Metinvest and DTEK:

Risks from the railroad blockade

Alexander Paraschiy | ap@concorde.com.ua
Andriy Perederey | aper@concorde.com.ua

CONCORDE CAPITAL

February 22, 2017

Summary

The blockade of most of the railway connections with the occupied territory of Donbas started in late January and intensified on Feb. 11. It has already had an adverse effect on Metinvest and may have an effect on DTEK - the two holdings that depend heavily on commodity transit to and from occupied Donbas.

As of now, the activists who are making the blockade demand the freeing of all hostages (kept on occupied territory) and that the Ukrainian parliament adopt a law on occupied territories that will include a ban on trade with the occupiers.

Our base-case scenario is that the blockade will finish some time in March. If so, it will have a **minor effect on** DTEK (the affected power plants of which still have coal stockpiles for about seven weeks) and **some negative effect on Metinvest** (whose Yenakiyeve Steel and Krasnodon Coal have been stopped recently).

Our analysis suggests that a permanent blockade will cause a bigger negative effect on the EBITDA of DTEK than Metinvest, all else being equal.

In any scenario, Metinvest will generate more free cash flow than it needs for a smooth interest payment (in maximum possible amount of 10.88%), so **we are bullish on METINV bonds.**

For DTEK, any scenario (even the no-blockade case) does not guarantee enough cash flow for smooth interest payments in 2017, so **we currently are cautiously neutral on DTEKUA bonds.** The blockade is only one of many unknown factors for DTEK in 2017.

If the blockade continues permanently:

- **Metinvest** will lose about 8% of its revenue and about 10% of its EBITDA, as compared to a no-blockade scenario. In this case, Metinvest will be still able to generate about USD 520 mln of free cash flow (vs. USD 640 mln in base-case) which will enable it to smoothly pay full interest on its debt (USD 245 mln) and even deleverage.
- **In the very worst case for Metinvest** (if it will have to stop Avdiyivka Coke), it will lose about 22% of its revenue and 24% of its EBITDA. Even in this case, Metinvest will be able to generate about USD 400 mln of free cash flow, we estimate. This would be still enough to service its debts smoothly.

- **DTEK's** revenue will not suffer much in the case of a blockade, but its costs will increase due to the need for coal imports. The total annualized effect on EBITDA (as compared to a no-blockade-case) may be close to 25%, if the holding will have to import all the anthracite for its two power plants located in central Ukraine.
- We believe **DTEK** will be able to limit its CapEx by the corresponding amount so that the effect of the blockade on its free cash flow won't be significant.

Another risk for DTEK (irrespective to the blockade removal) is that the power blockade revealed the lack of efficiency of beneficial pricing for the electricity produced by Ukrainian thermal power plants (the price is now a function of the international steam coal index API2). The key idea of this methodology was to enable power plants to buy coal abroad, while DTEK continued to get most of its coal from own mines in 2H16.

The new pricing methodology, valid since April 2016, caused an 82% yoy increase of the average price of electricity sold by DTEK's thermal power plants, up by to UAH 1700/MWh in 4Q16. Since beginning of 2017, the price declined 20% as compared to 4Q16. The removal of the beneficial pricing methodology (which could be made, e.g. on the demand of the activists close to those responsible for the railway blockade) will have a negative effect on the prices achieved by DTEK's power plants, and thus on DTEK's ability to generate cash.

The blockade and DTEK, Metinvest assets

Currently the railway blockade makes it impossible for DTEK and Metinvest to supply any goods though the line separating the occupied and government-controlled parts of Ukraine. The only exception is Luhanska Thermal Power Plant, which is located outside the occupied zone but still receives coal from the zone.

DTEK: three thermal power plants (TPPs) and three mines suffer from the blockade

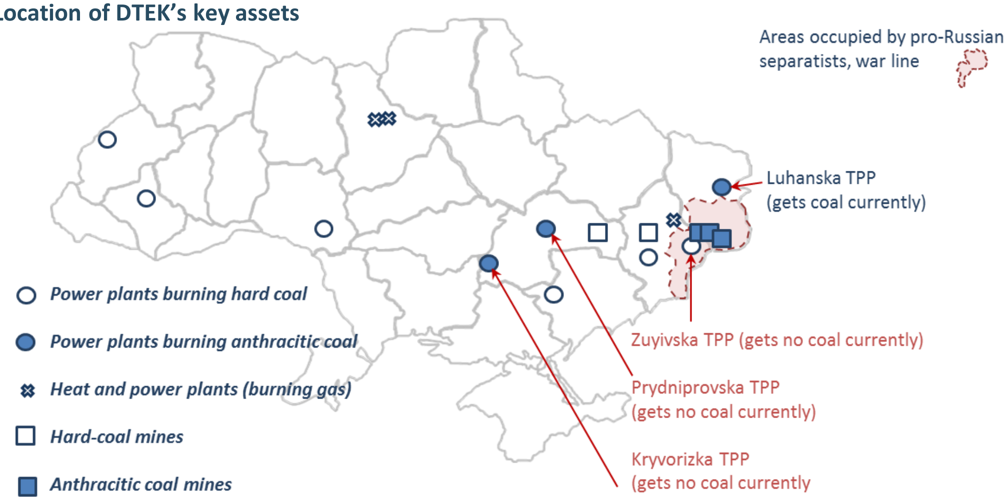
- Prydniprovska and Kryvorizka TPPs, located in central Ukraine (they produced 17% of total DTEK's electricity in 2016). They receive anthracite coal mined by DTEK in the occupied zone. Thus far, the plants have enough coal stockpiles to operate in the current (economy) mode for 67 and 49 days, respectively. If the blockade won't finish in seven weeks, they will have to import all their coal from abroad.
- Zuyivska TPP (8% of DTEK's power generation), located in the occupied zone, but depends on hard steam coal supplies from outside the zone (no hard steam coal is mined there). Theoretically, it can burn some mix of lean coal (mined by DTEK in the zone) and coking coal (also available there). But there is a risk of it being stopped very soon.
- Luhanska TPP (8% of DTEK's power generation) is still receiving anthracite from the occupied zone, as it's not easy to block the railway connection there. In case it is blocked (which is not very likely), it will be hard for the plant to import coal.
- Three mines producing anthracitic coal (28% of DTEK's mining in 2016), are located in the zone. Currently, they can only supply coal to DTEK's Luhanska TPP (which consumed about 27% of their total mining output in 2016).

Metinvest: all assets in the occupied zone are idle now

- Yenakiyeve Steel, located in the zone, depends on iron ore and coke supplies from government-controlled territory. The holding reportedly stopped steel production there on Feb. 20. Yenakiyeve accounted for 21% of Metinvest's reported steel production (excluding its JV Zaporizhstal).
- Krasnodon Coal (contributing about 10% of coking coal inputs for Metinvest coke plants in 2016) has been idle since Feb. 20.

- Also, the whole situation might have a negative effect on Avdiyivka Coke (which made more than half of Metinvest's coke in 2016). The plant is constantly suffering from artillery shelling. It might have been heavily dependent on coking coal supplies from the war zone (Metinvest has no consistent info on that). Also, according to DTEK, this plant gets electricity from Zuyivska TPP, which is under risk of completely running out of coal. We believe some idling of Avdiyivka is possible, for any reason, but that it will not last for a long time.

Location of DTEK's key assets



Location of Metinvest's key assets

Source: Company data, Concorde Capital research

Dependence on the cross-line:

Hard-coal-to-power-generation cycle: low

- Only Zuyivska power plant (8% of DTEK's power generation) is unable to get hard coal. The rest of the hard-coal-fired TPPs (59% of DTEK's power generation) easily receive their coal;
- Hard coal from DTEK's mines can be supplied to third parties if Zuyivska is not accessible.

Anthracitic-coal-to power-generation cycle: heavy

- Two power plants in central Ukraine (17% of DTEK's power generation) don't receive coal. Importing is possible but will cost twice more for the power plants;
- Most anthracite coal (28% of DTEK's coal mining) is not reachable by consumers.

Risks: the third anthracite-using power plant (Luhanska TPP), located to the north of Luhansk on government territory, may be blocked too. Coal deliveries from abroad are hard to implement for this power plant, as it has no port connections that bypass occupied territory.

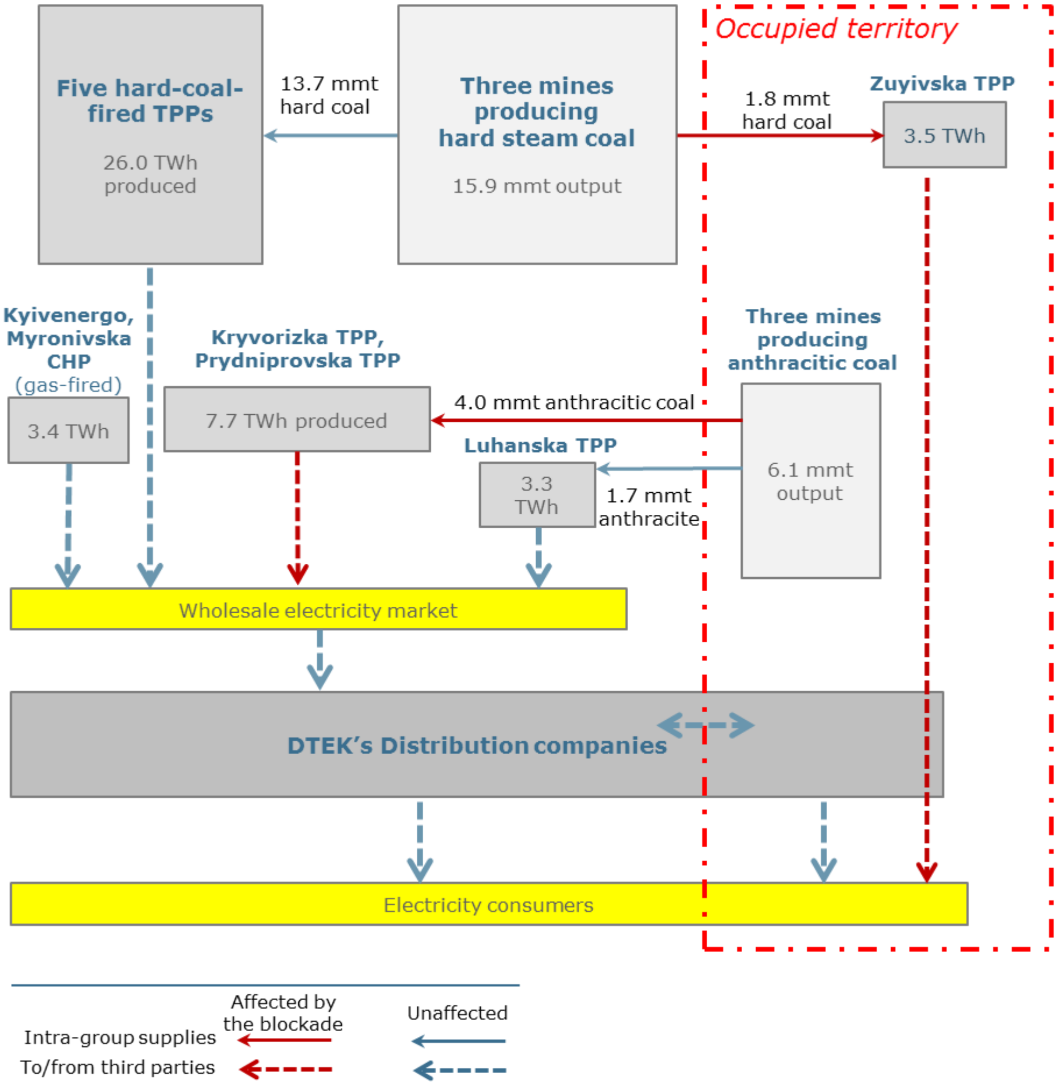
Power distribution segment: low

- Power is easily supplied to any location, so nothing has changed with the railway blockade;
- However, payment discipline in the occupied territory is very poor. The share of the war zone in DTEK's total electricity supplies is close to 30%.

Other risks, opportunities of the blockade:

- In case the blockade goes on, DTEK will need to import more coal, which will inflate its costs. Theoretically, the power sector regulator may include additional costs in an increased tariff for DTEK's power plants to offset the negative effect.
- The government/regulator may decrease the average electricity price of DTEK's power plants, e.g. in exchange for a removal of blockade, which will negatively affect DTEK's fundamentals.

DTEK production chain in 2016, occupied zone and the blockade



Source: Company data, Energobiznes, Concorde Capital research

Blockade scenarios for DTEK

In scenario without blockade (0), we assume DTEK will produce the same amount of coal and power in 2017 as in the year before. We also estimate that DTEK generated EBITDA of USD 550 mln in 2016, and will generate about USD 470 mln in EBITDA in 2017.

(1) current situation, i.e. the blockade remains as it is:

- The blockade will make it impossible to deliver anthracitic coal to Kryvorizka and Prydniprovska TPPs.
- Luhanska TPP will continue receiving anthracite from the occupied territory.
- The blockade will make it impossible to deliver hard steam coal to Ziyivska TPP.
- The mining of hard steam coal will increase 5% yoy.

In such case, we expect:

- Kryvorizka and Pridniprovska TPPs will decrease their power output 50% yoy. They will have to import anthracite (about 2 mmt p.a.) at an additional cost of around USD 50/t.
- Zuyivska TPP will stop (which is very conservative assumption).
- Output of Luhanska TPP will be unchanged.
- All the other TPPs (fired by hard coal) will increase their output so that DTEK's total electricity output is flat yoy.

This case will imply:

- DTEK will have to import about 2.0 mmt of anthracite and 0.4 mmt of hard steam coal, annually. This will imply an increase of coal costs of about USD 120 mln (implying a respective decrease in annual EBITDA).

(2) the blockade intensifies to entire war line:

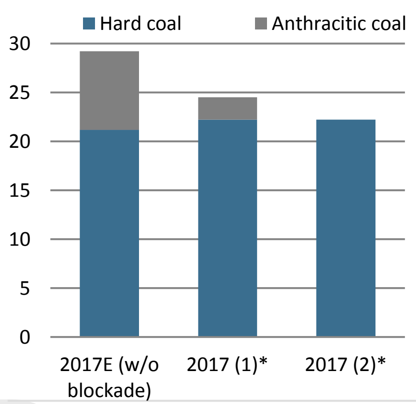
- The blockade will make it impossible for Luhanska TPP to receive anthracite. It will become idle.
- All other things are as in scenario (1).

Such case will imply:

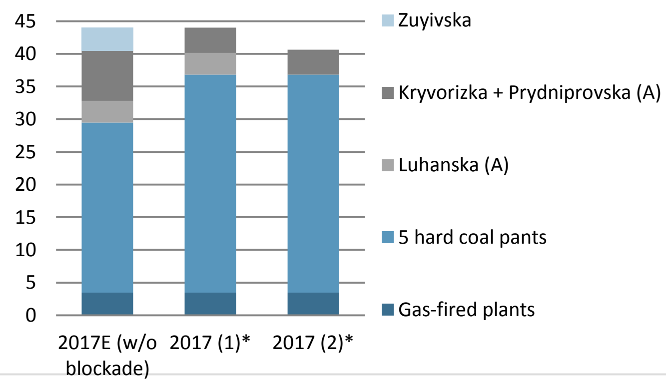
- DTEK will lose sales of Luhanska's power (about USD 150 mln p.a.). This will decrease EBITDA by about USD 40 mln p.a.
- DTEK will have to import annually about 2.0 mmt of anthracite and 0.4 mmt of hard steam coal. This will imply an increase of coal costs by about USD 120 mln p.a.

In our view, in any scenario (including the no-blockade-case), DTEK will only be able to smoothly pay interest on its debt if it significantly limits its CapEx appetites – well below the allowed cap for 2017 (about USD 475 mln).

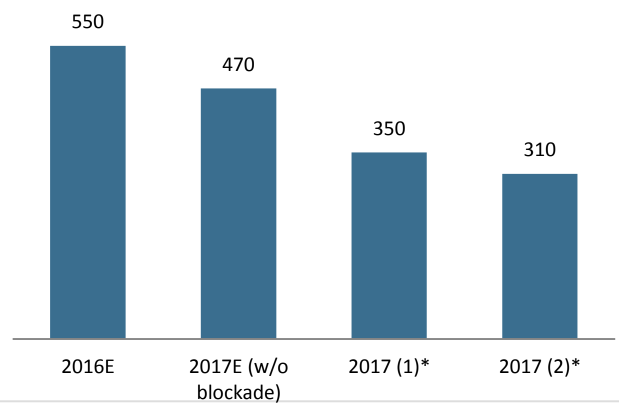
DTEK coal mining scenarios (ROM), mmt



DTEK power generation scenarios, TWh



EBITDA by scenarios, USD mln



** Calculated based on annualized effect (i.e. assuming the scenario is applied for the entire 2017 year)*
Source: Company data, Energobiznes, Concorde Capital research

Metinvest production/supply chain, 2016

Dependence on the cross-line:

Iron ore: very low

- no iron ore is mined in the zone;
- in case of a blockade, the holding may redirect ore sales to external markets.

Risk: No info on how much ore is supplied to third parties in the war zone (but it's unlikely to be more than 7% of total production, and its supply can be switched for export).

Coal and coke: medium

- All operational coke plants are outside the zone;
- Coal input from its mine in the zone looks insignificant;
- Coke supplies to the zone look insignificant, theoretically may be switched to other markets.

Risks:

- A lot of third party coal may be supplied from the zone (no info available, but the holding told us its sources of coking coal supply are diversified). The blockade may have a short-term effect on coal supply;
- The biggest coke plant (Avdiyivka) is located very close to the war zone (constant risk of damage).

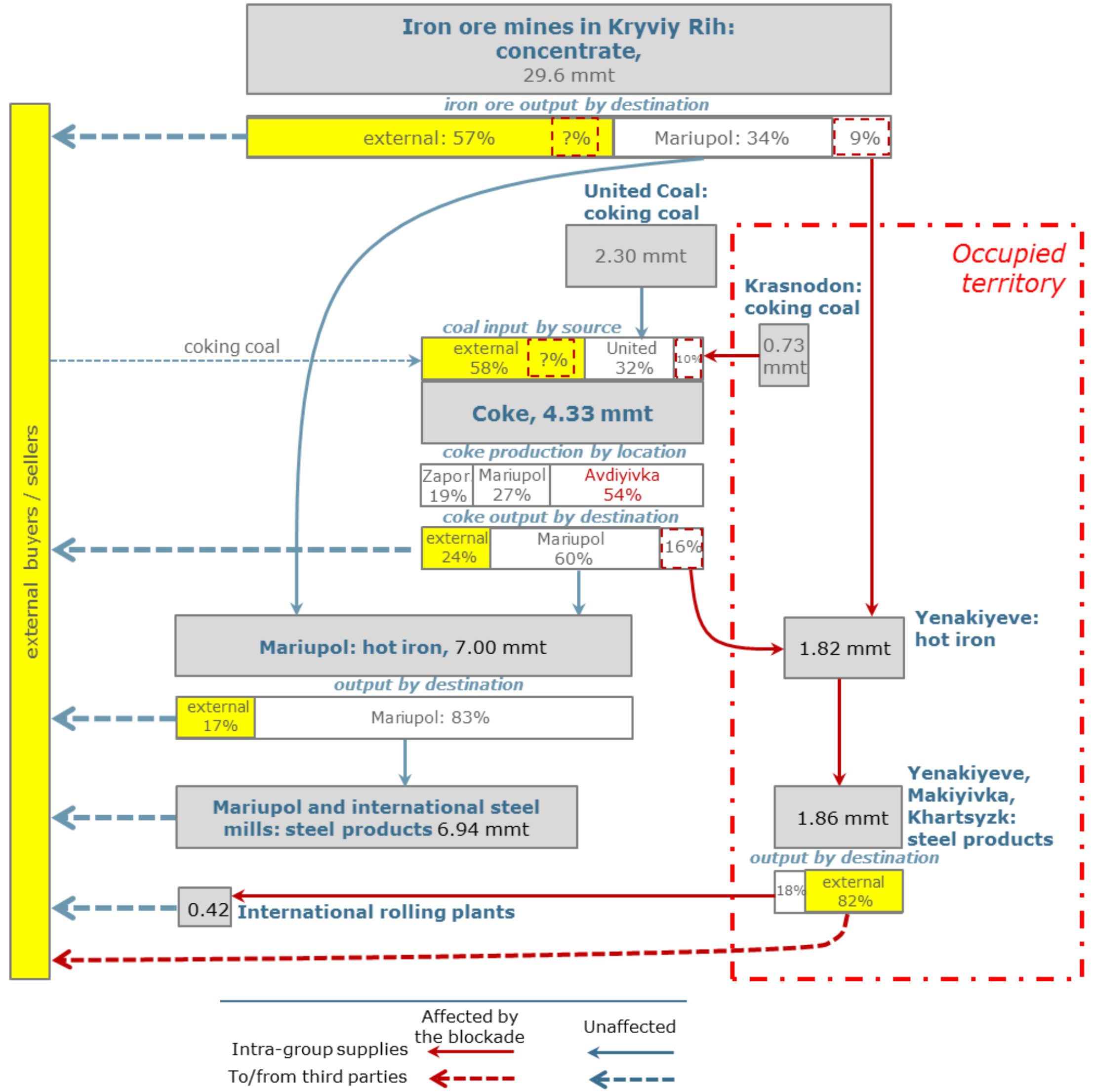
Hot iron, steel & steel products: medium:

- The war zone accounts for production of 21%* of Metinvest's crude steel and about 20%* of metal product sales. In case the blockade goes on, Metinvest won't have steel production in the war zone.

Risks:

- Maripol-based plants (namely, Illich Steel) may suffer from a coke deficit (see coke risks above).

Metinvest production chain in 2016, occupied zone and the blockade*



* *The data does not include Zaporizhstal, a JV in which Metinvest has a share of 50%.*
Source: Company data, Concorde Capital research

Blockade scenarios for Metinvest

In scenario without blockade (0), we assume Metinvest will produce the same amount of steel, ore, and coke in 2017 as in the year before. We also estimate Metinvest will generate EBITDA of USD 2.20 bln in 2017 (up 64% yoy).

(1) current situation, i.e. the blockade remains as it is:

- Yenakiyeve Steel and Krasnodon Coal will remain idle. This will lead to a 22% p.a. decrease in steel products sales by Metinvest (-11.3% of the holding's revenue, -9.8% of EBITDA);
- Metinvest's coke plants will get 10% less coking coal (supplied from Krasnodon), but internal consumption of coking coal will decrease (due to idled Yenakiyeve), so the holding will be able to sell an additional 0.23 mmt of coke p.a. to the market (+0.9% of total revenue);
- Metinvest's iron ore plants will supply an additional 2.6 mmt of iron ore (due to idled Yenakiyeve) to the market (+2.7% revenue).
- Overhead costs of idled facilities may be close to USD 40 mln p.a.

The total effect on revenue will be -8%; on EBITDA will be -12%.

Even if the blockade will be permanent, Metinvest will be able to generate USD 1.70 – 1.96 bln in EBITDA annually (as compared to USD 2.22 bln in case of no blockade). We estimate this will allow Metinvest to generate USD 400 – 520 mln in free cash flow annually (vs. USD 640 mln in the case of no blockade). This will be enough for the holding to pay fully the 10.875% interest due on its debts in 2017 (including catch-up interests/repayments) which total USD 245 mln p.a.

(2) the blockade will lead to the idling of Avdiyivka Coke:

This can happen for two reasons:

- The blockade will stop Zuyivska Power Plant (see DTEK case), which is the core supplier of electricity to Avdiyivka. If no alternative power supply will be found, this may lead to the coke plant being idled.
- It could be that Avdiyivka was getting most of its coking coal from beyond the war line.

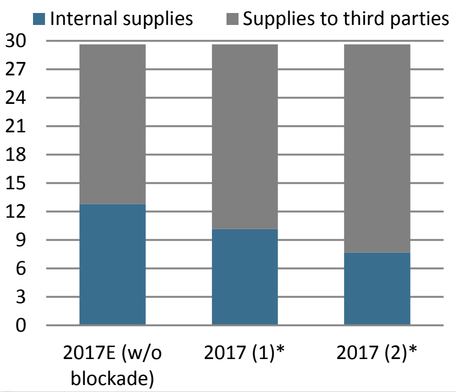
In any case, the idling of Avdiyivka will be temporary.

In such case:

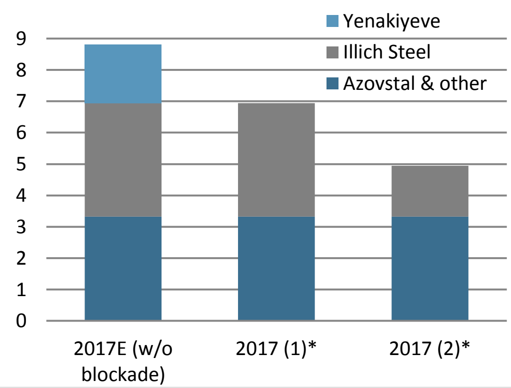
- Due to the lack of coke, production of hot iron (and steel) by Maripol-based Illich Steel will decrease by 55% (in addition to idling Yenakiyeve). The total effect on sales, compared to case (0), will be -24%, and -20% on EBITDA.
- No coke sales to third parties (-3% of revenue). Additional iron ore sales (+5% of revenue).

Total effect on revenue will be -22%; on EBITDA it will be -24%.

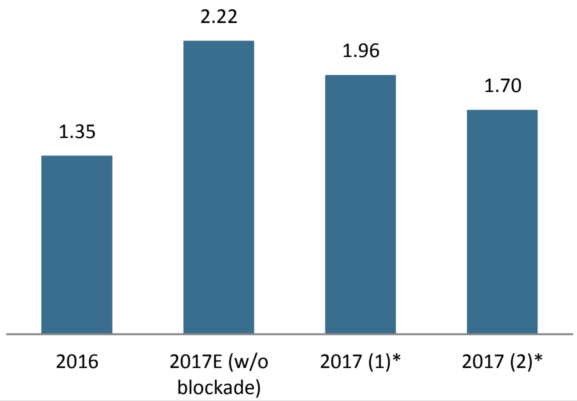
Iron ore concentrate output, mmt



Steel & products output, mmt



Metinvest EBITDA by scenarios, USD bln



** Calculated based on annualized effect (i.e. assuming the scenario is applied for the entire 2017 year)*

Source: Company data, Energobiznes, Concorde Capital research

Disclaimer

THIS REPORT HAS BEEN PREPARED BY CONCORDE CAPITAL INVESTMENT BANK INDEPENDENTLY OF THE RESPECTIVE COMPANIES MENTIONED HEREIN FOR INFORMATIONAL PURPOSES ONLY. CONCORDE CAPITAL DOES AND SEEKS TO DO BUSINESS WITH COMPANIES COVERED IN ITS RESEARCH REPORTS. AS A RESULT, INVESTORS SHOULD BE AWARE THAT CONCORDE CAPITAL MIGHT HAVE A CONFLICT OF INTEREST THAT COULD AFFECT THE OBJECTIVITY OF THIS REPORT.

THE INFORMATION GIVEN AND OPINIONS EXPRESSED IN THIS DOCUMENT ARE SOLELY THOSE OF CONCORDE CAPITAL AS PART OF ITS INTERNAL RESEARCH COVERAGE. THIS DOCUMENT DOES NOT CONSTITUTE OR CONTAIN AN OFFER OF OR AN INVITATION TO SUBSCRIBE FOR OR ACQUIRE ANY SECURITIES. THIS DOCUMENT IS CONFIDENTIAL TO CLIENTS OF CONCORDE CAPITAL AND IS NOT TO BE REPRODUCED OR DISTRIBUTED OR GIVEN TO ANY OTHER PERSON.

CONCORDE CAPITAL, ITS DIRECTORS AND EMPLOYEES OR CLIENTS MIGHT HAVE OR HAVE HAD INTERESTS OR LONG/SHORT POSITIONS IN THE SECURITIES REFERRED TO HEREIN, AND MIGHT AT ANY TIME MAKE PURCHASES AND/OR SALES IN THEM AS A PRINCIPAL OR AN AGENT. CONCORDE CAPITAL MIGHT ACT OR HAS ACTED AS A MARKET-MAKER IN THE SECURITIES DISCUSSED IN THIS REPORT. THE RESEARCH ANALYSTS AND/OR CORPORATE BANKING ASSOCIATES PRINCIPALLY RESPONSIBLE FOR THE PREPARATION OF THIS REPORT RECEIVE COMPENSATION BASED UPON VARIOUS FACTORS, INCLUDING QUALITY OF RESEARCH, INVESTOR/CLIENT FEEDBACK, STOCK PICKING, COMPETITIVE FACTORS, FIRM REVENUES AND INVESTMENT BANKING REVENUES.

PRICES OF LISTED SECURITIES REFERRED TO IN THIS REPORT ARE DENOTED IN THE CURRENCY OF THE RESPECTIVE EXCHANGES. INVESTORS IN FINANCIAL INSTRUMENTS SUCH AS DEPOSITORY RECEIPTS, THE VALUES OR PRICES OF WHICH ARE INFLUENCED BY CURRENCY VOLATILITY, EFFECTIVELY ASSUME CURRENCY RISK.

DUE TO THE TIMELY NATURE OF THIS REPORT, THE INFORMATION CONTAINED MIGHT NOT HAVE BEEN VERIFIED AND IS BASED ON THE OPINION OF THE ANALYST. WE DO NOT PURPORT THIS DOCUMENT TO BE ENTIRELY ACCURATE AND DO NOT GUARANTEE IT TO BE A COMPLETE STATEMENT OR SUMMARY OF AVAILABLE DATA. ANY OPINIONS EXPRESSED HEREIN ARE STATEMENTS OF OUR JUDGMENTS AS OF THE DATE OF PUBLICATION AND ARE SUBJECT TO CHANGE WITHOUT NOTICE. REPRODUCTION OF THIS DOCUMENT IN WHOLE OR IN PART WITHOUT PRIOR PERMISSION IS PROHIBITED.

NEITHER THIS DOCUMENT NOR ANY COPY HEREOF MAY BE TAKEN OR TRANSMITTED INTO THE UNITED STATES OR DISTRIBUTED IN THE UNITED STATES OR TO ANY U.S. PERSON (WITHIN THE MEANING OF REGULATIONS UNDER THE U.S. SECURITIES ACT OF 1933, AS AMENDED (THE “SECURITIES ACT”)), OTHER THAN TO A LIMITED NUMBER OF “QUALIFIED INSTITUTIONAL BUYERS” (AS DEFINED IN RULE 144A UNDER THE SECURITIES ACT) SELECTED BY CONCORDE CAPITAL.

THIS DOCUMENT MAY ONLY BE DELIVERED WITHIN THE UNITED KINGDOM TO PERSONS WHO ARE AUTHORIZED OR EXEMPT WITHIN THE MEANING OF THE FINANCIAL SERVICES AND MARKETS ACT 2000 (“FSMA”) OR TO PERSONS WHO ARE OTHERWISE ENTITLED TO RECEIVE THIS DOCUMENT UNDER THE FINANCIAL SERVICES AND MARKETS ACT 2000 (FINANCIAL PROMOTION) ORDER 2005, OR ANY OTHER ORDER MADE UNDER THE FSMA.

Contacts

2 Mechnikova Street, 16th Floor
Parus Business Centre
Kyiv 01601, Ukraine
Tel.: +380 44 391 5577
Fax: +380 44 391 5571
www.concorde.ua
Bloomberg: TYPE CONR <GO>

CEO
Igor Mazepa im@concorde.com.ua

SALES & TRADING

Alexandra Kushnir	ak@concorde.com.ua
Marina Martirosyan	mm@concorde.com.ua
Yuri Tovstenko	ytovstenko@concorde.com.ua
Alisa Tykhomirova	at@concorde.com.ua

RESEARCH

Head of Research	
Alexander Paraschiy	ap@concorde.com.ua
Macro, Utilities, Financial	
Alexander Paraschiy	ap@concorde.com.ua
Basic Materials	
Andriy Perederey	aper@concorde.com.ua
Consumer	
Igor Zholonkivskyi	zi@concorde.com.ua
Editor, Politics	
Zenon Zawada	zzawada@concorde.com.ua
James Hydzik	