

PhosAgro

PhosAgro Q2 and 1H 2017 IFRS results

Conference call and webcast held on 24 August 2017, 3:00 PM MSK

Edited transcript

Speakers:

- Alexander Seleznev, Head of Investor Relations
- Andrey Guryev, Chief Executive Officer, Chairman of the Management Board, Member of the Board of Directors
- Alexander Sharabaiko, Chief Financial Officer

Participants asking questions:

- Konstantin Yuminov, Raiffeisenbank
- Nikolay Sosnovskiy, Prosperity Capital Management
- Laura Gardner Cuesta, Debtwire
- Nina Dergunova, Goldman Sachs
- Kevin Whyte, VTB Capital

Operator: Ladies and gentlemen, welcome to Phosagro's Q2 and 1H 2017 IFRS results conference call and webcast. I will now hand over to our host, Mr Alexander Seleznev. Sir, please go ahead.

Alexander Seleznev: Dear colleagues, good afternoon and welcome to our Q2 2017 IFRS results conference call. Presenting today will be Alexander Seleznev, Head of IR Department. As usual, we also have the entire management team here in the room ready to answer all your questions after our short presentation. The presentation slides we are using during the call are also available on our website at www.phosagro.com. During this conference call, we will be making forward-looking statements. The statements include but are not limited to statements about future financial and operating results. They are based on the management beliefs and expectations as of today dates and are subject to significant risks. The actual results may differ materially from the projected ones.

Let us start with the key highlights for Q2 2017. In Q2 2017, EBITDA stood at RUB 12.2 bn that implies almost a 25% y-o-y decrease and nearly flat dynamics q-o-q. Q2 2017 EBITDA margin stood at 27%. Net profit adjusted for one-off non-cash items related to FX losses decreased by 33% y-o-y to RUB 6.1 bn. Operating cash flow decreased by 15% y-o-y to RUB 9.3 bn, though it was almost fully compensated by low CAPEX spending. Free cash flow amounted to RUB 3.6 bn, which is more than USD 60 m, almost doubling y-o-y. According to yesterday's decision, the Board of Directors recommended paying RUB 8 per GDR as dividends for Q2 2017. This implies roughly 50% payout ratio based on the adjusted net income. As you may see on the bottom right chart, despite all the headwinds, the Company strictly follows its dividends policy.

Now on the key markets. The DAP price (FOB Tampa) stood at USD 357 per tonne or almost unchanged q-o-q and y-o-y. The urea price (FOB Baltic) stood at USD 192 per tonne that implies almost 20% weakening q-o-q. Historically, the second quarter is a mid-season with low activity on the key import markets for urea. Y-o-y urea price was almost flat. Prices for NPK 16:16:16 (FOB Baltics) were flat q-o-q, but went down 7% y-o-y.

Finally, the ammonia price was around USD 300 per tonne, though we saw some price weakening in June and July.

In terms of the situation on the key markets, the import of phosphates to Brazil is progressing very well. In Q2 2017, it added another 25% in P₂O₅ content y-o-y. Together with strong numbers for Q1 2017, year-to-date import of phosphates stood at 1.6 mt in P₂O₅ (a 50% increase y-o-y). As regards India, import of DAP to India in Q2 2017 decreased by almost 30% to 1.1 mt, primarily due to the lack of certainty regarding the new tax system. The decision on the unified sales tax came out only at the end of June and was much better than expected. The sales tax was approved at 5% instead of initially expected 12%. The favourable decision on the sales tax, good monsoon as of now and rupee appreciation should support the Indian demand for DAP in 2H 2017. In July, according to the preliminary statistics, DAP imports are already ahead of the last year's numbers. In 2017, the overall DAP imports to India are expected at 4.5–5.3 mt, according to CRU and Fertecon.

Now on China. In Q2 2017, phosphate exports grew by 20% to 2.9 mt. In 1H 2017, the cumulative exports reached 4.4 mt (up by 30%).

Finally, on fertilizer affordability. Given some weakening in urea and phosphate price at the end of Q2 2017 and strong performance [of grain prices], especially wheat and rice prices, fertilizers currently look relatively cheap vs the grain basket.

Regarding Phosagro in the market context, the Company managed to boost fertilizer and phosphate rock sales by 14% y-o-y. Despite the strong improvement in sales, a relatively flat price environment was fully offset by a further appreciation of the Russian rouble. In Q2 2017, rouble appreciated by more than 13% y-o-y and 3% q-o-q. As you may see from the two charts at the bottom of the page, FX losses are responsible for almost RUB 4 bn of EBITDA decrease in Q2 2017 and over RUB 10 bn of EBITDA decrease in 1H 2017.

Now let us touch upon the Company's financial performance. In Q2 2017, revenues stood at RUB 45 bn, 3% down y-o-y. The revenue breakdown by key products is as follows: DAP and MAP generated almost 36%, NPK – almost 30%, PhosRock and nitrogen – 11%. Geographically, PhosAgro's three key priority markets are still the same. Russia, Europe and Latin America together generated 75% of total sales.

On the next page, you can see detailed dynamics in the average domestic and export revenue per tonne for the key products.

In terms of segment profitability presented on page 11, the phosphate segment saw a 16% y-o-y decrease in gross profit to almost RUB 18 bn, with gross margin of 46% (down from 52% in Q2 2016). As for the nitrogen segment, its gross profit decreased by almost 30% y-o-y to RUB 1.6 bn. This segment's gross margin was 30% vs 47% in Q2 2016. You can see the detailed breakdown of export and domestic sales by segment on the right chart. If you need a more detailed breakdown, please contact the IR Department.

The overall CAPEX in Q2 2017 stood at almost RUB 6 bn that implies a nearly 40% y-o-y decline. Altogether, given the reported EBITDA for Q2 2017, it implies a CAPEX/EBITDA ratio at around 0.5x, which is fully in line with the Company's global policy. Net debt/EBITDA ratio increased from 1.75x in Q1 2017 to almost 2x as of 30 June 2017.

Finally, on the maturity profile. As you can see, the main exercise that is ahead for the Company is the Eurobond repayment in February 2018. Net of Eurobonds, the bulk of repayments is due after 2020.

Now on the cost of goods sold. In Q2 2017, it increased by 14% y-o-y to around RUB 25 bn. The key items were as follows: first of all, materials and services were up by 22% driven by an 18% and a 16% growth in rock and fertilizers production, and a 4.2% CPI. Salaries were down by 12% as Q2 2016 was affected by one-off bonuses related to PhosAgro's 15-year anniversary. D&A costs were up by 42% primarily due to asset commissioning. Potash expenses were up by 28% primarily due to more than a 50% increase in volumes and a 16% decrease in rouble price. Finally, on the ammonia: ammonia costs were up by 50% primarily due to a more than 40% increase in purchased volumes.

With that, we are finishing the presentation and are ready to kick off the Q&A session. Thank you.

Operator: Thank you. Ladies and gentlemen, we will now start our Q&A session. If you wish to ask a question, please press "01" on your telephone keypad. As a reminder, to participate in our written Q&A, type your question into the "Ask a question" text area, then click the "Submit" button. Thank you for holding until we have our first question.

Our first question comes from Konstantin Yuminov, Raiffeisenbank. Please go ahead.

Konstantin Yuminov: Hi, thank you for having my call. I have a couple of questions. First, could you please repeat again and confirm the date of commissioning of your new ammonia and urea plants and if they are still on budget? The second question is more technical and probably addressed to Alexander. It is about D&A, which increased in Q2 2017. Should we expect a bigger increase in D&A in 2H 2017 as you are commissioning the ammonia plant? Finally, yesterday's press release mentioned that the production target for 2020 was increased from the initial guidance of 8.7 mt to 9.2 mt. Could you elaborate a bit more on that? Are there any extra projects you plan to do to catch up this extra 0.5 mt, and what would be the associated extra CAPEX for this growth? Thank you.

Andrey Guryev: Hello, this is Andrey Guryev, CEO of PhosAgro. First of all, thank you everyone for joining our conference call. I would like to say a couple of words before answering the question. I think this was an extremely good half-year, particularly for PhosAgro compared to our competitors worldwide. We continue to show a strong growth in volumes and good economics. Answering your first question, we are indeed in the process of commissioning our major investment [project] that we have had for almost three years. Today it is on the run. We are already producing ammonia and granulated urea. Part of these products, particularly urea, has already been sold to the premium markets. Answering your question on commissioning of our ammonia plant, I can say that today it is underway. There are several on-going manageable issues mostly associated with the fine-tuning of some technical aspects. Nevertheless, ammonia is in production. Today, the ammonia plant operates at full capacity. There were several technical stoppages during the last couple of months, but I can say that together with the construction company and our Japanese partners, we are doing a good job to commission the plant in September as planned. After that, as you know, the contract provides for another year for the fine-tuning and further check of the plant to see how it works. I think today everything is going smoothly and is under control: we are producing ammonia and urea, a very good product. I have personally seen it several times already. Our clients who purchased it were able to appreciate it. I think we are on schedule, so we will get these additional volumes during Q3 and Q4 2017. With our current debottlenecking which has already given us extra 12% in 1H 2017, this year looks very promising to me in terms of growth.

Alexander Sharabaiko: I will take over the budget side and the D&A question. The budget of the ammonia and urea plant construction is strictly monitored, and I can tell you that there is no significant deviation from what we have budgeted for. On top of that, this contract is being financed through ECA, therefore, there is extra

control from the banking side. So, there is no overspending. As we do some customisation, there are some additional costs. Nothing major, around 1–1.5% of the overall costs. That covers the budget item. As for the D&A, the main difference between 6M 2017 and 6M 2016 was Main Shaft No. 2, which was put on our accounting books at the end of the year. Therefore, starting from 1 January this year, Main Shaft No. 2 will be amortising, and DD&A should be higher. As soon as we have the ammonia and urea plants put on our books, the same story will happen to these two big accounting items. Therefore, in 2018, the D&A figure should be higher. I do not think there will be a dramatic change in the D&A figure, but there will certainly be some increase. This is my take on the D&A. Andrey, would you like to comment on extra capacities?

Andrey Guryev: As for extra capacities, as you have mentioned, we will be modernising our ammonium nitrate plant, which today produces about 500,000 tonnes per year. The modernisation will give us another 150,000 tonnes of ammonium nitrate. The second stage of the modernisation is our NPK plant where we plan to receive around 350,000 tonnes of the new NPK product during the next couple of years. The modernisation is not expensive, and everything goes according to the plan. It will not have a substantial pressure on our balance sheet. This is briefly what we can say about that.

Konstantin Yuminov: OK, great. Thank you, gentlemen.

Operator: Our next question comes from Nikolay Sosnovskiy, Prosperity Capital Management. Please go ahead.

Nikolay Sosnovskiy: Hello, thanks a lot for the presentation. I have a couple of questions. The first one is on your working capital. In Q1 2017, you reported an about RUB 40 m build-up, and in Q2 2017, as I presume from your 1H 2017 numbers, it was roughly flat, no changes. Do you expect any positive changes or releases of working capital in 2H 2017 that will improve your free cash flow generation? This is my first question.

Alexander Sharabaiko: We suggest you ask all your questions, and then we will handle them.

Nikolay Sosnovskiy: OK, sure. The second one is on your expenditures and selling expenses, Russian Railways' infrastructure tariff and operators' fees. There has been quite a noticeable increase from RUB 1.9 bn in Q2 2016 to RUB 2.4 bn in Q2 2017. Are there any other factors affecting the total number apart from the volume increase and tariff inflation? That is my second question. Thank you.

Alexander Sharabaiko: I think I will cover both questions. There was indeed an increase in the working capital because we purchased some spare parts for the new ammonia capacities. I do not believe that we will continue this exercise going forward. You should expect this part of working capital to be released. It would be incautious to say that this will happen within the next three months. Maybe within six to nine months. After we have used these spare parts, we are not going to renew this additional spare part reserve.

Regarding our selling expenses, there were two major drivers for their increase y-o-y, namely increased sales volumes and increased domestic sales as we use different railroad tariffs and destinations not used before. Thank you.

Nikolay Sosnovskiy: A small follow-up on the selling expenses. Am I right in thinking that if your selling structure had remained the same vs last year, you would have had a more substantial increase in freight, port and stevedoring expenses, but, given this redistribution, the increase was not that significant?

Alexander Sharabaiko: Sorry, can you repeat the question? Or is it a statement?

Nikolay Sosnovskiy: It was a question. I just want to get a better understanding of how this works. You switched volumes from exports to the domestic market, and this is why freight did not increase as much as it would have done otherwise, right?

Alexander Seleznev: I suggest we revert with a more detailed breakdown in terms of CFR/FOB and domestic sales a little bit later.

Nikolay Sosnovskiy: OK, thank you. No worries at all.

Operator: Our next question comes from Laura Gardner Cuesta, Debtwire. Please go ahead.

Laura Gardner Cuesta: Hi. Thank you for taking my question. I want to follow up on the Eurobond repayment in February 2018. I wonder if you plan to access capital markets to refinance this. What are your plans to address this? Thank you.

Alexander Sharabaiko: Hello. At the moment, we are open to all options. We have not specified any particular one. What is most likely going to happen closer to the maturity, February 2018, is that we will decide on the exact instrument or maybe a few instruments that we are going to pursue. Then we will approach the banks and have an in-depth discussion on the prospects of such an exercise. So far, there is nothing to report, frankly speaking.

Laura Gardner Cuesta: OK, thank you.

Operator: Our next question comes from Nina Dergunova, Goldman Sachs. Please go ahead.

Nina Dergunova: Good afternoon. Thank you very much for the presentation. Most of my questions have already been answered, but I still have two. The first one is about market pricing. You have mentioned that market prices could be weaker through year-end. Could you please quantify how weak is “weak”? Speaking about spot prices at USD 337 per tonne for DAP (FOB Tampa), how much lower do you think the industry can dip from here? The second question is when you plan to release your strategy for the next CAPEX cycle (projects, cost estimate)? Thank you.

Andrey Guryev: Regarding the market conditions, we always expect the fourth quarter of any year to be weaker in terms of pricing. We have gone through it for the last couple of years. Today it is quite clear what the minimum level of market prices can be. They are based on the cost of DAP production, if we talk about DAP, or urea, in China. Based on our own and some other analytical estimates, the cost of DAP production in China today is about USD 320–325 per tonne. I believe that it is a real floor for the prices considering there is no speculation or short sales, which usually do not work in the fourth quarter. I think that today this level is very stable and fundamental ... given that China accounts for almost 30% of phosphates traded globally. I think this is a very big volume, which may simply disappear. If China is disciplined, we may not even see such numbers. Economically wise, the cost of production in China is USD 320–325 per tonne (FOB). I wonder what it will be for urea as it is heavily dependent on the coal price, which may be volatile in the fourth quarter. Anyway, we will see.

Nina Dergunova: Thank you very much for details, Andrey. That is very helpful indeed. What about the strategy?

Andrey Guryev: As for the investment cycle in your second question, I think we will be able to suggest new numbers as we are in the process of considering further investments and development until 2025, our

possibilities and so on. I believe this will be in a year's time, maybe in 1H 2018, when we are 80% ready to give you more or less real numbers if we consider any further investments. Is that OK?

Nina Dergunova: Very good, thank you.

Operator: Our next question comes from Kevin Whyte, VTB Capital. Please go ahead.

Kevin Whyte: Hello, thank you very much for the presentation and an opportunity to ask questions. First of all, I would like to ask you whether your mid- to long-term target of net debt/EBITDA remains at 1x and whether you are focusing on returning to that level? My second question is as follows: now that rouble has stabilised, how much more growth potential do you see in the Russian market? Thank you.

Andrey Guryev: Do you mean the consumption growth potential?

Kevin Whyte: Yes, exactly.

Andrey Guryev: Answering your second question, the growth potential of the Russian market depends heavily on the condition of the Russian agricultural producers and available subsidies. Other factors include harvest, weather conditions, etc. In 1H 2017, our domestic sales volumes have already shown a substantial increase – by over 20% y-o-y. We already see strong demand for September and October. This gives us a signal that the Russian agricultural producers have already started buying fertilizers for the spring. This is why I expect the Russian agricultural market to be very healthy. We know for sure that the government will continue to subsidise the agriculture given new sanctions and other factors. Today, this market is booming, and all the figures show that we can easily see a 20% increase against last year. If the trend continues going forward, we will be happy as the largest supplier of fertilizers domestically. I can give you the figure. Today, PhosAgro enjoys an almost 30% share of the Russian fertilizer market. Both the Minister of Agriculture and the government are very bullish about the Russian agriculture. It is one of the industries that will develop and perform with the help of God as we say here, in Russia, about the weather. The pricing conditions for soft commodities are very healthy. Today, we expect a decrease in harvest across Russia compared to last year. This can be good for the farmers because it will mean tight supply together with good prices. This will be beneficial at least in terms of the pricing environment. I am very positive in this respect. The market will continue to grow, which is very important for us strategically as we rely on it all the time.

Alexander Sharabaiko: Hi, Kevin. Regarding the net debt /EBITDA level we reconfirm that 1x is a strategic target for us, and we would like to be there in the midterm (over the next 12–18 months). This is what I can give you right now. There is no change to our strategic leverage target. Thank you.

Kevin Whyte: Thank you, gentlemen.

Operator: Our next question comes from Konstantin Yuminov, Raiffeisenbank. Please go ahead.

Konstantin Yuminov: Thanks. A very quick follow-up from my side regarding CAPEX. Alex, could you, reconfirm the guidance for this year as we now at the end of August? Do you have any initial thoughts on the CAPEX for the next year?

Alexander Sharabaiko: Hello again. It is too early to provide you with any details regarding the next year. We are still in the process of collecting all the potential projects and searching for the best mix that will help us increase the profitability of our business and bring additional volumes. As for this year's CAPEX, we can reconfirm it at around RUB 30 bn. Thank you.

Konstantin Yuminov: All right, thanks.

Operator: We have a follow-up question from Nikolay Sosnovskiy, Prosperity Capital Management. Please go ahead.

Nikolay Sosnovskiy: I also have a quick follow-up on the mid-term net debt / EBITDA guidance of 1x for the next 16 months that you have just reconfirmed. Given that now it is 2x, do you expect EBITDA to double or your net debt to decrease 50%, or a combination of both? I assume that currently you use more or less the entire free cash flow to pay dividends, and if we assume that the prices stay where they are and there is some operational growth, do you see any risks of lower dividend payouts from net income matching free cash flow if you spend some of it to decrease your overall net debt? Thank you.

Andrey Guryev: It is a very interesting question, which in itself gives many answers. The current net debt / EBITDA level is based on reduced EBITDA, which was caused by lower prices rather than our new borrowings. Of course, speaking about our strategic net debt / EBITDA target of 1x, we have to look at the cycle rather than the point which is the bottom of the market. Today, we are definitely at the bottom of the cycle. There is no need to show you any figures. You can look at any fertilizer producer in the global market to see where we are. This is not the number that was caused by our overspending and so on. Of course, we want to achieve the numbers we used to enjoy two or three years ago, but the prices plunged 100%. What I can say definitely is that we are not going to increase our borrowings in that respect. At the same time, we also want to stay in line with our promises in terms of dividend payments of 30–50% if it is reasonable. Today we have several issues like refinancing our USD 500 m loan in Eurobonds in February 2018, which is the task of our management. In the normal cycle and the normal way of doing business, net debt / EBITDA at 1x is our strategic target along with others. We do not want to break any covenants, etc. We will be managing our balance sheet based on a conservative approach to borrowings, dividend payments, etc. We feel very strong compared to our competitors and will continue to pay our dividends without any further borrowings from the market.

Nikolay Sosnovskiy: May I restructure my question a little bit? What are the conditions under which you can go back to 30% net profit dividends?

Andrey Guryev: These will be a further reduction in prices and our EBITDA.

Nikolay Sosnovskiy: OK, thank you.

Operator: We have no further questions at this time. Ladies and gentlemen, I would like to remind you, if you have any further questions please press “01” on your telephone keypad. To participate in our written Q&A, type your question into the Ask a Question text area, and then click the Submit button. Thank you for holding.

Ladies and gentlemen, as a reminder, if you wish to ask a question, please press “01” on your telephone keypad. To participate in a written Q&A, type your question into the “Ask a question” text area, then click the “Submit” button. Thank you for holding.

We have no further questions. Dear speakers, back to you for the conclusion.

Alexander Seleznev: I would like to thank all the participants for joining us today for the Q2 and 1H 2017 IFRS results. Thanks for your questions. See you in November for Q3 2017 results. Thank you.

Operator: This concludes today’s conference call. Thank you for your participation, you may now disconnect.

