ALROSA speakers

Alexey Philippovskiy – Chief Financial Officer
Igor Sobolev – Managing Director
Yury Okoemov – Senior Sales Officer
Sergey Takhiev – Head of Corporate Finance

Participants asking questions

Dan Shaw – Morgan Stanley
Des Kilalea – Canaccord
Nikolay Sosnovskiy – Prosperity Capital Management
Anton Fedotov – Bank of America Merrill Lynch
Anna Antonova – J.P. Morgan
Boris Sinitsyn – VTB Capital
Kirtan Mehta – HSBC

Presentation

Sergey Takhiev

Good morning and good afternoon, ladies and gentlemen. My name is Sergey Takhiev, Head of Corporate Finance, and I am honored to have my first conference call at ALROSA. Thank you for joining us today on our conference call to discuss ALROSA financial performance in the first quarter of 2018. As always, elements of our presentation are forward looking and based on our best view of the market.

Today our call will be led by our CFO Alexey Philippovskiy who will walk you through the key operating and financial highlights of the first quarter, and then we will be happy to take your questions. Today, senior management team, Igor Sobolev, Managing Director, and Yury Okoemov, Senior Sales Officer, are joining us and will be happy to answer your questions as well.

That's all from my side and I hand over the call to Alexey Philippovskiy, please.

Alexey Philippovskiy

Thank you, Sergey. Ladies and gentlemen, I'm happy to welcome you to our Q1 2018 results conference call. Today we will briefly discuss our Q1 numbers published earlier today and answer your questions. Now I would suggest to turn to page three of the presentation.

Speaking about the markets in Q1 2018, the Company was able to take full advantage of the improved market environment, which was the main driver behind our strong financial performance, well supported by our cost controls.

Thanks to increasing diamond jewelry sales and diamond prices, the sentiment in the rough diamond market is also positive. Higher demand for medium and large size diamonds in early 2018 led to 27% and 31% increase in the average price of the diamonds and gem-quality diamonds sold, respectively. The hike in sales came on the back of diamond cutters’ restocking due to higher than expected amounts sold by retailers during the New Year holiday season.

Production in Q1 2018, ALROSA Group’s diamond production was about 7.4 million carats, down by 26% quarter-on-quarter and 17% year-on-year. The key factors behind the decline were reduced production at
Mir mine following August 2017 accident, processing of lower grade ore from the Jubilee pipe and termination of processing of ore from the Udachnaya pipe after the open-pit mining was completed.

Our sales in Q1 were 13.4 million carats, up by 43% and by the way Q4 2017 figure was still 5% lower than last year. The difference between sales was covered by diamond inventories, which decreased by almost 33% over Q1 2018 and stood at 12.3 million carats as at the end of March 2018, approaching the technological minimum level.

Our first quarter revenue reached RUB 96 billion – 58% higher than the last quarter and 13% higher year-on-year. Sequential growth was driven by strong sales, improved product mix and overall growth in prices.

Our Q1 margins expanded to 50%, 9 percentage points above the last year’s results. Company demonstrated strong free cash flow generation and solid financial standing.

Now let me briefly walk you through our financials.

Please turn to page four. Our Q1 costs were down by 3% year-on-year amid a 5% reduction in sales over the same period. If you look at cost dynamics line by line, you see that there was a decrease pretty much in every line, partially it was driven by the absence of production at Mir mine and the divestiture of our natural gas assets.

Now, please turn to page five. Our EBITDA grew by 37% year-on-year. The key factors contributing to this growth were changes in the sales mix and increase in the average selling price for the Company’s end products. At the same time, the Russian ruble’s 3% appreciation against the US dollar caused our EBITDA to decline by RUB 3 billion.

Going to page six, our Q1 free cash flow reached RUB 41 billion, this is a 19% growth against last year numbers. This growth was driven by lower capex, strong profitability growth and working capital release as we sold almost 6 million carats from inventories.

Net profits on page seven, grew by 40% year-on-year to RUB 33.2 billion on the back of stronger EBITDA and a decrease in financial expenses by almost RUB 3 billion because we made early loan repayments and brought our debt down from RUB 93 billion to RUB 59 billion, I am talking about gross debt now.

Page eight, our capital expenditures went down by 17% year-on-year to RUB 4.8 billion. The decrease was also mostly driven by an impacts from Q1 2017 investments in technical renovation and upgrade of the Mir underground mine, and the divestiture of the gas assets.

On page nine we discuss our liquidity position, the liquidity remains high, free cash flow in Q1 2018 increased to RUB 41 billion, with the Net Debt / EBITDA ratio dropping to 0.1x at the end of the quarter, comparing to 0.7x at the end of 2017. And liquidity was further supported by the sale of the gas assets for RUB 30.3 billion.

A couple words on the strategy execution and dividends before we turn to the Q&A section. ALROSA is continuing with the strategy of efficient asset portfolio management focusing on our core business, which is diamonds production, simplified corporate assets structure, and disposal of non-core assets. In February this year, we sold our gas assets at an auction rising more than RUB 30 billion. In addition, the Company has sold or in the process of divestitures of our other non-core assets such as agricultural companies, our timber processing business, as well as minority stakes in other non-core operations. This will streamline our business model and will allow us to focus even more on the key value creating operations.

On dividends, the Supervisory Board recommended that the shareholders approve the pay-out of 50% of the Company's IFRS net profit for 2017 in dividends, which is equivalent to RUB 38.6 billion altogether or RUB 5.24 per share.

The focus of our capex program is still on upgrading, developing and enhancing the efficiency of our core production assets.

Our production outlook for the year remains unchanged at 36.6 million carats. Our sales are expected to be in the range of 38-40 million carats.

That is all on my side and we are ready to take your questions. Thank you!
Questions and Answers

1. Dan Shaw – Morgan Stanley

Hi. I have three questions from my side. First one, just on the purchase of the treasury shares, the RUB 7 billion. Can you just give some detail around, what is happening here? What the shares are going to be use for?

Second question on capex, you are trending well below the RUB 32 billion guidance has been given previously. Do you expect a pick up in capex through the rest of the year or is there some downside risk to that number?

And then on sales, can you give any indication in Q2, how you are tracking in terms of revenue per carat relative to where you were in the first quarter? Thank you.

Alexey Philippovskiy (translated)

As far as your first question, Dan, well, as discussed earlier the Supervisory Board of the Company approved stock options plan in principle and that occurred in the fourth quarter last year. Since we need to fund that program, the Company started purchasing its own shares in the market and in Q1 we acquired 81 million shares in total for the amount of RUB 7.1 billion. So far the stock options plan has been funded by 110 million shares, and the final setup of the program is to be discussed by the Supervisory Board at the end of June meeting and hope we will approve. So far we are aware of the following metrics three years as total operation, about 100 people to encompass and total shareholder return as the key metrics. Further allocation of the shares, as well as the volume of the total stock options program is to be considered by the Supervisory Board at the end of June meeting and hope we will approve.

Igor Sobolev (translated)

As far as the capex is concerned, we are going to stay within the area and then guidance for the full year in total. However, certain redistribution is going to occur quarter-to-quarter. The key reason for that is very low ambient temperatures that we have this winter less than minus 40 degree centigrade, which prevented operations of crushers which we use to get the dirt for earthwork for Verkhne-Munskoye access road. Hence capex redistribution from Q1 towards Q2 and Q3.

Yury Okoemov (translated)

Regarding the price, average realized price per carat or as you call it revenue per carat in the second quarter. We expect the revenue per carat in dollar terms in the second quarter to be very close to the actual result of the first quarter, maybe it is going to be somewhat lower due to the changes in the mix.

2. Des Kilalea – Canaccord

Thank you very much and two brief questions. The first is, could you comment on your levels of rough inventory and whether you feel you have too much or too little?

And then, the other is whether you are a big seller into India in terms of rough, have you noticed any material impact on your sales or the sentiment in India from the fairly large fraud in Punjab? Thank you.

Yury Okoemov (translated)

Regarding your first question, indeed we observed certain influence of the seasonal factor in terms of demand seasonality and also prediction seasonality, using that factor we significantly reduced our inventories from more than 18 million carats at the end of last year to 13.3 million carat at the end of the first quarter. We are going to see a further decline in significance update in the coming months with a further ramp up in the second half of the year. This is going to be driven by the seasonality factor, yet again, because in summer we start producing from our alluvial deposits which have no winter production at all. In terms of our assessment of that level, we believe that the level is currently normal as compared to our technological needs in the production chain.
Regarding your second question on the changes in the sentiments of our Indian customers following the newly discovered fraud with banker in case. Well, the banks are currently undertaking more stringent measures towards their borrowers, more stringent requirements (inaudible) borrowers, and however, solvency and demand on behalf of our customers have not been affected, so as far we see at least. I believe we are going to see to get a better view in the second half of the year, in terms of any impact on liquidity and on demand once the new more stringent borrower requirements have been put forward by the banks.

3. Nikolay Sosnovskiy – Prosperity Capital Management

Thanks a lot for the presentation. I have couple of questions. First one on the production guidance for the next couple of years. I assume that some time has passed from the Mir mine accident and some big internal work has been done on production and how Company can counteract the situation. So, can you share any new plans regarding to any particular assets, maybe how you can, in addition to what you have already disclosed, how can you increase production and substitute Mir volume, because I assume the Company almost never had a situation when it was forced to increase production quite dramatically? That was the first question.

And second one, probably, related to the first one increasingly was a conference devoted to the Mir mine restoration and was quite well attended as far as I know. So can you share at least maybe some preliminary results of this conference and maybe some preliminary suggestions for the restoration process and decisions that should be taken with regards to Mir mine? Thank you.

Alexey Philippovskiy (translated)

Regarding your first question on the production volumes. We may well capture the numbers, that are available in the Investor presentation. We maintain the same guidance. As displays previously the Company will not be able to fully substitute the volumes of the Mir underground mine. In 2017 and in 2018, we manage to ramp up our sales as compared to production using our inventories. However, in 2019 sales from inventories is not going to be an option any further.

As mentioned on previous calls, our EBITDA is going to lose about RUB 20 billion, that’s the impact of the Mir mine accident. Partially this volume is going to be replaced by increased production at Severalmaz, Almazy Anabara and also Udachny mining division. However, Yubileynaya pipe is going to see a natural decline and the planned reduction of production volumes. So the total number of 38 million carats is what you are going to see in the course of several years to come.

Igor Sobolev (translated)

Again to maintain flat production and use the additional volumes of certain assets to offset natural decline at other assets and there is no opportunity to fully replace the Mir underground mine volumes using other yielding assets. Our initial plan for 2019 stood at 41 million carats, including Mir production and the volumes without Mir stands at 38 million carats the number you heard from Mr. Philippovskiy and now the second question.

Regarding the second question of yours. As far as the conference is concerned. Well, answering that question, let me outline how we structure our efforts to find a solution towards the Mir mine. First and foremost, is the Company arrange for an internal conference of ALROSA engineers, so that they could come up with their ideas and proposals. The second phase included a broad call for ideas and proposals that is nationwide culminating in conference to sum up those operations obtained.

And the third stage is also underway with international experience summed up and studied involving three international adviser companies. We are going to proceed after stage three has been completed with a developing a concept, further adding numbers to that and looking into the feasibility of that concept.

Stage three has not being completed so far. As far as stage two is concerned, that culminated in a most Group conference with multiple ideas and proposals discussed by various representative turnout of leading scientists. Those ideas that has been marked as perspective, they commended for further more thorough analysis and we have taken that for more detailed consideration. However, we cannot predict now any particular timeline or solutions or further to that investment volumes that would be required.
4. **Anton Fedotov** – Bank of America Merrill Lynch

Thank you very much for presentation. I have two questions. My first question relates to your management incentive program. You mentioned that you purchased RUB 7 million of shares in the first quarter. Have you completed your purchases of shares or you are planning to buy more shares from the market?

My second question relates to the news on dividends, you announced 50% payout for 2017, do you plan any special dividend for 2018 based on the proceeds received from the sale of the gas assets? And are you also planning any amendment to the dividend policy and potential migration to the payout based on the free cash flow instead of net income? Thank you.

**Alexey Philippovskiy** (translated)

In course of April and the first half of May the Company continued acquiring treasury shares from the market and the current total stands at 110 million shares, depending on the allocation decision, we could potentially acquire more shares from the markets. But that depends on the eventual decision that’s the Supervisory Council takes at the end of June.

As far as your second question is concerned dividends, well, we do not expect any special dividend to be paid out based on the sale of gas assets, at least not in 2018. And as far as any potential alternatives to the dividend policy are concern? Well, we do have instruction from the Supervisory Council to prepare and present to the Council a long-term liquidity profile of the Company and potential alternative dividend policies that is going to happen in the June meeting. This work is currently underway with consultations ongoing with members of the Supervisory Council, as well as members of the investment community at large. One option to be considered is the free cash flow base dividend. However, that will be decided by the Supervisory Council itself. And I guess, you could expect further news after the June meeting.

5. **Anna Antonova** – J.P. Morgan

My question relates to your potential M&A activity. Basically could you please provide us some more color on the recent press statements with regards to the potential acquisition of Russian domestic polisher Kristall? That is the first part of the question.

And are you potentially considering other M&A deals, for example, there were articles in the press about some Zimbabwean assets potentially? And the last thing, could you please update us on your status of ALROSA-Nyurba shares are purchased from the equity and authorities? Thank you.

**Alexey Philippovskiy** (translated)

Regarding any further M&A activity, indeed at the most recent meeting of the Supervisory Board, it was considered that acquisition of Kristall in Smolensk could provide some synergies, given the nature of ALROSA’s business.

Currently, Rosimushchestvo, the Russian State Agency for Property Management is looking into the evaluation. ALROSA has submitted valuation metrics. What is to be looked at and the valuation exercise is currently underway on the part of Rosimushchestvo. This will result in the final price, which is going to be the basis for further negotiations. I would not expect the acquisition to take place in Q2.

Regarding any interest towards Zimbabwe, indeed our top managers visited that country with the purpose of information exchange. Currently there is no significant interest on the part of ALROSA.

And regarding the third part of your question on acquisition of shares with ALROSA-Nyurba. It is a feasible project given that this is our core business and we will be able to reduce administrative expenses by discontinuing certain management further that are currently in place because this entity is currently a standalone enterprise. We are now expecting a government that actually enabling ALROSA to acquire the stake in question and the transaction is expected before the end of the second quarter.
6. Boris Sinitsyn – VTB Capital

Hello. Thank you for the presentation. I have three questions. First two is on market specifically on midstream profitability. So, year-to-date, major miners like De Beers and ALROSA increased rough diamond prices, like roughly from 2% to 3% excluding the mix effect. At the same time, polished prices are also up to around 3% at least based on weighted average index. So the question is, based on your observation, do you see any change in midstream profitability year-to-date?

And second question, do you expect further price increase for rough diamonds during the rest of the year? Third question is on your non-core assets mentioned in the beginning of the presentation. Do you expect them to be sold in 2018 and if you have estimate what is the estimated proceeds from the sale? Thank you.

Yury Okoemov (translated)

You have rightly observed the trend, so as seen in the first quarter with moderate growth of rough diamond prices and moderate growth for cut diamond prices as well and a strong demand for diamond in general. I would say that your question already contains the answer, which means that the situation in midstream as well is stable.

As far as price guidance for 2018 is concerned, we can observe both positive and also negative drivers. The positives include good results during the Christmas sale season in the United States, the pick-up in demand in the Chinese market which is recovering and becoming live here. Major retailers have submitted some good financial accounts for the financial year 2017.

On the background of that some negative drivers can also be observed and one of that has been discussed during this call already. And referring to the bank guarantees fraud discovered in India, and as mentioned previously, we are going to see the impact on liquidity we get from that in the second half of this year.

And another negative influence – financial accounts from Signet, a major retailer in diamond jewelry, which has been showing downward trend in diamond jewelry sales for two years running. Overall, with those positives and negatives considered, we have a stable market and I do not think there will be major movements before the end of the year, including price movements.

Alexey Philippovskiy (translated)

Regarding non-core asset divestment, in the course of 2018 we are going to divest from our timber processing business, and as well a small agricultural enterprises, and also we are getting to sell minority stake at Yakutian Railway. However, all of these assets are not comparable in scale to the gas assets, which we have recently divested. In total, we would expect several million US dollars of proceeds to arrive in our accounts in the course of this year. Thank you.

7. Kirtan Mehta – HSBC

ALROSA has shown its cost reductions on several component, particularly I was interested in knowing the more color around the 12% cost reduction in wages, and another 15% cost reduction in materials. Are this sustainable through the year? And could you also give us a color on the RUB per carat cost for 2018? The second question about the sort of the differential winter impact and processing rate versus the run-of-mine production, while processing rate was lower in Q1 at 5.7 million ton, run-of-mine production actually sequentially increased to 19.1 million cubic meters. Could you explain the impact of the winter differential impact of winter on these two components?

Alexey Philippovskiy (translated)

Regarding your question indeed our cost down by 3% and one major line here is payroll, which is down by 12%. There are two drivers explaining why this particular line has come down. Quite unfortunately there is no further costs for the Mir underground mine in the course of this year. And starting mid-February, we are no longer bearing the cost for our gas assets from which we have divested.

And another major factor is cost optimization program, of course, we are striving for higher efficiency and undertook major measures in the following fields, capital construction department, geological exploration, our research institute and also a number of measures to improve productivity with other assets. The total
headcount has come down by 6% year-on-year, given the new parameter of the Company and this is going to be a major sustainable factor driving this particular cost line.

Regarding second part of your question. In terms of productivity, well, look up to the following metrics, cost per carat is one thing and cost per cubic meter of rock is another. As far as cost per carat is concerned, that is going to be affected by the following drivers, inflation is one thing, efficiency improvement measures is another and generally lower average grade of our ore, because we are ramping up at Severalmaz where the ore grade is lower and Mir underground mine is no longer with us, which used to have a high grade. So all these three drivers combined are going to result in a cost per carat and inflation that is a little bit lower than gem inflation.

As far as the cost per cubic meter is concerned, well, it was down in 2017, it was 10% down in course of 2018 and we are going to see a pretty much the same effect. The cost per cubic meter is going to grow at base a little bit less than inflation. Thanks to our measures to improve efficiency. I hope this answers your question and can you repeat your second question?

Seasonality is impacted by the following drivers. First and foremost that is our alluvial deposits, which can only operate in the warmer seasons, as we roll that, it will be summer, so in summer we have a higher production volumes with alluvial deposits as we do and in winter that was normally lower and it is also lower for the major part of spring and autumn.

Another driver affecting the seasonality is also the schedule of repairs and maintenance. Most of that concerns beneficiation plants. We are trying to schedule the maintenance in the following arrangements, so as to ensure timely delivery of materials, which has to be brought in. And also financial impact on our operations. You have rightly marked that our Q1 production volume is 17% or less year-on-year, but we still confirm our full year guidance of 36.6 million carats.

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