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TRANSCRIPT: Q4 2021 NLMK Earnings Call (IFRS)

Corporate participants

Grigory Fedorishin - CEO

Shamil Kurmashov - CFO

Dmitriy Kolomytsyn - Director for Corporate Finance, IR

Dmitriy Kolomytsyn

Yes. Thank you so much. 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 fourth 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, present key operating highlights as well as Strategy 2022 progress. And following that, our CFO, Shamil Kurmashov, will discuss our financial results in more detail. We'll then be happy to answer all of your questions.

With this, I hand this over to Grigory Fedorishin.

Grigory Fedorishin

Thank you, Dmitriy, and good day, everyone. Let's start with Page 4, where we'll discuss key market trends. Economic activity was expanding globally despite energy headwinds, although the pace of recovery eased towards the end of the quarter with the fade of catch-up effects. Steel consumption demonstrated divergent trends across key regions in Q4. Demand in China declined as a result of slowdown in the property sector and soaring energy costs.

In the EU, steel consumption decreased on the stocks build-up during the previous quarter and low activity in the automotive sector caused by the ongoing deficit of semiconductors. Consumption in the US stood at a multi-year highs. Demand in 2021 was up 25% year-on-year. However, with lead times normalizing amid deflating steel prices, the pace of sequential growth has stalled.

Steel demand in Russia was remarkably strong, driven by replenishment of depleted stocks spurred by healthy demand from end users. Iron ore prices were steadily going down until December, when they started to improve following sluggish supply from Brazil due to heavy rains. Global coking coal prices went down from their peak levels, mainly as a result of Chinese domestic production ramp up and supply recovery from Mongolia.

Let's now turn to Page 5 to discuss steel prices performance. Global steel prices continued to normalize, yet remaining significantly higher compared to 5-year average levels. In the US, prices factored in increasing imports availability as well as rising domestic supply. In the EU, weak buying interest from car makers pressured prices. In China, prices eased due to energy-related and other output restrictions in manufacturing coupled with the construction sector crunch. Russian export quotes moderated amid weak demand from Turkey and seasonally weak activity in the EU in December. Steel margins in the US and EU remained elevated, yet continued to come off from the peak levels.

Let's now move to Page 6 to discuss our operating results. During the fourth quarter, NLMK's steel production increased by 16% quarter-on-quarter to 4.5 million tonnes as capacity utilization at NLMK Lipetsk grew after Q3 repairs completed. Sales grew by 8% to 4.5 million tonnes following the output growth. Export duties made us reluctant to continue shipping billets to the international markets. And on top of that, we reduced shipments of semis to external customers in favor of internal slab sales, mainly to US. It means some of these slabs are to be sold as finished products later at the beginning of 2022, and that explains the difference between growth in production and sales in the first quarter.

On Page 7, you can see that Strategy 2022 delivered $340 million of positive EBITDA effect in 2021. Contributions from the operational efficiency programs came at about 180, almost 2 times above our annual target. The major impact was brought by structural coal charge mix optimization and concentrated billets output growth due to shorter downtime. Gains from investment projects amounted to $160 million, including the Cornerstone project of the Strategy 2022, the steel production grew at an NLMK Lipetsk. We plan to give the market an update on accumulated effects and performance versus Strategy 2022 targets in context of Capital Markets Day in March this year. We're also going to provide the first pack of ideas on the next phase of Company's strategic development during that event.

Let's move to the first quarter outlook presented on Page 8. Overall, we anticipate ongoing correction in prices, yet the pace of decline in main vary across regions. In the US, prices have lost another $150 in January. New capacities ramp-up as well as high imports as a result of an agreement between the EU and the US to scrap the 25% tariff would contribute to further price correction.

In China, prices to be supported by high raw material costs, which could inflate at an accelerated pace following China's monetary easing. On top of that, we expect surge of activity in steel markets after the end of the Lunar Year and the Olympic Games.

In Europe, we anticipate price dynamics to weaken. However, prices may edge up if semiconductors issues are resolved and performance of the construction sector remains at an elevated level. In Russia, seasonally weak demand at the beginning of the year might weigh on prices. But on the other hand, planned repairs at major steel producers might provide some support. In terms of production, we expect output at NLMK Lipetsk to come at 3.6 million tonnes, that's plus 7% year-on-year. This is in line with our target to reach 14.2 million of steel output for this site per annum.

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

Shamil Kurmashov

Thank you, Grigory. Good day, everyone. Let me take you through our fourth quarter financial results. Let's please move to Page 10. Our revenue rose 2% quarter-on-quarter to $4.6 billion due to improved shipments. The share of the Russian market now already went up by 3 percentage points to 40% versus the previous quarter, following strong end consumers' demand and stock replenishment. EBITDA was down 23% on a quarterly basis and reached $1.8 billion on the back of the spike in coking coal prices coupled with steel quotes' softening. We had to accrue $245 million of export duties as well.

EBITDA margin stood at 38%, down from 50% in the previous quarter. All that resulted in corresponding subdued free cash flow generation of $0.8 billion.

Let us now move to Page 11 to discuss quarter 4 EBITDA and margin dynamics by division.

EBITDA at the Russia Flat division went down by 43% to $0.7 billion, mainly due to increase in coking coal quotes, decline in the steel product prices as well as the accrual of export duties. EBITDA margin reached 20% in the fourth quarter, which was less than in the previous quarter and even during the same period last year.

The Russian Long products division's EBITDA softened by 21% quarter-on-quarter to $125 million on the back of decrease in long products/scrap spread and lower export shipments of billets.

In the Mining segment, EBITDA was down 39% quarter-on-quarter to $417 million, mainly due to raw material price weakening. Output growth at NLMK Lipetsk supported improved shipments.

EBITDA at NLMK USA was up by 5% to $373 million amid wider price spread. That was an extraordinary good year for USA. EBITDA at Dansteel reached $29 million due to the increase in plate/slab spread. This is a significant improvement compared to the third quarter.

Finally, at NBH, EBITDA moved higher to reach $19million or an increase of 27% quarter-on-quarter. This was backed by the ramp-up of production of the hot strip mill at NLMK La Louvière, after the completion of the first phase of modernization.

Let us now discuss cash flow dynamics on Page 12. Our free cash flow went down by 26% to $0.8 billion against the backdrop of lower EBITDA as well as increased CapEx. Working capital build-up totaled almost $260 million. Let me discuss in detail the following factors that caused such an increase.

First major factor is inventories, which consumed additional, more than $500 million, mainly due to increased cost of stock due to raw materials price inflation, mainly coal, which added $335 million out of $500 million.

The second (factor) is seasonal increase in scrap, higher iron ore, coking coal and other raw materials inventories due to planned increase in production in the forthcoming quarter (the first quarter 2022). This factor contributed to the outflow of $85 million.

The third factor is stocks accumulation at NLMK USA and Dansteel due to deceleration of consumers' activity, which added another $90 million. High stocks of slabs at ports amid shipments deferral to the first quarter, contributing $52 million. But there was also one counterbalancing factor, which produced positive influence on working capital. That was stocks optimization of flat products in the Russian market, which gave an inflow of $58 million. On other hand, almost $250 million inflow was caused by rising payables following growth in coking coal prices and the share of prepaid sales.

The Group's CapEx in the fourth quarter increased by 30% to $354 million. Our total CapEx for the whole year was $1.2 billion, in line with the original projections provided to the market.

Please take a look at Page 13 where we present some of the key metrics describing the strength of our balance sheet. We ended the quarter with a liquidity position of circa $542 million of cash and short-term investments. Additional $1.5 billion of undrawn credit lines remain at our disposal. We plan to roll over 54% of the working capital lines maturing in 2022 and refinance another 45%.

NLMK's average cost of debt edged down to an all-time low level of 2.3% following the debt portfolio optimization. Net debt was up by 7% quarter-on-quarter to $2.9 billion amid cash outflow to pay dividends for the third quarter of 2021 and capital expenditure increase.

Our net debt to last 12 months EBITDA ratio slightly declined to 0.4 from 0.43 in the third quarter.

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

Questions and answers session

Dan Shaw - Morgan Stanley

The first question is, in light of the Russia-Ukraine situation, can you perhaps talk a little bit about any preparations you have made with regards to business continuity, just in case that there are some level of sanctions placed on Russia and/or certain companies? For example, as I'm thinking about your sales channels, banking relationships, access to liquidity, debt markets, supplies for the company and things like that. Is there anything that you can comment on that, please.

Grigory Fedorishin

Dan, thank you for the questions. Basically, we have a pretty detailed plan and procedures for all the areas that you have mentioned. So the sanctions risk efficiently is not something new for us, and we update those plans on the regular basis. I don't think that makes sense to share more details at this call, but respective risk management procedures are there.

Dan Shaw

Okay. Understood. Then I just wanted to ask with some sort of M&A-type activity we're seeing in the space with the spinout of coal from EVRAZ and the sale of coal by Severstal. Does that change the time line for decarbonization for NLMK? In other words, with peers now sort of matching your no-coal integration situation, is there almost a kind of greater competition perhaps to drive a more rapid decarbonization profile? And following on from that, when can we expect a bit more of an update on your plans there on the environmental side?

Grigory Fedorishin

I'll also take this one. Now the way the CO2 exposure is calculated honestly doesn't make much difference, whether you have captive coal assets or not, because if you calculate taking into account the indirect emissions, we are still the same blast furnace-based producers consuming coal to produce coke and then to burn in the blast furnaces, right? So to us, those particular transactions do not really influence our attitude to decarbonization. But we do have quite a few developments on that front, and I'll start with your last question. So we are going to provide extensive update on that in our Capital Markets Day that we'll host in March this year.

At the end of the previous year, the Board approved environmental and the climate Strategy for the Group. So we'll come up with more aggressive and more long-term targets in terms of CO2 emissions and with very practical steps how we're going to move there.

Dan Shaw

Okay. Great. And then just lastly, if I could ask about the US business there, another good quarter. With margins looking sort of quite elevated at least versus history in that division, how do you see sort of the long-term outlook for that business? Do the high margins now provide an opportunity to look at a divestment? Or does it remain a long-term strategic part of your overall portfolio?

Grigory Fedorishin

I'll answer probably the same way we keep telling about the US story in the recent 3 years. We are open and we consider all the options, including M&As and exits. Now the US story is considered as a part of the wider strategic planning discussions and that we keep for every division, and we are going to come up with a new strategy probably early next year. And we need to consider the new inputs. The 232 and 25% duty was one that really changed the business model. Now we have to include decarbonization also into the equation. The market, in terms of the consumption, there is also changing. So we are analyzing all these inputs and basically now all the strategic options are on the table. But so far, it's an important part of our portfolio. And you're right. It's earning money and we are making good margins on top of our slabs and on top of external slabs that we are buying.

Sergey Donskoy – Sberbank CIB

I have 2 questions. Starting from the financials. We estimate that you may be carried about between $800 million and $900 million of sort of excess working capital that might be released during this year. Is this number about right? Or how would you comment?

Grigory Fedorishin

It's about right. But it's really subject to the price fluctuations that we see this year. The speed of release is really a question mark.

Sergey Donskoy

Understood. Second question is about coal, which is now one of the major moving parts and one of the major course drivers. I realize that you may not be at liberty to disclose important information about how your contracts work. But just broadly, what sort of benchmarks do you use? And what sort of a lag are built in those contracts for us to understand how changes in any seaborne benchmarks, for instance, might affect your cost performance.

Dmitriy Kolomytsyn

Sergey, it's Dmitriy. Look, as we have said before, we always use a combination of contract/spot basis. It's approximately 70% and 30%. So 70% - spot; 30% - contracts. The prices are usually linked to international benchmarks. But as you have seen many times in our presentation, and as you know, there's a very significant discount to international prices usually. The best way to do it, I would suggest to track monthly performance of international coking coal prices, that will be Australia, and apply that with a 1-month lag to our financials with the historical discount that we would normally observe in the Russian market for coking coal prices.

Grigory Fedorishin

Let me add to that. Sergey, as Dmitriy said, I mean, it's really a mix. And currently, the spot portion of this mix is higher. So about 70% of what we buy in terms of domestic coal spot based. Really deviations are possible and that's the point, right? So that's a matter of commercial negotiations given our positioning in this market. I would follow international benchmarks very carefully. But again you will not find 100% correlation there, for sure.

Sergey Donskoy

I understand that, of course. And lastly, if you may, about a CapEx outlook for this year and whatever changes of variation that we may see? And then second, whatever cost pressures you are seeing also this year, any particular items maybe that's went down.

Grigory Fedorishin

In terms of the CapEx, it's going to be more or less the same we saw last year. I would give you a range of roughly $1.2 billion to $1.3 billion in total for the Group. It's still quite in line with what we guided for in terms of overall strategic CapEx. So we're busy implementing and completing the projects of Strategy 2022. That's probably the most active year in terms of the projects to be completed. And the new projects or at least material ones, are going to start late already in the course over the new cycle. In terms of the inflation, I'm sure you see the numbers. I would probably highlight that the labor cost where we follow the general inflation as a benchmark, and you know that in Russia, it's pretty high levels now for the last year, it was 8-point something. And it's still pretty high at the beginning of the year. The labor cost is going to be indexed on a higher rate than you saw in the last few years.

Alexander Nefedov - Renaissance Capital

I have the same question about legislation, as you previously have answered and about the working capital. If I'm right, you are going to release this working capital, but the speed of this release is really questionable. Am I right?

Grigory Fedorishin

Yes, you're right, and that's really the subject to the price movements. For the first quarter I can give you some of the factors that are manageable from our side. So in the financials, you saw that we had accumulated some of the slab stocks in ports. This is definitely going to be released in the first quarter. On top of this, slab stocks in US, because of decreasing consumption activity there, are going to be reduced as well. Besides, you will see seasonal decline in the scrap and some other raw materials. So all in all, our estimate says that it should release working capital in the magnitude of 200 to 250 probably million in the first quarter, right? But that can be easily balanced by the price component. If you take coking coal and the impact it has in the fourth quarter, it's difficult to comment on the final number of the expected release in such a volatile pricing environment.

Anton Fedotov - Bank of America

Can you please comment on the ongoing antitrust litigation in Russia, your company is subject to it. When do you expect any final conclusion? And what level of potential penalty can there be?

Grigory Fedorishin

Anton, thank you for the question. Well, it's really ongoing, and we expect the decision according to the process to come sometime this month. And I would wait to comment on any sort of penalties at this phase, given that the outcome of the litigation is uncertain.

Timothy Riminton - Barclays

I've got a few questions. I think firstly, continuing on the theme of higher costs. Obviously, that's been reflected in higher slab cost for you over the course of this year. You've spoken about a couple of the dynamics influencing that. Are there any other sort of raw materials we should be keeping an eye on that are feeding into that higher cost per slab?

Grigory Fedorishin

Coking coal remains the major factor. Now looking at their expected cash cost for the first quarter, I cannot see a material difference in other cost factors other than coking coal price volatility.

Timothy Riminton

Okay. And can you give us any idea of what roughly what price you're paying per tonne of coal at the moment, sort of factoring in that domestic discount that you've mentioned?

Dmitriy Kolomytsyn

The average price that we paid in the fourth quarter was roughly in the range of $250-270 per tonne. It's a coal basket, coal mix.

Timothy Riminton

Yes. Okay. Great. And then on the liquidity side, you mentioned that you have plans to refinance 45% of your short-term debt. Could you give us any indication on what options you're exploring for that refinancing? Obviously, debt markets are a little bit volatile in Russia at the moment, but is that something you'd consider if they settle down? Or are you more looking at banking options?

Shamil Kurmashov

Thank you for your question. We have already standby credit lines in the form of 2 roll of credit lines, one of them in the amount of EUR 600 million, which is composed of 9 banks and in its committed line. It can be enrolled each time with 6 months tranches. So it can be deemed. It can be considered like the loan credit lines, although nominally, it's like the short-term line.

And the second line, which is also standby $250 million (ESG) is a revolving credit line, which is also at our disposal. It's also committed. As of December 31, we had $1.5 billion of available credit lines ~~clients~~. We had 7 available credit lines, including 1 uncommitted line NLMK Trading with a total amount of $90 million. And we had 3 committed lines from Russian banks: VTB, Alpha Bank and Sberbank. They are multicurrency lines. We can draw them down in euro, dollars or rubles. So all that gives us full comfort about our liquidity because these lines are committed, and we have a long-lasting relationship with these banks. We don't feel any tension, that there are some problems in the public market in case of any sanctions.

Nina Dergunova - Goldman Sachs

Most of my questions have been answered already, so probably a few clarification questions from my side. The first one on the US division. Obviously, last year was a stellar year for US process. Could you advise how much EBITDA this division is earning at spot prices on annualized basis?

Grigory Fedorishin

I believe it's a bit commercially sensitive, so I wouldn't comment on that. The pricing level, you probably see it's sliding, but still the margins are well above average.

Nina Dergunova

That is clear. Understood. And then a quick follow-up regarding CapEx. Is it fair to assume similar spending rate in next years of $1.2 - 1.3 billion per annum?

Grigory Fedorishin

Yes, you can because it's part of the same Strategy that was created based on the same principles. We are not introducing anything major on top of what we already have guided for. You were asking about the hurdle rate, right?

Nina Dergunova

Well, on the hurdle rate, rather the spending rate, the $1.2 - 1.3 billion per annum spending, can we treat it as a new normal beyond 2022 and assume this?

Grigory Fedorishin

Yes, sorry, I got you wrong. No, I don't think it's the right assumption because we really live by strategic cycles. And the CapEx that you see now is the reflection of the overall Strategy with some delays driven by pandemic and other factors. The new norm will be driven by the new Strategy. And that's probably to be disclosed sometime next year. The principles that we followed in developing this Strategy. I mean balance of financial stability, return to the shareholders and developing the company with positive economics. That's going to stay.

Nina Dergunova

The new Strategy, this will be likely announced in the beginning of 2023? And can you shed more light on what kind of things we can hear on your nearest Capital Markets Day in March this year?

Grigory Fedorishin

I would highlight 3 blocks there. One I already touched on answering one of the questions. It's going to be a new climate Strategy and the new targets that we have in this area. Second is an update on the effects we have accumulated and the projects we have completed in the course of this Strategy. We are now a year before the final completion. That's the time to give you what has been achieved so far. And the third block is the first pack of 5 years that we believe will become a part of this new Strategy, where we already have some certainty that we are pretty sure we are going to implement.

Sergey Donskoy – Sberbank CIB

Yes. Just one thing, speaking about price dynamics on the Russian market, you commented during the presentation about the bounce and the recovery that you saw during the fourth quarter and that prices improved. Could you say a few words about what sort of dynamics you have been seeing year-to-date, if the price momentum has been continuing or whatever prices are growing right now since end of last year.

Dmitriy Kolomytsyn

Do you mean on the Russian market only, right?

Sergey Donskoy

yes, I guess maybe have a better idea of what's happening on the global market, although I appreciate that whatever you say or whatever you think about Russian market has to be somehow aligned with the global developments, too. But Russia is maybe the more interesting part.

Dmitriy Kolomytsyn

It remains very regional. China is definitely benefiting from lower interest rates and the announcement that was made recently. You also see the inflation in coking coal prices and iron ore prices, which is driven by weather conditions. So that's putting some upward pressure on international benchmarks. And that's clearly impacting prices in this hemisphere. I mean, Europe and the Russian market because obviously, Russian prices are tracking international prices and Black Sea FOB prices. Europe should benefit from continuously low interest rates, although ECB has already stated that they may start thinking about raising rates. But while rates are low, that should benefit the construction market.

Don't forget that last year, the world didn't produce 30 million cars. And somehow, this needs to be rebalanced and those cars needs to be produced, and that's 30 million tons of high-quality steel. And we allocate it right where half of those cars were not produced, I mean, the US and Europe. And as Grigory has already mentioned, in the US, we do observe some price correction, which is driven by imports as well as the expectations of customers that there will be more supply coming to the market. Inventories are high. So while the market is eating through those inventories, prices would be under somewhat pressure. But once the infrastructure is now worth $400 million starts kicking in, that should start supporting consumption and hopefully, prices. But in the meantime, we continue seeing about 1,200 to 1,300 per tonne level in the US.

Sergey Donskoy

And speaking of the Russian market, if there's anything you could say about the current direction?

Dmitriy Kolomytsyn

In the Russian market?

Sergey Donskoy

Yes.

Dmitriy Kolomytsyn

Yes, in the Russian market, as I said, we see prices tracking global prices. We see prices tracking Black Sea FOB prices. So there's some upward movement because there's still construction going on. Even though interest rates are going up and mortgages are going up, you still have a lot of construction that needs to be finished that was financed by the purchases made last year. Besides, we are obviously patiently waiting for all the infrastructure projects that were planned back in 2018 to start kicking in.

Anna Antonova - JPMorgan

Quite a few brilliant questions on the line. Just a quick follow-up from our side. You've guided that you're planning to return to about 40 million tonnes run rate of Lipetsk plant this year. Could you please maybe comment on this production or sales volume dynamics across your other steel operations like Russia alone, NLMK US? And what kind of volume dynamics you expect in Europe, perhaps comparing to last year? Should we expect lower, higher flat volumes this year, that would be much appreciated.

Grigory Fedorishin

Let me take this segment by segment. I can comment on the plans, but again, they are subject to the market performance. For the long products, as we do expect market growing on the Russian side with a healthy, let's say, 3% rate. I would expect comparable performance in terms of volumes when we talk about our Long Products division, with an exception of billets. Billets are the marginal product that we sell to the export markets where there is an opportunity. I'm talking mostly rebar and other downstream projects or products that we have there. In the EU, you remember that last year, we had a significant modernization of the mill that we have in Belgium, the strip mill. That influenced heavily the volumes. We are still on the ramp-up curve, and you may expect a significant increase in volumes this year. Another phase of this modernization will happen in summer 2022, but it's going to be on a less scale compared to the last year. So all in, in strip, I mean coils, you can expect material increase in volumes.

As for plates, I would say, roughly should be the same comparing to last year in Europe. In US, there's going to be a balance of 2 factors. The beginning of the last year was very weak, it was entering out of pandemic and some other industry-specific factors there were as well. So we lost some volumes and we might recover this year. So far, the utilization rate there is higher compared to the comparable period of the last year. But we see that the buyers now in the US, at least part of them, they are in a sort of a wait-and-see mood expecting for prices to stabilize and that has an impact on volumes. If you put these 2 factors together, I would say it is probably flat comparing to the last year.

Dmitriy Kolomytsyn

Thank you so much for all your questions. We really appreciate them. And I appreciate your attention to our results. We are looking forward to seeing you again in April when we can discuss our first quarter financials. Have a good day, everyone.