Ukraine | Research
Fixed Income | Iron & Steel
Company Update

January 16, 2014

Metinvest

Favour the resilient Ukrainian metals exporter on steel sector recovery

Metinvest (METINV), the largest Ukrainian steel producer, reported its 9M13 financials in late December in which it improved its earnings yoy, in sharp contrast to its CIS peers. Though mainly one-off items were behind the better earnings during the period, Metinvest, as the least levered steel producer in the CIS, is positioned to reap the most benefits from a steel price recovery expected in 2014, which will translate into brisker free cash flow growth. The recently gained natural gas price discount for Ukraine and implementation of PCI projects will contribute to the company's margins widening. The company's leverage will remain at a safe level below 0.4x in gross debt/equity and below 1.6x in gross debt/EBITDA.

Earnings improved in 9M13 due to one-offs in 2Q13. Compared to its CIS peers, Metinvest reported quite a rosy financial performance for the first three quarters of 2013. Unlike steelmakers from neighbouring Russia, which endured falling revenues, the Ukrainian company kept its top line flat yoy (at USD 9.8 bln). Higher iron ore product revenue and almost doubled resale of Zaporizhstal products offset plunging steel product prices and finished products sales that dwindled 3% yoy. On the earnings side, Metinvest reported EBITDA of USD 1.8 bln (+18% yoy) and net income of USD 463 mln (+8% yoy). The main growth drivers were one-off items that occurred in 2Q13, including a reversal in impaired receivables and fees for overdue receivables. In 3Q13, EBITDA decreased 28% qoq to a 'normalized' quarterly level of USD 566 mln.

Leverage is declining, stays much below peers. During 3Q13, the company reduced its total debt by USD 56 mln to USD 3.7 bln (down from USD 4.3 bln December 2012). That helped to cut its total debt-to-EBITDA ratio to 1.6x as of September from 1.8x in June, significantly below its Eurobond covenant of 3x. That's a strong result compared to the range of 2.8x-8.5x for its Russian peers (see Appendix).

Profitability to bottom out, minimum debt to draw down in 2H13. Export steel prices in the Black Sea region have slumped at least 2-3% h/h in 2H13 on average, according to Metal Courier. At the same time, Metinvest sales volumes, which increased qoq in 3Q13, are likely to have dampened in 4Q13 due to seasonal weakness. Hence, its 2013 yoy operating performance will be relatively stable in its trading update. Metinvest's strong 1H13 financial result will likely be neutralized by expected lower earnings for 2H13. Thus, we expect the company will report its 2013 yoy EBITDA growth at around 15% yoy to USD 2.3 bln, which implies 2H13 EBITDA of USD 1.1 bln. The company had to finance CapEx of around USD 310-360 mln in 2H13, repay a debt of USD 260 mln and pay out dividends of around USD 300 mln. Thus, we don't see any vital need for an additional drawdown of debt facilities by the end of 2013. The company was free cash flow positive in 1H13 (at USD 596 mln) and will remain so by the year end, we estimate.

FCF positive in 2014. Metinvest will continue to generate positive free cash flow in 2014, despite its guidance of higher CapEx. This expectation relies on our fundamental assumptions, which includes improving steel prices and decreasing production costs. We forecast at least a 22% yoy EBITDA increase to USD 2.8 bln in 2014.

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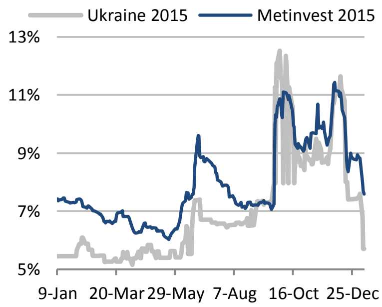
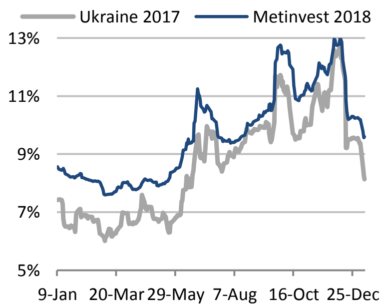
Bloomberg ticker	**METINV**
Outstanding, USD mln	500
Maturity	20. May 2015
Coupon	10.25%
Fitch / Moody's / S&P	B- / Caa1 / na
Outstanding, USD mln	750
Maturity	14. Feb 2018
Coupon	8.75%
Fitch / Moody's / S&P	B- / Caa1 / na

YTM



Source: Bloomberg

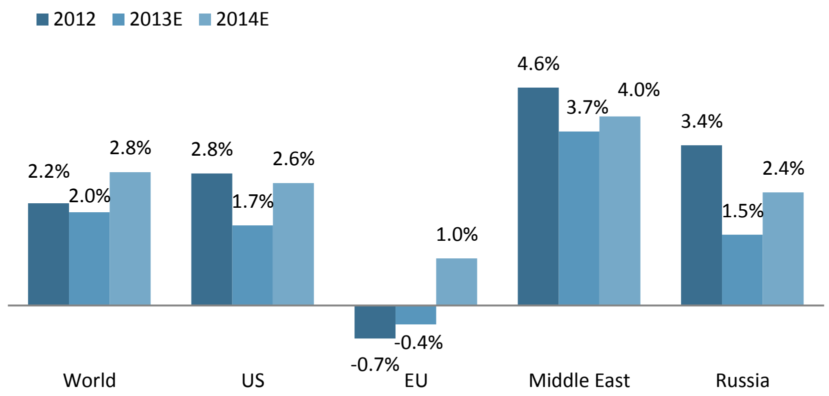
YTM



Source: Bloomberg

Steel prices to head north in 2014. The primary factor in improved profitability in 2014 will be start of a steel price recovery after last year's lows, driven by expected revitalization of economic growth on the key steel markets.

Real GDP growth, yoy, %

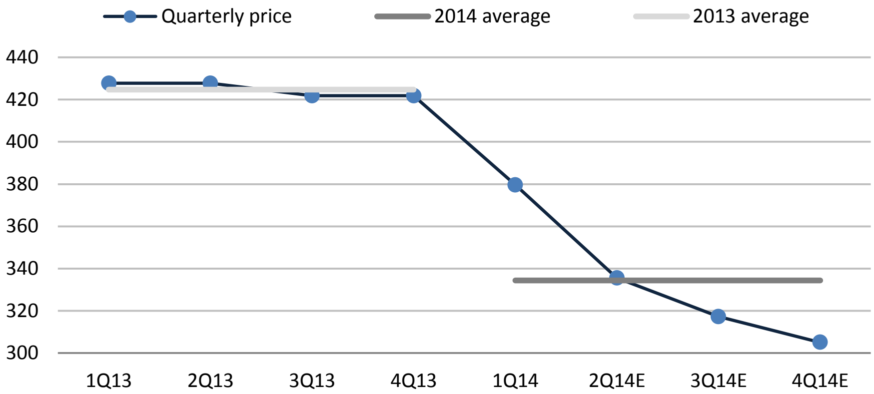


Source: Bloomberg

Ukraine's Delfica agency forecasts an increase in HRC prices in the Black Sea region by 4% yoy to USD 572/t in 1H14 and billet prices by 6% yoy to USD 548/t. Accounting for some price correction in 2H14, we project average selling price growth of 3% yoy, enhancing Metinvest's EBITDA by USD 300 mln in 2014, given stable production.

Gas price discount to improve margins. Russia's Gazprom cut Ukraine's natural gas price by USD 132 per tcm to USD 268.5/tcm upon quarterly review, according to the Dec. 17 deal. However, the domestic price for industrial consumers in Ukraine will decline in stages, as decided by the state regulator. According to the regulator's schedule, the average discount for Metinvest and other industrial consumers will reach USD 87/tcm in 2014.

Schedule of the industry's gas price in 1Q13-4Q14, without VAT and surcharges, USD/tcm,



Source: National Commission for State Regulation in Electricity Sector of Ukraine, Concorde Capital estimates

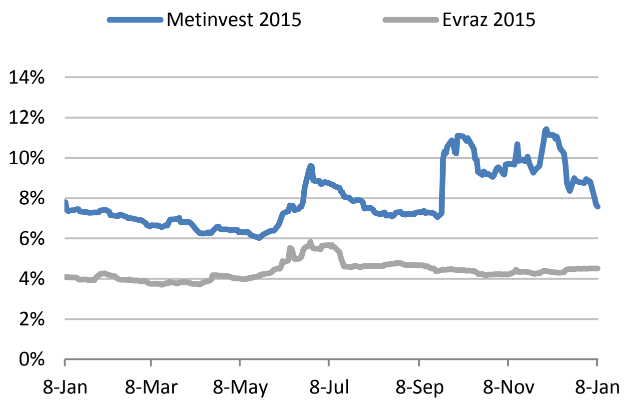
The company's annual gas consumption comprises around 1.5 bcm p.a. If the recent price discount is applied to this volume, Metinvest will save around USD 131 mln in 2014. The implementation of PCI units at Yenakievo Steel in 2014, cutting a third of the plant's gas consumption, will provide further savings of USD 60 mln.

No need to increase leverage in 2014. Before the announcement of the gas price deal between Ukraine and Russia, Metinvest's management commented that the company will have to raise USD 200-300 mln in 2014 to cover its financing needs. With the recent developments in gas price and a possible mild slide in the exchange rate, the company will be able to cut its debt further in 2014, we estimate, despite higher CapEx projections (+35% yoy to USD 1 bln). The scheduled repayment of debt is USD 867 mln in 2014. With a possible dividend payment of around USD 400 mln, total cash outflow will add up to USD 2.2 bln. With our EBITDA projections at USD 2.8 bln in 2014, Metinvest will be able to keep its gross debt-to-EBITDA ratio next year even below its last reported level of 1.6x.

No EU Association Agreement is neutral, Russia rapprochement uncertain. Since the Association Agreement wouldn't have brought any major benefits to Ukrainian steelmakers, including Metinvest, we don't see any negative implications from the suspended negotiations with the EU and warming relations with Russia. The agreement's free trade area would have made Ukraine's steel scrap deficit more acute as a result of decreased export duties. At the same time, despite Russian promises of improved trade relations with Ukraine, there is looming overcapacity on the Russian market, where large new enterprises emerged in 2012-2013. In the best case, Metinvest will keep sales to the Customs Union at current levels and any breakthrough is hardly expected. Metinvest generates 22% of its revenue in the EU, and around 15% in the Customs Union.

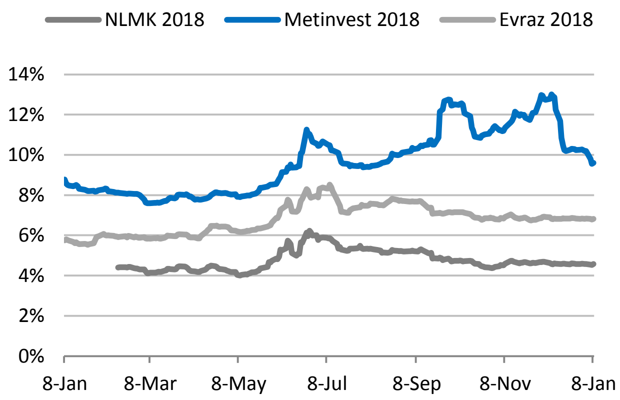
Metinvest trades at premium to peers due to sovereign. Despite being in an apparently better financial stance, having healthier leverage and stronger margins, Metinvest's bonds trade at a significant premium to its Russian peers. Historically, the rating of Ukraine's sovereign bonds served as a ceiling for corporates, including Metinvest. Though we don't expect such a ceiling to disappear in the framework of rating agencies, there are strong fundamental reasons for the bonds to trade at narrower spreads to its Russian peers.

YTMs for 2015 bonds of Metinvest and Evraz



Source: Bloomberg

YTMs for 2018 bonds of Metinvest, NLMK and Evraz

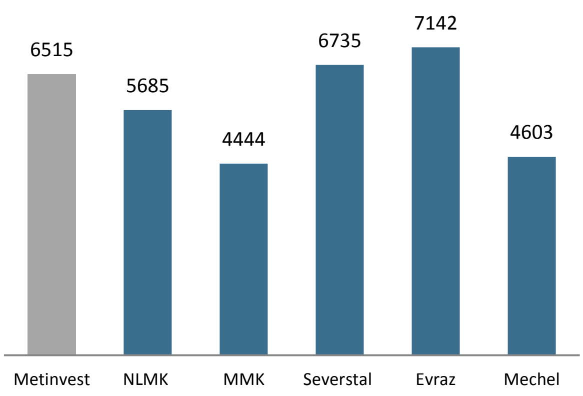


Source: Bloomberg

Shorter bond more attractive. The average spread of Metinvest 2015 to Ukraine 2015 sovereign was 102 bps during last year, and currently it's as high as 152 bps. At the same time, the Metinvest 2018 bond trades at a spread of 110 bps (to Ukraine 2017), while the historic mean is 128 bps. This makes shorter bonds more attractive.

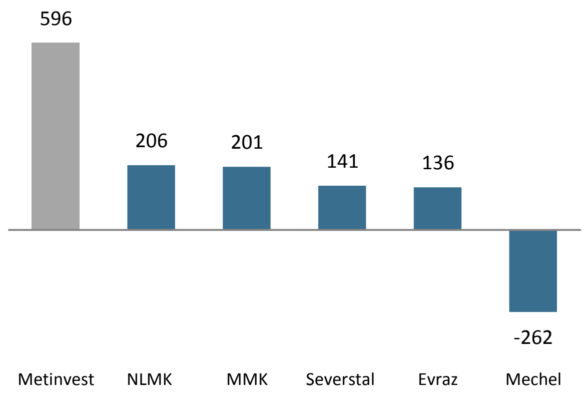
Appendix. Financials of Metinvest vs. its Russian peers

Revenue in 1H13, USD mln



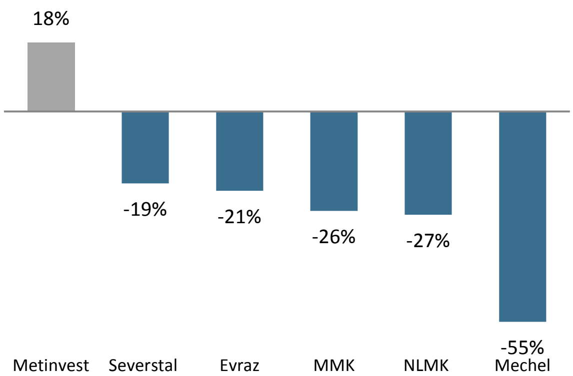
Source: Company data

Free cash flow in 1H13, USD mln



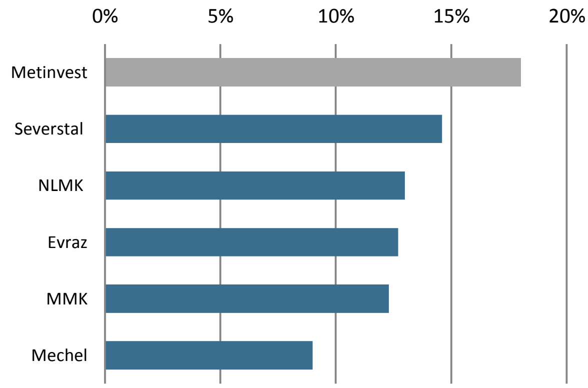
**Free cash flow = Net operating cash flow - CapEx*
Source: Company data, Concorde Capital estimates

EBITDA growth in 9M13 (1H13 for Evraz), yoy



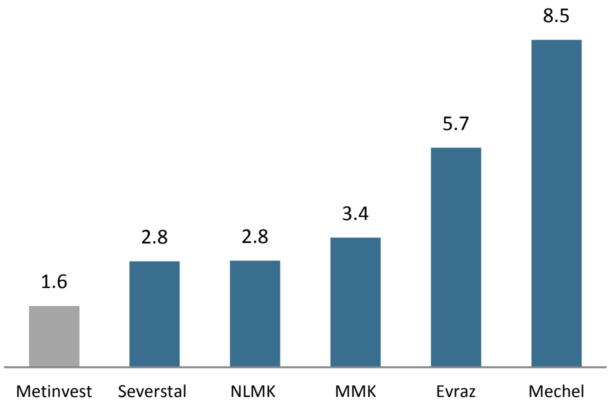
Source: Company data

EBITDA margin in 9M13 (1H13 for Evraz)



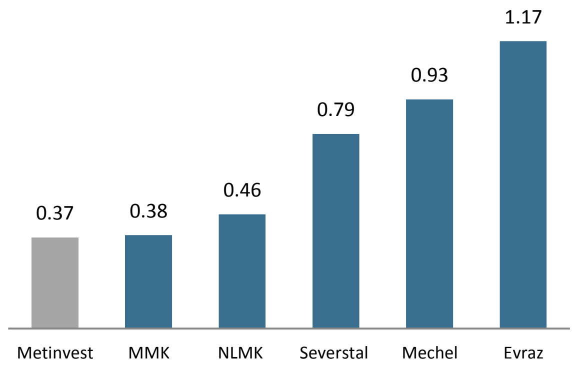
Source: Company data

Total debt-to-LTM EBITDA, as of end-September 2013 (end- June for Evraz)



Source: Bloomberg, Concorde Capital estimates

Total debt-to-equity, as of June 2013



Source: Company data, Concorde Capital estimates

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