CONCORDE CAPITAL

Ukraine
Fixed Income | Iron / Steel
Company Update

October 23, 2014

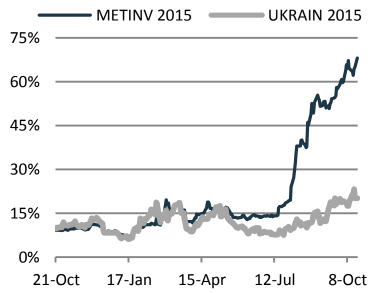
Metinvest

Restructuring of its shorter bond is on the table, but it might not be enough

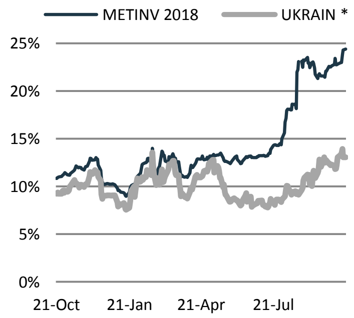
Roman Topolyuk
rt@concorde.com.ua

Bloomberg ticker	**METINV**
Outstanding, USD mln	500
Maturity	20 May 2015
Coupon	10.25%
Fitch / Moody's / S&P	CCC / Caa2 / na
Outstanding, USD mln	750
Maturity	14 Feb 2018
Coupon	8.75%
Fitch / Moody's / S&P	CCC / Caa2 / na

YTM



YTM



**Interpolated yields for Ukrainian sovereign bonds maturing in Nov. 2017 and Sept. 2020*

Source: Bloomberg

Ukraine's largest steelmaker, the vertically integrated holding company Metinvest (METINV), reported solid 1H14 financial results on Oct. 21 and, on the same day, issued an exchange offer for its 2015 Eurobond. The restructuring move had been highly anticipated by the market and has a high chance to be approved by the majority of bondholders, we believe. However, the company's management didn't make certain during an Oct. 21 conference call when – or whether at all – production at its three steelmakers would be restored to full load. While margins are shifting towards the steelmakers at the expense of iron ore mining, given the current and projected low capacity loads, Metinvest is slated to report poor financials in 2015. This will require additional involvement of both banking lenders (postponing the maturity of their facilities) and shareholders (claiming sharply less dividends). As both measures aren't the case yet, we maintain our negative view on Metinvest bonds.

Robust 1H14 financials. Metinvest reported strong 1H14 financial results. Despite an 8% yoy decrease in revenue to USD 6 bln, prompted by falling sales volumes and selling prices, EBITDA for the period grew 29% yoy to USD 1.6 bln, its EBITDA margin grew 10pp to 29%, net income surged 46% yoy to USD 653 mln, and its net margin improved by 4pp to 11%. Operating cash flow before working capital changes grew 17.5% yoy to USD 1.39 bln. Though EBITDA came in 11% lower than we projected for the period, generally profits were positively influenced by the deep hryvna devaluation, and to a lesser extent by efficiency projects, like the implementation of a PCI at Ilyich Steel, as well as a decrease in raw materials prices.

Maturity extension for 2015 bonds offered as an equivalent to divs. Simultaneously with the 1H14 results, Metinvest made an offer of a cash upfront payment to the holders of METINV 2015 bonds at 20% of the bond's principal, while the 80% balance (equivalent to USD 400 mln) could be exchanged for notes maturing on Nov. 24, 2017. This offer expires on Nov. 18. It also includes a coupon increase to 10.5% from 10.25%, and a one percent incentive fee for those bondholders who agree to the proposal by Oct. 31. Despite operating conditions worsening significantly in 3Q14, which is one of the reasons for the restructuring talks, Metinvest paid USD 250 mln in dividends in 1H14, and is planning to distribute around USD 400-415 mln for the full year of 2014, which is equivalent to the offered restructuring. Questions surrounding the appropriateness of offering a maturity extension at the same time as paying out generous dividends were frequently posed during the conference call.

Metinvest started talks with banking lenders. On top of USD 500 mln in Eurobonds to be repaid next year, Metinvest has to redeem USD 1.2 bln in banking loans by the end of 2015. Company management stated it is conducting negotiations with banking creditors and is expecting that a deal could be concluded by the end of 2014.

Selected financial items of Metinvest, USD mln

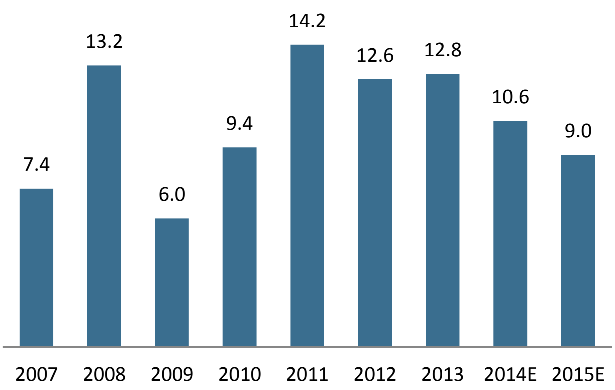
	1H13	1H14E	Chg yoy	2012	2013	2014E	2015E
Revenue	6,515	6,023	-8%	12,565	12,807	10,605	9,009
EBITDA	1,243	1,609	29%	1,985	2,291	2,034	1,624
Net income	443	653	47%	435	592	685	-75
CapEx	290	279	-4%	765	747	450	451
Dividends	284	253	-11%	575	544	398	395

Source: Company data, Concorde Capital estimates

Warfare and logistics hurdles still in place. The operating environment in Ukraine's industrial hub, the Donbas region, remains tough due to damaged railroads and continued shelling. Management doesn't expect the restoration of steel production volumes back to normal in the foreseeable future. Metinvest is restarting Yenakiyeve Steel, but plans to maintain production at the level of 50% of capacities. Two Mariupol steelmakers, Azovstal and Ilyich Steel, are running at 50-60% capacity load and Metinvest doesn't project a significant recovery so far. Krasnodon Coal – a domestic coking coal miner that satisfies up to 24% of the holding's needs – endured bombardment and logistics constraints in August. Beginning in October, the subsidiary restarted production with capacity utilization of around 24%.

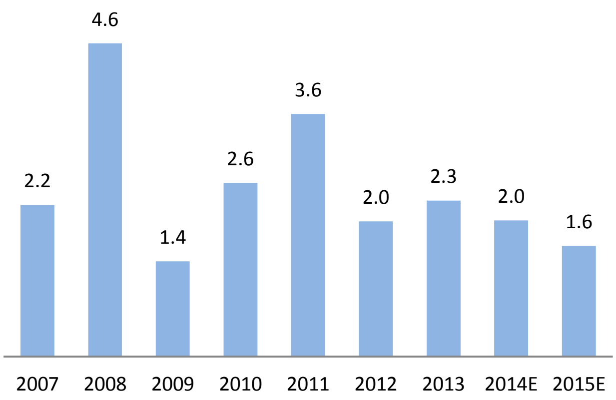
Theoretically, full recovery of railways and production volumes could be achieved within a month, according to management, but it remains unclear precisely when it may happen. Modeling 2015 production volumes as they are now, we project steel product sales of 10.6 mmt next year, 27% less than 2013 and 11% less compared to our outlook for 2014. Under such a scenario, we forecast EBITDA of USD 1.6 bln in 2015, compared to USD 2.3 bln in 2013 and our projection of USD 2.0 bln in 2014.

Revenue of Metinvest, USD bln



Source: Company data, Concorde Capital estimates

EBITDA of Metinvest, USD bln



Source: Company data, Concorde Capital estimates

Profits are drifting to steelmaking division. The 1H14 financial report earmarked a structural shift of profitability from iron ore miners towards steel producers, along with an ongoing plunge in iron ore prices (by 38% YTD to USD 80/t). If more than 80% of Metinvest's EBITDA had been generated in mining previously, by 1H14 already more than a third of EBITDA of USD 572 mln came from the metallurgical division. We expect this proportion will only increase as an oversupply on the global iron ore market will push prices further down. With its vertically integrated structure, Metinvest could partially compensate for the decline in iron ore prices with higher profits from its steel enterprises, but due to logistics constraints, the holding isn't able to do that to the fullest extent.

Metinvest limits capital expenditures. Metinvest reported CapEx of USD 279 mln in 1H14 (-4% yoy), almost evenly split between its metallurgical and mining divisions. The working capital investments amounted to USD 276 mln during the period. For as long as the war continues, the company most likely will keep CapEx at current levels, or around USD 450 mln annually in 2014-15, while investments in normal circumstances would be closer to USD 700 mln a year, we estimate. Key projects will be the installation of a PCI unit at Yenakiyeve Steel and Azovstal, as well as crusher and conveyor technology at Northern Iron Ore.

The company doesn't need funding to reconstruct facilities damaged by warfare on any material level, as was made clear from management's comments during the call.

Shareholders and banking lenders to be involved in the "bailout" plan. If the company doesn't manage to get back to normal steel products output in 2015, and capacity load remains throughout the year as reported by management now, we project Metinvest will be able to generate only USD 943 mln in net operating cash flow next year, implying free cash flow of about USD 500 mln. This can cause a substantial liquidity gap at the end of 2015, even if the 2015 Eurobonds would be exchanged as proposed by the issuer (USD 908 mln of banking debt to be redeemed next year). Such a scenario would also require shareholders to scale down dividends from the current annual level of USD 400 mln.

Assuming the restructure happens, the bond should be priced at 80. Currently METINV 2018 trades at a YTM of 24%. We believe the shorter bond should provide a comparable yield if we take for granted that the restructuring happens (implying that 80% of its amount outstanding will be repaid in late 2017). In order to provide the comparable IRR to the 2018 bond, the shorter bond should be priced currently at 80% of par.

Contacts

CONCORDE CAPITAL
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

Alexandra Kushnir	lk@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

Macroeconomics

Alexander Paraschiy	ap@concorde.com.ua

Metals & Mining, Consumer

Roman Topolyuk	rt@concorde.com.ua

Utilities, Energy, Financials, Consumer

Alexander Paraschiy	ap@concorde.com.ua

Politics

Zenon Zawada	zzawada@concorde.com.ua

Editor

Zenon Zawada	zzawada@concorde.com.ua