Considering the continuous rise in CapEx, and it seems like it's going to stay this level for a while, do you plan to reconsider your normalized CapEx that you use for dividend calculations? And if you do, when should we expect it to happen? From next year? Or can this already happen next quarter?

Grigory Fedorishin

Thank you for the question. Given that we are moving in line with our Strategic guidance both in terms of CapEx and in terms of the effects, the capital allocation that we have now, that's basically the same that we guided for in 2018. We believe that the dividend policy works pretty well. We don't see a need to change it before the end of this Strategic cycle. So we'll probably reconsider the dividend policy by the end of the cycle as we usually do. But currently, we're pretty happy with it.

Maria Martynova – Sberbank

Thank you for the presentation. Three questions from our side. I'll ask them one by one. First, if we read the financial statement correctly, export duties in the third quarter totaled $56 million. It seems that this amount is somewhat lower than it could be. Could you please explain the reasons for that? And should we expect a catch-up in the fourth quarter if that was a one-off?

Grigory Fedorishin

Thank you for the questions. That's probably the subject to the revenue recognition period first and the share of our export sales, of that particular months. In Q4, we definitely do expect the growth in this number. By the way, actually, the $56 million that you're referring to, that's what you have in the P&L, right? But if you can see the cash outflow, we have prepaid about $150 million of the duties. So that brings the total number order of the cash outflow to $200 million for the third quarter. For the fourth quarter, we expect the duty to be in the range of $350 million for the quarter. But again, as I have said, that depends on the revenue recognition point and the final share of the export sales.

Maria Martynova

The second question relates to coal. What was the growth in coking coal and PCI purchase prices in the third quarter compared to the fourth quarter of last year? And what dynamics do you see in the current quarter?

Dmitriy Kolomytsyn

You're talking about our purchasing price in Russia or are you talking about overall global prices?

Maria Martynova

If you can answer both questions, it would be great.

Dmitriy Kolomytsyn

The coking coal prices spiked significantly in both Australia and China. In China, it's the supply/demand issue, mainly supply, lack of supply from Mongolia and continued strong demand, which started declining significantly towards the end of the third quarter. And in Australia, the price is driven by strong demand from India, South Korea, Japan and Europe. So therefore, the blended coal mix increased by about 50% in the third quarter to about $154. That's excluding transportation costs. In the current quarter, price is anticipated to gain additional 60% to 70%. As Grigory has mentioned, that would contribute about $60 per tonne in our cash cost.

Grigory Fedorishin

Yes, that's correct. And there are 2 reasons for that. One is, there is a time lag. And another one is because of starting from the end of last year, we have increased the portion of our spot purchases in the coking coal portfolio. Now we're buying about 70-80% on spot. That means that the price on the domestic market doesn't follow the international benchmark of 100%. So that's subject to discounts and commercial negotiations. But we already see some developments of the prices falling, and if you take the current level of prices, that should translate into about $60 per tonne increase of the integrated cash cost of steel of Q4.

Maria Martynova

And finally, a question on your foreign assets. In the third quarter, we do not see any impact on costs at the European assets from energy side. Could you explain this? And how will an ongoing power crunch affect your operations and costs in Europe in the fourth quarter?

Grigory Fedorishin

The rally started towards the end of the quarter. That's one reason why you don't really see the impact. Also, there was some price growth, but not that significant comparing to what we have seen very recently. On top of this, we have part of our energy cost hedged for the long-term contracts. That's another reason. So far, we don't see any supply disruptions or production disruptions because of this factor, and we are able to pass the respective increase in energy cost to consumers.

Daniel Shaw - Morgan Stanley

I actually had quite a few answered, but just one left. I'm not sure how much you can say on this, but in relation to the tax changes that or at least the latest that we know around all the tax changes, what do you anticipate the potential impact would be on your financials next year relative to the current year?

Grigory Fedorishin

Thank you for the question, Dan. I mean the numbers are public and the formula is there. Also, it's still subject to some smaller revisions. But generally, I wouldn't comment on the next year because we don't know what the year is going to look like, right? But if you take what we can call the normal year or the normalized year, and you can take 2019 as a proxy of the sort of mid-cycle year, right, so then the impact should be somewhere around $300 million per year, all-in, mining plus steel. If you take a peak year, and I would call 2021 definitely a peak year, then the impact should be in the range of $500 million to $550 million. That's sort of what gives you a sense of the overall impact on the Company.

Boris Sinitsyn - Renaissance Capital.

In the third quarter, actually, you saw quite an improvement in your foreign operations. So I have a few questions on those, on the outlook. First, on the US operations, it looks like despite strong earnings momentum, you were selling steel in the third quarter with some 20% discount to benchmark. So the first question is do you expect this discount to shrink in coming quarters? And the second question on this topic is on your NBH operations, what is the outlook for volumes, either in the fourth quarter or for the whole 2022?

Dmitriy Kolomytsyn

Well, let's start with the US operations first. You correctly have pointed out that there's a certain time lag between the prices that you see on the screen or you see in SBB or Metal Bulletin or Bloomberg and the price that we actually record when we sell and we show our revenue. On average, there's at least a 2 month lag. As you know, in order books in the US, there was a significant spike. And in certain cases, we were selling 2-2.5 months in advance. And therefore, in the third quarter results that we have published, you see mostly second quarter prices. And therefore, in the fourth quarter, for the US assets, you're going to see the prices that you saw in the US in August, September. So that would strengthen our results for the US for the fourth quarter.

Grigory Fedorishin

I will probably also mention there is using share of the long-term contracts, right? We sell more on spot now. The portion of the spot sales is growing at the higher markets. And on top of what Dmitriy has said, I would add that we are going to have a strong fourth quarter for US even given the fact that prices are gradually sliding, but most of the order book is already sold until the end of the year. We'll see the growth in output roughly, I would say, 3% to 5% growth in output plus very strong pricing environment should translate into strong financial result comparing to Q3. Coming back to your question on NBH. You should expect a considerable increase in the output there. Basically have 2 reasons for that. One is Q3 is usually a seasonally quiet quarter. So Q4 volume-wise is almost always stronger. The second reason is we had our modernization of the hot strip mill at La Louviere in the second quarter. Then there was a ramp-up curve and the site is continuously increasing the production. The numbers I have in front of me in terms of the flat products, that's going to be almost double the volumes comparing to the third quarter. That should translate again into our overall volume growth and the financial result growth for the division.

Boris Sinitsyn

That's pretty clear. I also had a question on working capital. Sorry, if I missed it. So in the fourth quarter, what are your expectations on net working capital movements?

Shamil Kurmashov

Thank you for your question. We expect to see some release of working capital in the fourth quarter due to a decrease in steel prices as well as decline in scrap iron ore and finished steel inventories. But there will be also counterbalancing factors like the amount of physical volumes of sales, which are going to increase in the fourth quarter inside the country. At the bottom line, we expect a slightly positive release working capital with a considerable and sizable portion of it falling within the first half of the next year.

Timothy Riminton - Barclays Bank

Actually, most of my questions have already been answered. Perhaps, on the Chinese steel market, I mean any comments you've got in terms of your insights there I think would be interesting, and especially any indications of potential weakness in the property market. And yes, just general thoughts on whether you think the current environment of extremely high steel prices is going to continue on well into 2022.

Dmitriy Kolomytsyn

Timothy, with regards to the Chinese market, I guess our insights are as good as yours so as anyone else's. I don't think we have a better view than most of the market participants have. Everyone expect steel production in China to continue declining. The Chinese government has a very aggressive target for the year, as you know, which means that steel production would need to decline further in the remaining months of the year, and that should technically put more pressure on coking coal prices in China. As you already have seen, Chinese coking coal prices started declining already this week, that could put additional pressure on iron ore prices. All scrap prices for that matter, depending on what strategy the Chinese government chooses, which type of production they prefer, electric arc furnaces or blast furnaces. So in either way, we expect Chinese production to decline. If Chinese demand and supply are declining in line, then it means there will be less exports, and that should be positive for global steel benchmarks.

Grigory Fedorishin

We don't expect steel prices to normalize to the mid-cycle levels that we have seen during previous 5-10 years next year. There are few structural reasons for that. I'll give you some of them. China is becoming a pretty expensive steel producer given the cost curve is actually getting higher. Unless they are not going to devalue the local currency, which is going to be like really open trade war, the cost is going to grow further in China. On top of this, the exports from China are becoming structurally less. One reason is growing cost. Another reason is strict controls over the steel production coming from the environmental restrictions and some others. One more reason we still have postponed demand coming out of pandemics that will probably take us 2-3 years to resolve. You have liquidity around the globe and you have elevated raw material prices with their own factors behind it, right? If you put all this together, our view is, for the next year or 2, we should see a relatively strong pricing environment, probably not as strong as we see this year, but comparing to the mid-cycle levels, elevated.

Dmitriy Kolomytsyn

Thank you, everyone, for joining this call, and thank you very much for your answers. One thing we would like to remark is regarding the increase in cash costs that we have mentioned in the beginning. We did say that coking coal prices could lead to a $60 increase in our cash cost, but there are some offsetting factors such as lower scrap prices, et cetera. And so overall, we would not expect our cash cost to increase more than $40 in the fourth quarter.

Otherwise, thank you very much for your attention and for your questions, and we are looking forward to seeing you in 2022.