ALROSA H1 2014 IFRS Results

Conference Call Edited Transcript

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ALROSA speakers

Ilya Ryashchin – *First Vice President*

Igor Kulichik – *Vice President, CFO*

Sergei Mezhokh – *Head of Investor Relations, Corporate Finance and Analytics*

Participants asking questions

Neri Tollardo – *Morgan Stanley*

Andrey Lobazov – *Bank of America Merrill Lynch*

Sergey Donskoy – *Société Générale*

Richard Hatch - *RBC*

Nitesh Agarwal - *Citi Group*

Ksenia Mishankina – *UBS*

Presentation

Sergei Mezhokh

Good day. Welcome to ALROSA conference call on H1 2014 results. I am Sergei Mezhokh, Head of IR, and I will make a few introductory notes. Our call today is led by Ilya Ryashchin, First Vice President of ALROSA, and Igor Kulichik, CFO. We have prepared several slides for you, which are uploaded to the IR section of ALROSA's website and were emailed to you earlier. We would refer to them while making the presentation.
Before we start, as usual, I would like to remind you that the information provided during this call may include forward-looking statements that involve risks, uncertainties, and assumptions. If such risks or uncertainties ever materialize or the assumptions prove incorrect, our results may differ materially from those expressed or implied by such forward-looking statements. We assume no obligation and do not intend to update any such forward-looking statements.
Now I pass a word to Ilya Ryashchin. Please.

Ilya Ryashchin (*translated*)

Good afternoon, ladies and gentlemen. On behalf of ALROSA, I would like to welcome you at this call on H1 2014 ALROSA IFRS results.
Our performance in H1 2014 has demonstrated significant growth across pretty much every metric.
ALROSA revenue went up by 27% to reach RUB 104.8 bn, whereas the EBITDA increased by 34% in excess of RUB 47 bn. EBITDA margin stands at 45%, whereas the net profit went up by nearly 60%, and the free cash flow is now in excess of RUB 20 bn, growth by more than 2.3 times.
Our outstanding H1 2014 financial results occurred due to the ruble weakening and decisions made by ALROSA management to sell more diamonds from stock. Since most of the destocking occurred in Q1 2014,

our Q2 results are more representative and more reflective of the current market situation and our sales volumes.

Since our sales in volume terms went up by 10% vis-à-vis H1 2013, please, mark that in Q1 2014 our sales volumes in carat terms exceeded production by nearly 5 mln carats, whereas in Q2 our volumes got back to normal to hit 8.4 mln carats which is slightly more than the production volume in the course of the same period.

In H1 2014 the average realized price of gemstones hit USD 172 per carat, which represents a 4% growth vis-à-vis USD 165 per carat last year, and pretty much most of that growth is driven by improvements in our assortment.

In Q1 ALROSA destocked by pretty much 5 mln carats, whereas in Q2 our sales volumes were on par with production. As a result, our revenue in Q2 went down by 16% vis-à-vis Q1 2014 to reach RUB 47.9 bn.

On top of that, our revenue in Q2 vis-à-vis Q1 went down because of regular maintenance in some of our wells in the gas assets, so production went down because of that maintenance.

I would like to place special emphasis on the positive development of rough diamond demand across 2014. Year-to-date we have observed a price increase of 7–8%.

Average realized price of gemstones in Q2 2014 reached USD 200 per carat, which represents a nearly 30% growth to the average price of Q1. Out of the USD 45 increase, USD 41 is contributed through an improved assortment, whereas another USD 4 comes through leveraging on the market environment.

This improvement in the assortment is explained by the low base effect. The thing is, in Q1 2014 we sold from stocks, which mostly was smaller sizes, and that resulted in a low average price of USD 155 per carat. This has been addressed in Q2 with better assortment.

The cost of sales growth was driven mainly by the increased diamond sales volume, increased depreciation, transport, and extraction tax costs, as well as sales volumes in other operations, including sales of gas.

The extraction tax costs increase in H1 2014 was a result of a new Ministry of Finance diamond price list for MET calculations, coming into force on 15 March 2014. Please, note that the prices in the price list have been up by about 35%. To compensate for that, the Republic of Sakha (Yakutiya) has already transferred to the Company across H1 2014 about RUB 500 mln out of the RUB 1.8 bn planned to compensate social costs in 2014.

Wages, salaries, and other staff costs increased by 8% as a result of quarterly indexation of wages at the inflation rate.

H1 2014 transportation costs increased y-o-y, and that increase of 90% came as a result of additional expenses for goods transportation by trucks in winter due to reduced period of navigation on the Lena River in 2013, as we explained on the previous disclosure call.

Depreciation growth in H1 2014 occurred mainly due to increased gas production volumes and new equipment commissioning at Severalmaz, also due to commissioning new equipment and acquiring that for the alluvials in Almazy Anabara and Nizhne-Lenskoye.

Other operating expenses decreased by 5% y-o-y, mainly due to the lower exploration costs. Lower exploration expenses are explained mainly by the fact that some of the works started in H1 2014 will be completed in H2 and accounted for at that point.

I would like to mark that positive developments of EBITDA and net profit have been strongly influenced by the combination of factors, such as the weaker ruble and extra destocking.

Our net profit in H1 2014 went up by 58% y-o-y to reach RUB 23.1 bn due to the development in our gross profit from diamond sales and positive developments of the weaker ruble and the FX fluctuations.

At H1 2014, our capital expenses stand on par y-o-y. Please, mark reduced CAPEX in Severalmaz having launched the second module of the processing plant at Severalmaz back in March.

Proceeding to our working capital and the cash flow, I would like to mark very positive developments, such as reduced investment in working capital by 87% y-o-y mainly through reduced stocks and inventories. Increased cash from diamond sales and reduced investment into working capital were the key drivers behind the free cash flow increase by more than 2 times y-o-y.

Speaking of our debt and loans, in Q2, the Company has done an extensive effort to refinance its short-term debt with bank loans with the maturity of up to 3 years, and also establish a liquidity cushion to repay the Eurobond issue summing at USD 500 mln. Our total debt currently stands at USD 4.2 bn, and 81% of that is long-term.

Also, please, mark the net debt number standing at USD 3.9 bn as at 1 January or USD 3.3 bn as at 1 July.

In conclusion I would like to mark it once again, that the positive performance by ALROSA in 1H 2014 is explained to a large degree by our leveraging on the market environment and further destocking. I would like to conclude the presentation part here, and we are open for your questions.

Questions and Answers

Neri Tollardo – *Morgan Stanley*

Thank you, gentlemen, for the conference call. I have got three questions for now. First of all, could you give us any update on your CAPEX and sales volumes guidance for the second half of the year? My second question is on diamond prices outlook for H2. We continue to hear that the polished diamond prices are not performing as well as the rough diamond prices, and it would be interesting to hear what you think about that, it that is a threat for ALROSA to maintain the high prices that we have seen year to date. And the last question is on the diamond mix that we can expect in Q3 and Q4 this year. Will they be more similar in terms of pricing to Q1 or to Q2? Thank you.

Ilya Ryashchin (translated)

Speaking of our CAPEX across the Group, as disclosed quite a few times earlier, the target is RUB 38 bn, no change to that.

Speaking of rough diamond prices expectations in H2 2014, our internal forecast is flat. Year to date, we have observed the price increase of 7–8%, and we believe, given the current market environment, that this is the level where it currently stands. Our sales for the full year – here we don't see any major difference from the guidance we announced previously. In money terms, however, most of the extra revenue would come from the effect of the weaker ruble.

Speaking of the diamond mix, it is hard to give guidance at this point. However, looking back, we believe that the full year mix will be pretty much in line with last year's mix again.

Neri Tollardo – *Morgan Stanley*

Thank you, could I just ask a follow-up on the second question on the diamond pricing outlook? You said you expect them to remain flat at the current levels. Would you be able to, please, elaborate on the reasons why you expect growth to slow down?

Ilya Ryashchin (translated)

Well, let's look back into this year first. Again, recollecting our strategy, we had envisaged 4–5% growth, more or less. So far we have exceeded that, not only achieved, but exceeded. And so far we don't see any further drive behind that growth. As you rightly put it, polished diamonds are not developing that well pricewise as rough diamonds. And we have observed that in July and August this price has been quite in place, which further reinforces the message.

Andrey Lobazov – *Bank of America Merrill Lynch*

Hello, thanks a lot for the presentation. I have three questions; my first question will be on Severalmaz. Can you, please, update us on the ramp-up progress there? Also, since production has already commenced, can you, please, compare the asset's performance to ALROSA's average in terms of the average price per carat and in terms of the average cost per carat? My second question will be on destocking. Can you, please, reiterate your destocking plans for 2015? If I am not mistaken, you plan to sell 2 mln carats additionally next year. And should we also expect the diamonds to sell next year to be of a similar low quality as the ones you sold at the beginning of this year? And my last question is on your working capital. What working capital movements should we expect in H2 2014? The reason why I am asking is because the q-o-q increase of the working capital was one of the main reasons behind the almost zero free cash flows in Q2. Thank you.

Ilya Ryashchin (translated)

Speaking on your first question, Severalmaz, we have always explained the project is very complicated indeed. The average price per carat at Severalmaz currently stands at USD 70. Whereas the cost of production stands at USD 60 per carat, as at today. This is explained by the fact we have not ramped up to full capacity as yet, so we are not yet producing from the better ore grades. And we could have the full representative picture of the economics of this project in 2016.

Speaking of our destocking, as for this year, 2014, we plan to go down by 2-2.5 mln carats. Whereas speaking of the following year, 2015, we will not be that high on stocks, so we cannot see that much destocking either. We could probably be talking of 1 to 1.5 to 2 mln carats. A lot depends on our total annual production numbers in 2014 and the production volumes from the alluvial deposits. As soon as we know these, we will be able to judge. But the guidance has been disclosed, I believe.

Speaking of our destocking in H2 2014, given the seasonality of our alluvial operations, we don't see further destocking in H2 2014. Instead, we may see a slight rebound since we simply wouldn't have time to premarket the diamonds and get them ready for sales.

Sergey Donskoy – *Société Générale*

I have two questions, please. First, could you, please, provide us with some update on the start-up of Udachny underground mine? Could you remind us when the mine is supposed to start production? And my second question is on a hypothetical situation. Suppose that sanctions against Russian diamonds are introduced by the EU, and ALROSA thereby loses the ability to sell diamonds into Europe. Will you be able to relocate, redirect your sales to other regions, and how much time might this take? Would this be associated with some losses to your realised prices, possibly?

Ilya Ryashchin (translated)

Speaking of the Udachny Underground Mine, we have explained and disclosed this quite a few times. This year we have already launched the first stage of Udachny underground mine. And we expect first volumes to arrive next year. Ramp-up to full capacity is expected in 2019. We expect that to be at 5 mln carats, that is the design capacity.

Speaking of the sanctions, really, it is quite hard to discuss a hypothetical thing when you do not know what these sanction could be, what these would be targeted against and what particular tools would be applied. It is even more difficult, given the degree of uncertainty in the question, to give any guidance on our realised price. Although we do look into different options of how we could sell our products, which regional markets we could use and which tools we can employ to refinance our debt.

Richard Hatch - *RBC*

Just a couple of questions. Firstly, the D&A charges is RUB 7.5 bn, is that reasonable in future half-yearly periods, or should we be modeling more? And then, secondly, just a question on M&A, is that something that is in your thinking at the moment, or is that not in your thought process? Thanks.

Ilya Ryashchin (translated)

Speaking of the D&A charges, indeed, there is some growth, and as I explained it in the main part of my presentation, that is contributed by booking some of the new fixed assets at Severalmaz, Nizhne-Lenskoye, Almazy Anabara and our gas assets. Looking at our CAPEX plan, it is unnatural to assume that, looking forward, our D&A charges will be growing at a higher pace than other cost lines.
Speaking of M&A, we are currently not working on any.

Nitesh Agarwal - *Citi Group*

I have several questions. First of all, on volume guidance. Sorry if this has already been covered. Your guidance of 36 mln production and destocking of about 3.5–4 mln carats means total sales of about 40 mln carats. That implies almost flat year-on-year sales in H2. Is that correct? And next question is on dividends. Can you give any details on the current dividend or on the dividend policy? Is that 35% payout? Thank you.

Ilya Ryashchin (translated)

Speaking of our production vis-à-vis sales volumes, let me remind you that in H1 2014 we produced 16 mln carats, whereas we sold 21 mln carats. In H2 2014 we expect to produce about 20 mln carats, and we expect to sell about 17 mln carats.
The lower than production sales have already been explained – we just do not have enough time to premarket all the diamonds before year-end that we produce.
Speaking about dividends, as explained in our dividend policy that 35% of our IFRS net profit.

Ksenia Mishankina – UBS

I have two questions. Are you taking any steps to diversify your sales away from Europe, and what is your CAPEX guidance for FY 2015?

Ilya Ryashchin (translated)

Speaking of our sales policy, no significant changes are expected looking forward.
We may see an increase in the number of long-term clients, but these are one-offs. And mostly these new ones will be coming from China and India.
Speaking of our CAPEX guidance for 2015, I do not think that would exceed 2014, it will be pretty much in line, standing at RUB 36–38 bn, but we are still working on the CAPEX program.

Neri Tollardo – *Morgan Stanley*

Just two follow-up questions on corporate governance. There were some news reports that some sizeable shareholders voted against investment in Severalmaz. I am not sure how much you can say about this, but any comments on the reasons or rationale for these votes will be very much appreciated. And second, on the long-speculated CEO potential reelection, if there is any key date that we should be looking forward to or any update on that. Thank you.

Ilya Ryashchin (translated)

Commenting on the position of our shareholders on Severalmaz, given that the shareholders in question have been with us only since very recently. Communication has not been fully established as of yet. This question was discussed very extensively at the meeting of the Supervisory Board at ALROSA. The board meeting featured very detailed materials on that, whereas the shareholder meeting had more concise information packs, and that was not fully representative and did not give the full picture to our shareholders. In fact, that is more of a technical question of converting debt to equity. And I believe, should communication have been more streamlined, the full information pack in place, our shareholders would not have had questions.
As for our President and the renewal of his contract, that stays within the scope of the Russian Federation Government, and we are keen to get some news from there.

Colleagues, thank you for joining our call. I hope we have made you happy with our performance. And we will try to keep it there, we will try to ensure that our calls always enjoy some happy atmosphere. Thank you. Goodbye.