ALROSA Q1 2017 IFRS results conference call edited transcript

26 May 2017

ALROSA speakers

Sergey Ivanov – CEO

Igor Kulichik – Vice President – CFO

Sergey Mezhokh – Head of Corporate Finance

Participants asking questions

Vahe Ovasapyan – Goldman Sachs

Anton Fedotov – Bank of America Merrill Lynch

Nikolay Sosnovskiy – Prosperity Capital Management

Dan Shaw – Morgan Stanley

Beatrice Bushati – East Capital

Evgenia Molotova – Verno Capital

Boris Sinitsyn – VTB Capital

Richard Hatch – RBC

Kirtan Mehta – HSBC

Presentation

Sergey Mezhokh

Good day, welcome to ALROSA's conference call on Q1 2017 results. I will make a few introductory notes.

Our top management team today is represented by Sergey Ivanov, CEO, Igor Kulichik, CFO, and Svetlana Linnik, Chief Accountant.

As always, before we start, I would like to quote the disclaimer. The information provided during this call may include forward-looking statements that involve risks, uncertainties and assumptions. If the risks or uncertainties ever materialize or the assumptions prove incorrect, our results may differ materially from those expressed or implied by such statements. ALROSA assumes no obligation and does not intend to update such forward-looking statements.

Now, I pass the floor to Sergey Ivanov, please.

Sergey Ivanov

Good day, colleagues. I am happy to welcome you to our conference call on Q1 2017 results.

Our performance has slightly improved compared to late 2016, driven by better diamond market conditions and our cost control program. Currently, a stronger ruble is putting pressure on the Company's margins. However, we have sufficient cash flows to carry on with our capex plan and cover our operating expenses.

Q1 2017 was another period of sustainable growth in the global diamond market which is not over yet. Our sales were almost RUB 85 bn, 40% up q-o-q, regardless of the strong ruble. Due to the strong diamond market we have increased rough diamond prices up 3% year to date.

The Indian demand recovery helped us destock materially. Year to date, our inventories went down from 19.4 mln carats to 13.7 mln carats virtually touching our process floor level. The Company’s revenue was down y-o-y, mainly driven by the stronger ruble (up 22%) and a different diamond mix. We control our costs pretty well – in Q1 2017 our production cost was up just 4%, with the cost of sales expanding in line with the growth in volumes.

ALROSA keeps running its capex plan – in Q1 2017 we continued delivering the transport infrastructure for the Verkhne-Munskoye deposit and developing the Udachny underground mine. The increase in expansion capex was due to massive stripping at the Zarya pipe in Aikhal, with more than 100 meters of overburden. Zarya is set to come on stream in 2021. Now, let me hand over to Igor Kulichik for further comments on our performance. Thank you.

Igor Kulichik *(translated)*

Hello, ladies and gentlemen.

To add to what Mr Ivanov has just said, I would like to note that the financial performance of the Company in Q1 2017 was mainly driven by reduced inventory of rough diamonds. Net income and cash flow on a q-o-q basis were up 37% and 4.7x, respectively, primarily driven by materially higher sales including over 5 mln carats from stocks.

To remind you, the inventory level accumulated by late 2016 contained mainly smaller stones unsold due to the reduced demand from India on the back of their monetary reform. Then, in Q1 2017, we successfully sold off this excessive stock. However, the average sales price was below the average annual level and down y-o-y. The negative impact on our revenue was also exerted by the stronger ruble, which was up 22% y-o-y. So our net income, cash flow and margins were down on a y-o-y basis.

The Company is still conservative in its liquidity management practices. In Q1 2017, we deleveraged from USD 2.3 bn to just USD 1.7 bn, with our cash and cash equivalents staying at approximately RUB 50 bn. The leverage of net debt to EBITDA is now at just 0.4x, our all-time low. So, ALROSA has got enough cash to keep running its capex plan and pay out dividends for 2016 at 50% of IFRS net income. Now we will be happy to take your questions.

Questions and Answers

Vahe Ovasapyan – Goldman Sachs

I have three questions from my side. Two questions to Sergey Ivanov.

The first one is about the potential increase of your stake in Catoca, by around 8% according to newspapers. Do you expect to increase the stake only by 8%? Do you have any potential to increase the stake by around 51%?

The second question is about ALROSA-Nyurba. What is the current status of this deal? Have you got any formal request for potential acquisition of a 10% stake from Sakha (Yakutia)?

And the last one is about profitability in Q1. As mentioned, it was under pressure due to the sale of low value diamonds in Q1. Do I understand correctly that you expect profitability in next quarters to go back to normalized levels?

Sergey Ivanov *(translated)*

We did have our next round of talks in Angola the day before yesterday and, so far, I would abstain from citing any percentage of equity proposed for sale. Anyway, this is not sufficient to let us gain control, as yet. This may be attractive if the price is attractive. And if any formal proposal is on the table I think it would be incorrect for us not to consider it. As for the media reports, there was some confusion. The matter is that, in parallel, a concession agreement on the deposit of Luaxe was signed. This is kind of a mining investment contract whereby Catoca gains 50.5% equity stake in Luaxe, with ALROSA and Endiama acquiring 8% each at a cheap price. So this is true to the extent Luaxe is concerned and the cost of developing Luaxe is likely to be borne by Catoca. However, this has not been decided yet and, before you ask, I can say that there are no specific numbers, because before Yakutniproalmaz delivers calculations we are not ready to announce any capex numbers since this is too early, but most likely in 2017 no material capex will be reported there. As far as Catoca is concerned, we will duly disclose any news and updates to the investment community.

Concerning your second question about ALROSA-Nyurba, that's right, the government of Sakha (Yakutia) has offered us to consolidate around 10% in ALROSA-Nyurba and now this is subject to valuation. In case the valuation number is attractive, we will keep on with the talks. If not, there will be no deal. There is no commitment from either side. I think this deal may be attractive to ALROSA, because it will help us to support the corporate structure at Nyurba and consolidate this fully on our accounts. But we must understand that this project involves some payback period anyway because you know that ALROSA-Nyurba is paying out considerable dividends, so this is yet to be studied.

Igor Kulichik *(translated)*

Our EBITDA margin was down to 42% in Q1 2017 vs 58% reported a year ago. The reasons are obvious, and, as we have said in our introductory presentation, they have influenced our margins, net income and cash flow. These are a stronger ruble and lower-value sales in Q1, dominated by smaller stones. In Q2 and Q3 this year, we do not expect these drivers to persist, so we believe our sales mix will be better going forward, dominated by bigger stones, while the ruble is expected to be sustainable in Q2 and Q3, maybe with some strengthening. As for our sales mix, I expect it to get back to normal and to match our production mix.

Anton Fedotov – Bank of America Merrill Lynch

Earlier, at the Investor Day, you provided certain sales volume guidance for FY2017 saying that your sales volumes will be equal to your production volumes. Would you change this guidance now after you sold more than 5 mln carats from inventories in Q1? The second question is about the current pricing trends you are you seeing right now. In April, based on your monthly data, the realized prices were higher than in Q1 but what is the outlook for Q2 and going forward?

Igor Kulichik *(translated)*

You have partly answered your first question. Yes, we are going to reconsider our sales volume guidance. Now all the calculations are in progress as part of our budget adjustment exercise. We hope to get done with this by the end of summer and we will update you in due course. But certainly sales volumes will be higher than the previous guidance.

Now the second question about prices. At our market councils, we did a number of price adjustments to actually push the price up 3% year to date. As for our budget adjustment exercise, we do not factor in any price increases or decreases, so we expect the prices to stay flat but it does not mean that this will persist for sure during the year. Certain minor adjustments to the price including minus 3% back are quite possible. To remind you, our price adjustments are regular actions to respond to the wishes and expectations of our clients and market situation and these are done for particular parts of our assortment.

Anton Fedotov – Bank of America Merrill Lynch

As a follow-up to my first question, what level of diamond inventory would you see as normal?

Igor Kulichik *(translated)*

The inventory level is now about 13.5 mln carats, at the beginning of the year it was around 19 mln carats. To remind you our so-called floor process level or minimum technological level is around one third of our annual production volume, or 12 to 13 mln carats. This is the process level attributable to how diamonds move through the value chain from the mine to the sorting center and then to the trading session. So our minimum level is virtually achieved now, and it would not be reasonable and necessary for us to cut it down further considerably.

Nikolay Sosnovskiy – Prosperity Capital Management

I have got several questions.

First, on Angola and potential developments there. Assuming that you will likely increase your stake in Catoca to maybe close to 50% or maybe above that, and also involve in Luaxe somehow, are you planning to assume sales responsibility for these volumes and do all kind of sorting and sales for Catoca and Luaxe yourself or will Endiama remain responsible for this process? If yes, do you expect any kind of positive synergy with your marketing department and would it be possible to sell Catoca’s and potentially Luaxe’s stones at better prices compared to the current moment?

Sergey Ivanov *(translated)*

Let me add to what I have already said about Angola now. As yet, we are going to focus on the current sales offer and as I have already said the stake offered for sale is not enough for us to gain control over Catoca. But alternative offers are possible in the future and we will consider them in due course if and when they are on the table. Now, sales. The work is in progress but I guess it is too early now to give you any specific comments or guidance. First, we will see to which level we will be able to increase our stake and then we will duly consider the sales side of the process. Again, to remind you, Catoca is a profitable asset generating more than USD 100 mln in net income every year, so sales matters will be discussed with our Angolan colleagues on a separate basis.

Nikolay Sosnovskiy – Prosperity Capital Management

My second question. I just wanted to clarify on working capital. We have discussed quite thoroughly inventories and what could happen. It looks like no major changes apart from the seasonal fluctuations for the rest of the year. But in Q1 working capital release was not that strong as inventories, because it was adversely affected by some negative changes in receivables and payables, so the question is whether you expect any positive changes not in inventories but in receivables and payables, that might lead to further releases of working capital, so that for the full year we would have greater working capital release compared to Q1?

Igor Kulichik *(translated)*

Our working capital is threefold, it is split into accounts payable, receivable and inventories, and, as we have already disclosed, our inventories were considerably down in Q1, which also led to a really considerable release of working capital. If you want to see details, we can update you offline. But again to stress, in Q1 our working capital was released quite dramatically on the back of dramatic destocking. Again, this inventory was dominated by smaller stones, accumulated back in Q3 and Q4 2016. During the remaining part of 2017, our working capital will be way less dependent on our inventory.

Nikolay Sosnovskiy – Prosperity Capital Management

And my last small question on interest payments. I have noticed that in Q1 results, in addition to Eurobond and bank loan interest expenditure, which was roughly USD 2 bn, other financial liabilities generated RUB 2.8 bn of interest expense in Q1. Was it some kind of a one-off expenditure, what really generated this part of interest expenditure, should we expect it going forward?

Igor Kulichik *(translated)*

This was an early repayment of a bank loan to VTB of 600 mln in Q1 2017 and the amount you have quoted was actually an early repayment fee paid to the bank. To remind you, the original loan contract did not provide for an early repayment option, but we negotiated with the bank to restructure the loan contract and so we made it possible. Hence we repaid it earlier and it was a one-off event and you should not expect anything of the kind before the year-end.

Dan Shaw – Morgan Stanley

I have got two questions.

The first one relates to the cost line you have shown lately for the inventory sold during the quarter. If I look at that vs the amount of extra carats you sold, I will see the cost per carat standing at RUB 2,700. This compares to RUB 1,500 per carat in each of the four quarters in 2016. What drives the increase in costs? Is it production from different mines or something else? And could you also remind us of the accounting policy that you use to value your inventory and to re-categorize the costs when it is sold.

The second question is on polished diamond prices. You have mentioned that you have increased rough diamonds prices by 3% year to date. Can you give an indication of the prices for polished diamonds, have they increased as well? My understanding is that they are quite flat, is it right?

Igor Kulichik *(translated)*

Let us start with the third question. Yes, you are right, polished diamonds in terms of pricing stayed flat. Again, let me dwell upon the price adjustments we effected year to date. It does not mean that our diamonds became 3% more expensive, we simply adjusted our prices, rebalanced prices for certain parts of our diamond mix. In some parts of it, the price was moved up by 5%, somewhere it was down by 5%. All in all, across the whole sales mix, the price was rebalanced by 3% upwards.

Now your first question about the cost of carat. Again to remind you, in Q1 we sold a big chunk of smaller stones accumulated back in Q4 2016, the amount was around 5 mln carats. And jumping to your second question now, the cost was booked as ALROSA’S average. While booking the cost of diamonds in inventory we do not account for any breakdown by mine. All our costs are average company-wide. Moreover, your analysis seems to be inaccurate, as you do not exclude ore and sands movement when evaluating the cost per carat of diamonds sold from inventory. If you will consider this adjustment, you will see that cost per carat of diamonds sold from inventory has not changed y-o-y.

Beatrice Bushati – East Capital

I want to ask you about the capex programs. Since capex was quite low in Q1, do you still reiterate your previous guidance for the full year?

And also my second part of the question is regarding cost control, or cost reduction. As I remember Mr Ivanov had an idea to be quite tough on costs, so I was wondering where you stand on that.

Sergey Ivanov *(translated)*

Now I have on my table several orders pending my signature and these focus on both capex and opex reduction. As yet, it is too early to give you any precise numbers. I think we will duly update you on that in our H1 2017 disclosure conference call. But I can say that capex will certainly go down by several percentage points. As to opex, the work and calculations are now in progress, the task and the target are still relevant, and again we will update you on that in due course most likely in our H1 conference call.

Evgenia Molotova – Verno Capital

I have several questions. One is about the measured demand in Q1. Do you see better demand just in Indian cutters, who could not buy in Q4 because of the monetary reform, or can you comment on the global, not necessarily rough but polished industry as well, and jewelry. Do you see any improvement in demand in China or US?

The second question is just to understand a little bit how Q2 is going on. If we look at the carats that you are selling, is it larger diamonds? Will the mix be considerably better in Q2 vs Q1?

Another question is about your net debt. Net debt/EBITDA went down to less than 0.5x. What is your view and how low do you want to go on this ratio?

Igor Kulichik *(translated)*

We do see a sustainable demand in Q1 and Q2 continued and it is not going down, both from our Indian partners and other market players. The thing is that the Indians were so fast to recover that it was even a surprise to themselves. This was because the monetary reform did not hit them as hard as they probably expected, so after that they bought everything they could buy. The others are also feeling quite well and hence this brisk demand all across the diamond mix of our Company. We are talking to our marketing people on a routine basis and they are saying that demand is not going down. Besides, recently we have discussed the guidance in June and they are saying that the consumer appetite is not going down either. And this is quite surprising because typically this is the beginning of a low season in the year cycle. As we disclose our performance for Q2, I hope we will deliver some good news to you in terms of sales.

Sergey Ivanov *(translated)*

I would like to add that as we meet with and talk to our big midstream clients purchasing rough diamonds not just from ALROSA, but also in the broader market, I can say that they feel quite well and they are positive towards the year end. I am talking about really large midstream consumers with amount of purchases of USD 4–5 bn.

Igor Kulichik *(translated)*

Now our debt is USD 1.7 bn and the repayment profile is very comfortable, the debt is maturing in 2019-2020. We will see how we will manage this going forward, but now I can say that our free cash flow is sufficient to fully repay this outstanding debt. However, in 2020 we may consider tapping into capital markets with a new instrument to stay in the public debt capital environment. But we will consider it in more detail towards 2020.

Evgenia Molotova – Verno Capital

Just to clarify, could you comment anything on the product mix in Q2?

And also another question: is production guidance still 39 mln carats for this year?

Igor Kulichik *(translated)*

As I have said, the sales mix in Q2 is going to be significantly better than in Q1, because we have sold off virtually all the smaller stones in the reporting period. So the Q2 price per carat is going to be significantly better too.

As for our annual production guidance, yes, our budget for 2017 is based on 39 mln carats in both production and sales. Now we are adjusting our annual budget and most likely we will increase both the production and sales targets for the year.

Boris Sinitsyn – VTB Capital

Three questions from my side. First one is clarification on Luaxe. An 8% stake was announced, but in media we saw comments made by your partners about the potential financing for the first stage of roughly USD 100 mln. Just to clarify, should we view this amount as a payment for your 8% stake, or the payment terms and consideration are different?

Second one, do you expect any revaluation of your USD assets in 2017 based on stronger ruble?

And the last one is actually a broader question on Diamond Producers Association. This year, as we know, the budget for the whole Association was increased. What are your expectations and what other key measures will the Association take this year or probably within the next few years?

Sergey Ivanov *(translated)*

Let me comment upon Luaxe first and then move to DPA.

ALROSA's concession agreement on Luaxe is going to be very cheap for us, so the quoted number of USD 100 mln is not the price of the 8% equity stake. Again, our research institute Yakutniproalmaz is delivering estimates of the investment volume, and it is too premature to give you any numerical guidance. Besides, some estimates are now underway for Catoca, not ALROSA. So, probably you have seen some numbers relevant to Catoca's expenses, not ALROSA's ones. Anyway, as soon as the numbers are on the table we will duly disclose them to the investment community.

As for DPA, ALROSA together with its partners are now considering certain budget allocations for marketing of the natural diamonds as a unique thing, and subsequently all the relevant matters will be escalated to our Supervisory Board for due approvals. Actually, the Company's management are now pretty positive about the Supervisory Board's support and I personally believe our participation and involvement in DPA and the DPA itself are very important and relevant things these days.

Igor Kulichik *(translated)*

Now the USD exchange rate and our budget.

Our 2017 budget factors in the exchange rate of RUB 65 per USD. Now we are adjusting our annual budget and considering a number of cases with the USD exchange rate within the range of RUB 58 to 60. So a certain revaluation is underway in terms of our dollar assets and our revenue and net income numbers in the ruble equivalent are also going to be reconsidered going forward, but as yet it is too early to disclose any specific numbers, so we will duly update you going forward.

Boris Sinitsyn – VTB Capital

Just a follow-up on DPA, could we have an understanding of the approximate scale of your expenses on those at this stage?

Sergey Ivanov *(translated)*

I would not like to give you any guidance before our Supervisory Board's approval, but I expect our allocation for DPA to be approximately pro rata to our share in the diamond market in terms of production volumes. To remind you, another four or five companies are going to invest in DPA alongside with ALROSA.

Richard Hatch – RBC

Just a couple of questions on Luaxe. First, can you clarify any potential timing for first production and any anticipated size of annual production from that asset, please?

Sergey Ivanov *(translated)*

The short answer is we do not know. However, in Angola, we do not expect any massive stripping operations, so the first diamonds may hypothetically – I stress it, hypothetically – come into the pipeline in about 2018. In terms of when and how much, these are rather questions for our research institute Yakutniproalmaz and our Endiama partners. As yet, we do not know.

Richard Hatch – RBC

And, on the stones themselves, could you remind us what the average value and the quality of the stones themselves there?

Sergey Ivanov *(translated)*

I am not that deeply into diamond techniques to comment upon that question precisely, but in the layman language I can say that Luaxe stones are not worse than those from Catoca, and the grade is really good. Again, as I said, but I did not finish my statement, hypothetically, those stones may come into the pipeline in about 2018, that is if we decide to transport them using trucks to the processing plant at Catoca, which is just 20 km away from Luaxe. But this is still an open question and we are considering a number of options. Maybe we will transport the stones to Catoca plants, or consider the construction of a new plant locally at Luaxe. And the capacity of that plant, before you ask, is certainly yet unknown.

Kirtan Mehta – HSBC

I would like to go back to pricing. What is driving the positive demand from the midstream you have mentioned above? Could you also comment on the demand growth across different markets?

Igor Kulichik *(translated)*

As I said, year to date the price has been stable, and the 3% is again not a price increase by ALROSA, but rather a pricing rebalancing for certain components of our diamond mix. The prices in the polished diamond market and in diamond jewelry market are staying flat. And again, as we talk to our marketing people, they claim this stable pricing level most likely is the supporting factor for the current strong market. To remind you, neither ALROSA, nor De Beers increased their prices year to date. So we expect no price increases and we expect consequently the demand for rough diamonds to be quite strong before the year end of 2017.