ALROSA speakers

Alexey Philippovskiy, Deputy CEO – Chief Financial Officer
Yuri Okoyomov, Deputy CEO for Sales
Andrey Cherepnov, Chief Engineer
Sergey Takhiev, Head of Corporate Finance

Participants asking questions

Boris Sinitsy – VTB Capital
Anton Fedotov – Bank of America Merrill Lynch
Individual Investor
Anna Antonova – J.P. Morgan
Yury Vlasov – SOVA Capital

Presentation

Sergey Takhiev
Good morning and good afternoon, ladies and gentlemen. My name is Sergey Takhiev, Head of Corporate Finance, and I'm honored to conduct conference call at ALROSA. Thank you for joining us today on our conference call to discuss ALROSA financial performance in the Q3 and 9M 2018. As always, elements of our presentation are forward looking and based on our best view of the market as of today. Company's CFO, Alexey Philippovskiy will discuss key developments of the company and dive deeper into Q3 financials. And then, we'll be happy to take your questions. And also, today Senior Management Team, Yuri Okoyomov, Deputy CEO of for Sales, and Andrey Cherepnov, Chief Engineer are joining us today and we'll be happy to answer your questions as well.

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

Alexey Philippovskiy
Hello, ladies and gentlemen. I'm happy to welcome you to our Q3 and 9M results conference call. I would like to start with the diamond market update. Please go to slide 3. Growth in diamond jewelry demand, which was up 5% year-on-year coupled with tighter diamond supply in 2018, you can see this on the right hand chart on the top, led to both lower midstream inventories, hitting multiyear lows for July-September season, and improved prices. So the environment was rather supportive so far, and let's discuss how we've performed.

Please go to slide 4. Our Q3 production in carats seasonally grew by 23% against Q2, while over the last year quarter production grew by 2%. This growth came mainly from lower grade assets, including alluvial deposits and comes at the expense of average grade deterioration (it was down from 0.9 to 0.8 in the nine months of this year) and also significant growth in processed ores and gravels as we show this on the chart of the top of this page.

Now, please go to slide 5, where we will talk about our sales. In the last quarter, we noticed lower demand for smaller stones, which is largely attributable to tighter financial conditions and FX volatility in India, where 9 out of 10 stones are polished. Cutters and polishers reduced purchasing activity and relied on their stocks. This factor translated into lower Q3 sales, which were 23% down at 6.7 million carats. At the same time, share of large and mid-size stones in sales increased leading to higher prices for carats sold. Growth in index price, which was up by over 5% year-to-date on a like-for-like basis and better product mix, where we've signed a 9% growth in revenue for the 9M, despite a 9% decrease in sales volumes and carats.

Now please turn to slide 6. Seasonal growth in production at alluvial deposits and drop in small stone sales led inventory growth to 15.5 million carats, up from 11 million at the end of June.

Now let's go to slide 7, to review our key financial highlights. Q3 revenue was down 3% q-o-q, despite sales in carats decreasing by 26% due to stronger prices and better sales mix. Q3 profitability was sequentially flat, at a very high 57%, which was up by 11 pp against Q3 of 2017. Free cash flow in the Q3 was up by 13% q-o-q and doubled against last year quarter to RUB23.6 bn. Growth against 9M of the last year was 38%. Leverage remains below targeted level of 0.5 to 1.0 of Net debt / EBITDA levels.
Slide number 8 shows our cost dynamics and break down the unit cost in 9M in nominal terms were down by 2%, as we continue to improve efficiency. As you can see on the top chart here, Q3 unit costs increased by 18% largely due to decreased volume of run-of-mine ore and we expect levels should normalize going forward. Total operating costs for 9M were down by 5%, which was largely due to lower sales, optimization program effects, and one off factors namely closure of the Mir mine and disposal of gas assets. Profitability drivers, we discussed on slide 9, Q3 EBITDA was down by 3% q-o-q, as a 3% revenue decline was offset by improved sales mix and FX impact, partially compensating the decrease in volumes. These factors were also behind the 29% growth in 9M EBITDA. Q3 margins remained flat at 57% and 11 pp up over the last year quarter, on higher prices, well exceeding cost inflation. 9M margins grew by 7 pp to 54% on widened spreads between average selling prices and, as additional factor, lack of margin dilutive gas assets, which we sold earlier this year.

Now let's move to slide 10, where we talk about CAPEX. In Q3, CAPEX went up 22% q-o-q and reached RUB8.8 bn due to specific climate conditions and capital investments in the Verkhne-Munskoye deposits, which we launched in October 2018. This new asset is expected to produce 1.8 million carats per year. Total CAPEX for this project was RUB16 bn since, the work on the project started in 2015. Most of our CAPEX is dedicated to maintenance and large share of our CAPEX is RUB based. We expect 2018 CAPEX to be at around RUB29 bn to RUB30 billion.

Now let's take a look at slide 11. In Q3, free cash flow increased to RUB23.6 bn (13% up q-o-q) driven by strong profitability offsetting insignificant net working capital build up, which was RUB 1 bn versus RUB 6 bn in Q2 and also moderate CAPEX increase. We doubled our free cash flow over the last year, which was well supported by sizable growth in operating cash flow offsetting a 28% y-o-y growth in CAPEX. 9M free cash flow growth was up by 38% on a strong operating cash flow growth and conservative CAPEX. Slides 12 and 13 show leverage and net debt change analysis. In Q3, net debt increased from RUB6 bn to RUB36.6 bn following a 2017 dividends payments that took place in July. In Q3 2018, Company increased its stake in ALROSA-Nyurba from 87.5% to 98.1% mainly through the purchase of a 10% stake from the Republic of Sakha (Yakutia) for RUB12 bn. Net debt decreased by 59% against last year, which was due to growth in free cash flow and use of proceeds from gas asset sales to pay down debt. The Company's Net debt / EBITDA ratio stays at the low level of 0.2x.

Now let's go to slide 14 on dividends, based on our new dividend policy, which is outlined on this slide shareholders approved payments of the interim dividends of RUB43.7 bn or 70% of free cash flow. Payments have done in two installments in October and November of this year and next dividends recommendation will take place in March-April of the next year.

Finally, our outlook is presented on slide 15. Rising trade tensions and FX volatility should pose some downside risk on the industry, though, we believe the overall fundamentals of the industry are strong with underlying demand demonstrating moderate growth. We should notice that seasonally second half of the year in diamond industry is weaker and we see that this year, it's actually quite pronounced. We expect our sales should be in the range of 37 to 38 million carats for 2018, which is down from our previous guidance of 39 to 40 million carats. This decrease was due to lower than expected sales of small stones. And finally, the production outlook remains intact at 36.6 million carats this year, potentially there will be some insignificant revision upward, but nothing large. And speaking about the next year, currently, we expect roughly 38 million carats for 2019 in terms of production.
Questions and Answers

1. Boris Sinitsyn – VTB Capital
Hi. Two questions from our side. The first one is detailed on your costs, so we know that MET (Mineral Extraction Tax) is declining slightly throughout 2018, despite weak ruble and higher production volumes, if we look quarter-by-quarter. So what is the reason for that and do you expect it to recover or stay this low? Second one is on your actualized the market expectations, the guidance was decreased due to lower demand from lower price stones. Do you expect this lower demand to remain in place next year or in the beginning of the year or when do you expect the demands for this stones to recover?

Alexey Philippovskiy (translated)
As for the changes related to MET, so they are caused by the divestiture of gas assets that's why this figure has reduced. As for the diamond production, MET is a function of production, since nothing has changed in this regard we see what we see.

Yuri Okoyomov (translated)
So the process is related to the reduction in the demand for lower price products, is a factor of seasonality, which we observe every year. So on top of everything else we should not forget about the Indian holiday season in November, when they celebrate Diwali and when they just release all their labor force to celebrate this holiday (so this is an additional factor). When another factor, which makes an impact on the outcome is the tightening of the credit policy in India and the change in the exchange rates between rupee and US dollar. So we anticipate the upcoming and rising trend in December after this holiday season in India is finished. And we expect the demand for the lower price products to grow and recover in Q1 of the next year. Of course, we should not exclude such factors as the outcome of sales during the Christmas holiday season and the celebration of the Chinese New Year.

Boris Sinitsyn
Thank you very much. Just a follow-up on last question. So far Company's diamond index is up roughly 5% year-to-date, just wondering whether the dynamics for different segments of stones themselves like medium to higher price stones and lower price stones is it different actually within this 5%?

Yuri Okoyomov (translated)
This pretty complex and sometimes controversial of movements within the price index are pretty common and of the market. And this is a trend, which we used to and which we have been observing all the time. So we have a pretty broad range of products to offer our product mix consist of more than 500 products. So this short-term fluctuations and pricing normal and apply to all the components within this range. Sometimes the demand for lower price products may go up, while the demand for the more expensive product will go down and it will depend on the balance between the demand supply and the stock available to the market. So, as for the situation regarding 2018, so we observe the upward trends on more expensive product and maybe some of the downward trend on cheaper one.

Boris Sinitsyn
And one last question actually on insurance, could you please confirm that you received the part of insurance for Mir mine this year? And do you expect the remaining part to be received somewhere this year or next year? Thanks.

Alexey Philippovskiy (translated)
Yes, we do reaffirm that we have received RUB7.6 bn as of now, and before we the end of the year, we are expecting to get the full volume with full amount, which equals to RUB10.5 bn.

2. Anton Fedotov - Bank of America Merrill Lynch
Good afternoon, and thank you very much for your presentation. I have a few questions with regards to the small size diamonds as well. First of all, how would you define small size diamonds, what is the carat threshold level for this group? And how big is the share of the small size diamonds in the production and sales mix of ALROSA?
Yuri Okoyomov (translated)
So the small size stones defines in a traditional way in the diamond mining industry as the sieve class minus 11 and lower. They account for 40% in volume and from 20% to 25% in value. So this particular category turned out to be on the particular pressure during the period from September to November.

Anton Fedotov
Thank you very much and I have another question about your marketing policy. Your realized gem-quality diamond price reached really all-time highs in the Q3 close to $200 per carat despite the weak seasonality of the quarter. What's your expectation for the next couple of quarters in terms of your realized price direction?

Alexey Philippovskiy (translated)
I would say that actually the 9M results show that actually the structure looks like the larger stones demonstrate some +RUB55 bn however, the price index is +RUB5 bn, so which means that actually the structure predominates versus the price index. As for the expectations for the periods to come forward, I will pass it over to Mr. Okoyomov to answer this question.

Yuri Okoyomov (translated)
As for our expectations with regards to the 2019 market, so we expect it to be pretty stable without any major changes upward or downward. Of course, we think that it will be resulting from flat situation in terms of the balance between supply and demand. As for the average actual price, it is a function of the structure and during 2018 the effect of the more expensive stones prevails, so we expect the cheapest stones would take it over in the next year.

Anton Fedotov
Would you mind quantifying the increase of the cheapest stones share in 2019 versus this year?

Yuri Okoyomov (translated)
So I find it's a bit difficult actually to give you a quantitative prognostication and a sort of figure on that. As I said, pretty much depends on how quickly and how sustainable will be the supply or rather demand recovery at the end of the year.

3. Individual investor
Good afternoon. I have a question about M&A. This summer, the Company purchased 10% stake in ALROSA-Nyurba and now ALROSA has control over more than 98% stake, but there are still about 2% minority holders. Certainly ALROSA has no legal obligation by Russian law, on the other hand, the Company always follows higher corporate policies. Does the Company plan any tender offer to Nyurba’s minority holders to give them a chance to quit by the same conditions as Yakutia or the main option is acquisition and converting Nyurba’s shares to ALROSA’ shares as you told on press release? Are there any guesses when it starts? Will be dividend payout in Nyurba as before?

Alexey Philippovskiy (translated)
So thank you very much for your referring to our commitment to maintain high corporate governance standards in our Company. Indeed, in the mid-term, we believe it would be most appropriate to actually continue with the complete integration of Nyurba into the bigger ALROSA that the final decision on that has not been made yet. The same applies to the payout of dividends in 2018. It's being under consideration. Just to restate that the final decisions on this matters has not been made yet.

4. Anna Antonova – J.P. Morgan
Good afternoon, gentlemen. Two questions from our side. First on the employee stock option plan. You have been purchasing shares from the market year-to-date and last purchase made in Q3 as well. Could you please provide some guidance whether the accumulated 2.1% treasury stock is close to the limits that you have for the program and if not, could you please guide us whether you plan any further purchases of shares from the market in Q4 or maybe you could guide us about the total volume of the program? And the second question is, given that the minor changes in your sales and production guidance for this and next year. Could you please confirm your maybe CAPEX guidance, which you gave in July this year
for 2019 and 2020, which was I think about RUB26 bn for next year and around RUB28 billion for 2020. So my question basically is whether this CAPEX guidance still holds?

**Alexey Philippovskiy** (translated)

So let me start with answering your first question regarding the option program. Yes, indeed 2.1% is the right figure. This is the stock in the charter capital, which you referred to. We do not plan to grow it to 2.5%, but we could if we decide to do that. So now decision has been taken to purchase the remaining 0.4% of the market.

As for the second question, I do reaffirm the figures you referred to RUB26 bn of CAPEX for 2019 and RUB28 bn rubles for CAPEX in 2020, but let me underline that these figures will not include the potential costs for or related to Mir mine recovery since the decision of that has not been made yet.

5. **Yuri Vlasov – SOVA Capital**

Good afternoon, gentlemen. My question is about your overseas assets. Could you explain or tell us as much as you can. Is there a possibility that you could switch to off-take agreement with your stake in Catoca rather than receive financial benefits, which by all means, are not huge?

**Alexey Philippovskiy** (translated)

So answering the question, let me follow up on saying that such a scenario as you were referring to is not on the discussion right now, because it is pre-determined by the agreement which has been signed and actually the developments of an asset in that foreign jurisdiction is related to very complex legal matters and consequences. So, in agreement, it was clearly stated that we are going to act as a financial investor and we're going to adhere this arrangement.

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