# ALROSA Q1 2016 IFRS results conference call edited transcript

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# ALROSA speakers

**Igor Kulichik –** CFO

**Timofey Rodchenkov –** Head of Investor Relations

# Participants asking questions

**Neri Tollardo** – Morgan Stanley

**Des Kilalea** – RBC

**Sergey Donskoy** – Société Générale

**Oleg Petropavlovskiy** – BCS

**Vahe Ovasapyan –** Goldman Sachs

**Andrey Lobazov** – ATON

# Presentation

**Timofey Rodchenkov**

Good day, ladies and gentlemen, and welcome to ALROSA's conference call on Q1 2016 IFRS results. I am Timofey Rodchenkov, Head of IR, and I will make a few introductory notes. Our top management team is represented today by Igor Kulichik, CFO, and Svetlana Linnik, Chief Accountant.
We have prepared several slides, which were uploaded to ALROSA's website and e-mailed to you earlier. We would refer to them while making the presentation.
Before we start, I would like to remind you that some information provided during this call may include forward-looking statements that involve risks, uncertainties and assumptions. If the risks or uncertainties ever materialise or the assumptions prove incorrect, our results may differ materially from those expressed or implied by such forward-looking statements. ALROSA assumes no obligation and does not intend to update any such forward-looking statements.
Now, I pass the floor to Igor Kulichik. Please.

**Igor Kulichik** *(translated)*

Colleagues, welcome to ALROSA's conference call on Q1 2016 results.
In the reporting quarter, ALROSA demonstrated exceptional financial and operating performance. Q1 2016 marked a recovery of the demand for rough diamonds by cutters and polishers. This was driven by the overall positive macro environment backdrop affecting the diamond jewellery demand, and efforts by ALROSA, among other market players, to cut their sales in 2H 2015. Market activity in the reporting period turned out to be significantly higher than expected, which enabled ALROSA to maintain its pricing environment for rough diamonds on par with the 2015 level. The Company managed to reduce its rough diamond inventories by more than 18%, both in value and in volume terms.
Beyond that, the Company stays with the objective of not increasing the inventories in the course of FY 2016, and hence the management decided to review its production plan bringing the number down from 39 mln carats to 37 mln carats for the full year. These adjustments will not require and suspensions at the core deposits and can be effected by reducing production at our alluvial deposits.

In Q1 2016, we carried on with our construction operations to build transport infrastructure for the Verkhne-Munskoye field, as well as at the open pit at the Zarya pipe.

ALROSA built up in its current accounts and deposits a number of about RUB 76 bn as at the end of Q1 2016. This is sufficient to meet our obligations in short-term debt repayments, as well as to pay dividend of 50% of net income under IFRS for FY 2015. You can find more details on the outstanding financial performance by ALROSA in Q1 2016 on pages 3–4 of the presentation.

The Group's revenue in Q1 2016 reached RUB 102.3 bn, which is a 37% increase y-o-y. Alternatively, that is a growth of 16% if we compare that within the same FX of the RUB/USD environment.

The Company's EBITDA reached RUB 59.3 bn, which represents an increase of 38% y-o-y. Our EBITDA margin is record-high at 58%.

Pages 5–6 of the presentation discuss our revenue breakdown in Q1 2016. The increase in the Group's revenue vs Q1 2015 was driven by the increase in the revenue from diamond sales, which went up by 41%.

The key driver behind the increase in revenue from diamond sales were the higher sales volumes, which went up by 34% from 9 mln carats in Q1 2015 to 12.1 mln carats in Q1 2016.

Our production cost breakdown is represented on page 7. The key drivers boosting production costs were personnel costs (wages, salaries and other staff costs) and costs of materials, as well an increase in depreciation.

Wages and salaries moved up by 6%, mostly driven by the salaries and wages adjustment on par with the inflation rate in Russia.

Increase in production volumes within the Udachny mining division, as well as at the underground mine of Mir thanks to the successful completion of the water cut reduction effort caused not only an increase in depreciation costs by 24%, but also an increase in costs of materials by 31%.

Our costs of services, on the one hand, and on fuel and energy, on the other, moved in opposite directions due to the reclassification of costs for third-party electric power purchases in Q1 2016.

The Company's EBITDA in Q1 2016 went up by 38% y-o-y to reach RUB 59.3 bn. Pages 8–9 of the presentation demonstrate our EBITDA and net income breakdown.

Our FX losses went down by RUB 18.5 bn and the Company's EBITDA increased. The Company's net profit amounted to RUB 49.9 bn in Q1 2016, which is a 2.2-fold increase y-o-y.

As you can see from the chart on page 10, the Company's capex went down by 8%, mostly driven by the reduction in investments required for the technical renovation, overhaul and upgrade at our existing facilities in line with the Group's plan for 2016.

Please note the chart on page 11. The relative increase of investments in our production capacities is caused by the two prospective projects launched in 2H 2015, namely the construction of the open pit mine at the Zarya pipe, and construction of an access road to the Verkhne-Munskoye field, which is 170 km away from the settlement of Udachny.

Page 12 demonstrates the breakdown of the Group's net cash flow. It reached RUB 59.9 bn, which represents a significant y-o-y increase due to the increase in diamond product sales.

Also, thanks to a positive market in diamonds, ALROSA managed to reduce its rough diamond inventories by 3.9 mln carats in the course of Q1 2016. This translated into reduced investments into working capital, which went down by more than RUB 13 bn y-o-y.

The breakdown of our loans and borrowings is represented on page 13. As at the end of Q1 2016, total debt of the ALROSA Group in USD terms remained flat at USD 3 bn.

However, please note that post the reporting period, as of today, the ALROSA Group has successfully paid out its short-term debt to Alfa-Bank in the amount of USD 350 mln. As a result, our total debt to EBITDA ratio went immediately close to its target of 1x.

This concludes my presentation, and I suggest that we move on to Q&A. Thank you.

# Questions and Answers

**Neri Tollardo –** *Morgan Stanley*

First, about the Q2 dynamics in the diamond market. Have you noticed a little bit of a slowdown in the restocking demand on the part of the midstream? Do you think the channels down to the midstream are still fairly empty and there is a lot of restocking demand, or are they filling up?
The second question is about your inventory of rough diamonds in Q2. [I know it] is not finished yet, but would you say that you have been able to destock more in Q2, or are your sales now roughly in line with the production?

**Igor Kulichik** *(translated)*

Let me say a few words about the state of the diamond pipeline. As you remember, back in 2015, the middlemen in the diamond pipeline (cutters and polishers) had a deficit in their inventories of about USD 3–4 bn, which they are now restocking. That, effectively, explains our successful performance in the course of Q1 this year and our good sales volumes. Q2, Q3 and Q4 this year will be more stable, which is to say that we expect neither a surge nor a slump.
Now, on to your second question on inventories and destocking. Let me remind you of the numbers: in Q1, we managed to reduce our inventories by close to 4 mln carats, from around 22 mln carats to less than 18 mln carats now. In Q2, we expect this trend to continue, although no one expects that much of a downturn. No 20% reduction, for sure.

**Des Kilalea –** *RBC*

Following up on that inventory question, could you give us evaluation on that inventory now?
Could you also comment on two things? First, the dividend outlook for 2016 and maybe 2017 in terms of the percentage of earnings, and second – your thoughts on the debt repayment schedule of USD 1.1 bn for 2017?

**Igor Kulichik (translated)**

Referring to your first question on the current evaluation of our inventories: according to estimates, it currently stands at USD 1.8 bn.
Now let us move to the dividend policy. Let me remind you that, according to our dividend policy, we are to pay no less than 35% of the IFRS net income. In 2016, based on our performance in 2015, the Government – our major shareholder – decided, with a special decree, that we are to pay 50% of our IFRS net income, which is a little over RUB 2 per share, or RUB 15,4 bn in total. That money is coming to the shareholders as early as in July. As for our prospects beyond 2016, which is 2017 and onwards, we will in any case be paying no less than 35% of the IFRS net income, as it states in our dividend policy. The government, our major shareholder, has not yet decided what the payment could be. Let me remind you that the government decree on the dividends in the amount of 50% of the IFRS net income referred to 2015 financial performance only and is regarded as a one-off case.
Finally, the question on debt repayment in 2017. Indeed, we have around USD 1 bn due to be repaid in that year, but we are already working to refinance that. Our outlook is to refinance about USD 700 mln and extend the payment date to 2019 in terms of maturity. We hope that it happens soon, and as soon as it happens, we will be happy to disclose that to our investors and creditors. Thus, the Company will ensure a comfortable debt curve, and the repayment schedule will look as follows: 2017 will have around

USD 390 mln due for repayment, another USD 600 mln will follow in 2018, USD 700 mln in 2019, and around USD 1 bn in 2020. That is a very comfortable situation for the Company as we have a good cash flow to cover all of those.

**Sergey Donskoy** – *Société Générale*

First of all, speaking of realized diamond prices in Q1, I think you have mentioned that the prices remain in line with the previous year, but if I am not mistaken, the average realized price of gem diamonds in Q1 was around USD 146 per carat, while the average for the previous year was something like USD 170 or slightly above that. Did you mean that the Q1 price was affected by a different mix, and did you mean that the prices remained flat excluding these effects?
My second question is related to the first: what price dynamics have you seen so far in Q2 YTD? What do you think the outlook is? Also, with more than USD 1 bn of cash, basically no maturities this year, and plans to refinance USD 700 mln of the 2017 debt, are you considering any interim dividend payments? What are you going to do with all the cash you are apparently holding?
My third question: could you please comment on your production plans for 2016 and 2017? During the Investor Day, you mentioned the possibility of reducing your target production levels to align them with the demand – have you made any decisions here? What is the likely outlook for the medium term?

**Igor Kulichik (translated)**

Let me comment on the first question about the pricing level for diamonds in Q1. The prices in Q1 2016 did not change. At every pricing committee meeting, we had certain adjustments of prices for independent categories within the mix, but those were very insignificant adjustments.
In terms of the average realized prices per carat and their comparison quarter-to-quarter, let me call upon you once again not to do this comparison exercise because our marketing and sales team does that on a regular basis, readjusting the mix depending on the demand, and the comparison exercise does not make sense if applied to two different quarters – it only makes sense if applied to the whole year, with prices compared between the years.
Regarding your second question about our pricing outlook for Q2, currently we do not see any reason to move our prices either way, i.e. up or down. We receive positive feedback from our offtakers, and the market remains stable, no one expects any major moves, and we only have minor adjustments in prices between different categories, moving them up or down but very insignificantly. We are not planning to do any major move in prices across the board.
Regarding your third question about our cash available, indeed we had about USD 1 bn of cash in our accounts. But let me remind you that RUB 350 mln of those were repaid to Alfa-Bank as part of debt facility repayment, and the rest is well-arranged between different deposits to match our obligations, such as dividend payments, tax payments, and contractual payables. Overall, the amount is not that huge given all these commitments. We do have very sound liquidity management to make sure the Company has a liquid cushion in case there is extra volatility in the market. Responding to your question specifically, we are not considering interim dividends.
Regarding your fourth question about our 2016 and 2017 production outlook, as explained previously, indeed we have the option of being flexible in terms of reducing the supply side subject to negative developments in the diamond market, and indeed we have this tool in the form of alluvial deposits. Without affecting our core deposits, either underground or open-pit, we can increase or decrease production by 10% [within a year] by starting or not starting production at our alluvial deposits. That is how we manage our production plan, and we are going to use this tool this year. Using this tool does not lead to any increase in costs or any major detriment to the core deposits should the production be reduced.

**Oleg Petropavlovskiy –** *BCS*

First question: there were rumours that your diamond sales fell by 50% month-on-month in April. Could you share your estimate for April and May sights? Could give us your Q2 sales guidance? Second question: when do you think ALROSA may be ready for a privatization deal? Last question: your capex guidance for 2016 – could you please share it with us?

**Igor Kulichik (translated)**

The rumours you refer to are absolutely not true: the Aprils sights produced results pretty much comparable with March, whereas the May sights have not been completed yet, but we do not see any decline in demand. Regarding your second question as to when the Company could be ready for the privatization deal, the situation remains pretty much the same as you know it from media reports. What we have at present is the decree by President Putin to allow the Government to reduce its stake with ALROSA to 33.001% (from 43.9%). The Ministry of Economic Development together with the Russian State Property Management Agency, or Rosimuschestvo, have selected an agent to handle the deal – that will be Sberbank. Sberbank is currently actively engaging investors both domestically and internationally. Basically, the scope of this transaction remains the same as announced previously: 10.9% or up to that number available for sale in 2016. Timing is undefined as yet, and we are targeting all investors in Russia, Europe, America, and Asia. According to our early contacts with investors, they are all interested in the deal and very much like the cash flow that the Company will be benefitting from.
Regarding your third question about our 2016 capex guidance, we have not adjusted it in any way and it remains at RUB 38,9 bn.

**Vahe Ovasapyan –** *Goldman Sachs*

First question, the diamond market: Tiffany and Signet already reported their Q1 results, and generally the results from major players are weak, and they also provided quite cautious outlooks for the rest of the year. Do you think these results will have any impact on the diamond market? Second question, your production plan: you said that you can and are likely to decrease production to 37 mln carats. What is the rationale for the potential decrease in production given that you have strong sales for the first five months, as I understand from your comment, and secondly, a decrease in production would not result in any decrease in ALROSA’s workforce and thus in lower production costs for the Company?

**Igor Kulichik (translated)**

Commenting on your first question regarding Tiffany’s and Signet’s results and their outlook, the outlook is not that bad – they just do not see any significant growth. I would say that they have reported a very cautious outlook. What you need to take into account is the geographical breakdown of their markets: they are very cautious regarding China, indeed, with a major slump there caused, among other things, by the anti-corruption campaign but also other drivers. At the same time they are very positive about the US and Japanese markets. Overall, it is advisable to take a balanced approach to reports within the jewellery manufacturing industry: if you take a comprehensive approach to the 2016 numbers, they are overall positive regarding market developments.
Regarding your second question about our production plan, we have indeed made certain adjustments to take the number slightly down to 37 mln carats for FY2016 by reducing production at our alluvial deposits. Using the alluvial production is a painless effort for the Company that does result in cash cost reductions. Let me remind you that at the start of the year ALROSA had inventories of a total of 22 mln carats. Our

primary objective for 2016 is not to exceed that number, and our secondary objective is to reduce that number if possible. Within that framework, the decision was made to reduce production.

**Andrey Lobazov –** *ATON*

My first question is also on the diamond outlook. What has changed in your outlook for the diamond market and prices since the previous call on 2015 results back in March? And my second question is on Gokhran. According to press reports, they should buy RUB 5 bn of diamonds this year, maybe even more. In which quarter do you expect this to happen?

**Igor Kulichik (translated)**

Regarding our pricing outlook for 2016, we remain cautious, but do not expect any significant falls in pricing generally; instead we expect sustainable growth of about 2%. Our long-term outlook also provides for 2–3% CAGR in the course of the decade, and that remains unchanged. We do not want to be too optimistic based on our very good performance within just one quarter, because we have seen quite a few times a significant surge followed by a flatline or even a slump. So we remain calm, optimistic and hopeful there will be no negative developments in the market and hence no major volatility in pricing.

Regarding your question on Gokhran: indeed, Gokhran intends to purchase rough diamonds in the amount of RUB 5 bn, but that is an insignificant number. They normally buy about the same volume from us every year, and there is no quarterly breakdown on either ALROSA's or Gokhran's side. This is definitely happening in 2016, but in which quarter is yet unknown.

Colleagues, thank you for your questions and for your interest. Should you have any follow-ups, you are welcome to reach out to us. Good-bye.