Company Valuation

Subject company: **PJSC ALROSA**

Higher School of Economics

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ALROSA IS CURRENTLY UNDERVALUED BY 15.9% COMPARED TO ITS STRONG FUNDAMENTALS

OUR ANALYSIS BASIS

- Markets are now pricing in earnings decline in 2020
- Global supply chains and production have been impacted
- Strong fundamentals of the company
- Expected recovery on the key end-demand markets

15.9%
UPSIDE POTENTIAL

72.6 RUB
TARGET PRICE

ROUTE OF DIAMOND ACROSS VALUE CHAIN

Source: Bain, De Beers, Team Analysis

THE DIAMOND INDUSTRY SHOULD BE CONSIDERED INTEGRATED DUE TO THE HIGH INTERCONNECTEDNESS OF VALUE CREATION ELEMENTS

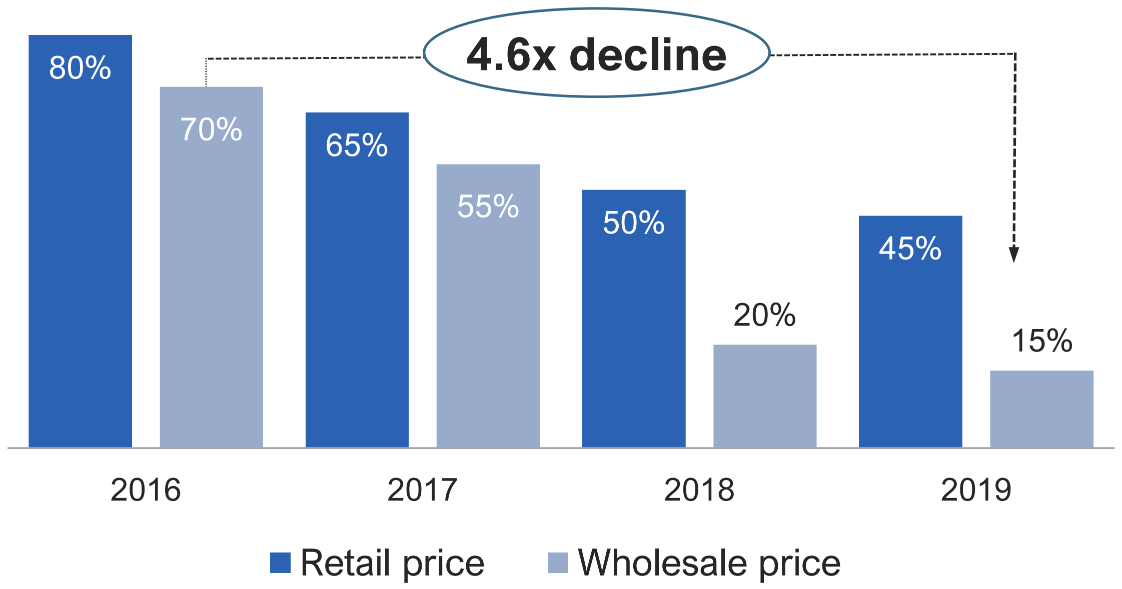
Upstream

Trend: Artificial diamonds (LGD)

The appearance of a cheap analogue of natural diamonds in the LR can limit the potential for rising prices of natural raw materials

In the past few years, there has been a decline in the price of gem-quality artificial diamonds. ALROSA's main competitor, De Beers, introduced the LGD Lightbox brand. ALROSA, on the contrary, intends to focus on natural diamonds.

LGD Price as a percentage of natural stones



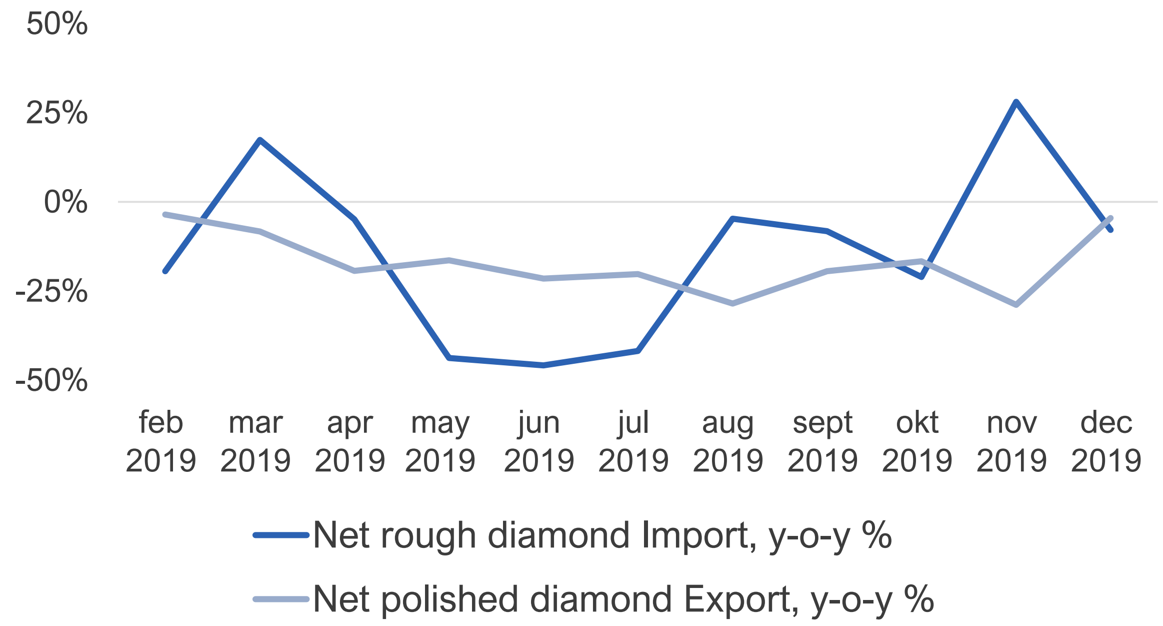
Midstream

Trend: India lapidary industry crisis

Tighter regulation in the banking sector negatively affected the availability of credit for cutters. This leads to bottlenecks in the value chain.

The Indian cutters in the last three months of 2019 show a positive trend in diamond imports. This may indicate a recovery in demand for raw materials.

Export / Import of Diamonds in India



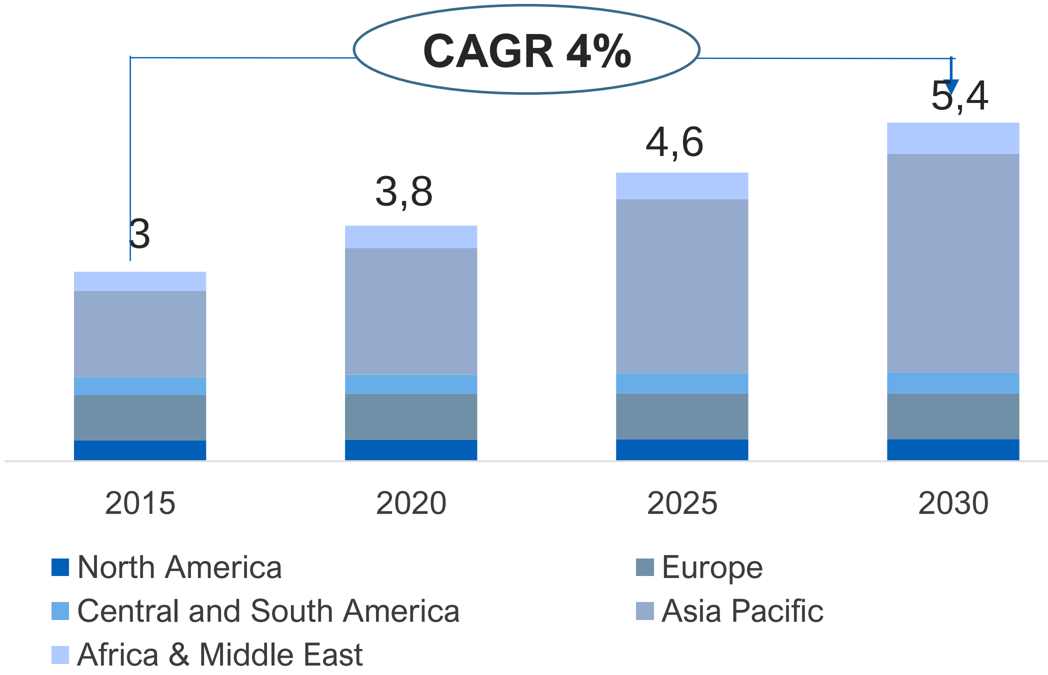
Downstream

Trend: World middle class growth

Due to the growth of incomes of the population of developing countries (India, China), a steady demand for jewelry will remain.

The world middle class is showing steady growth, which fundamentally strengthens the diamond industry.

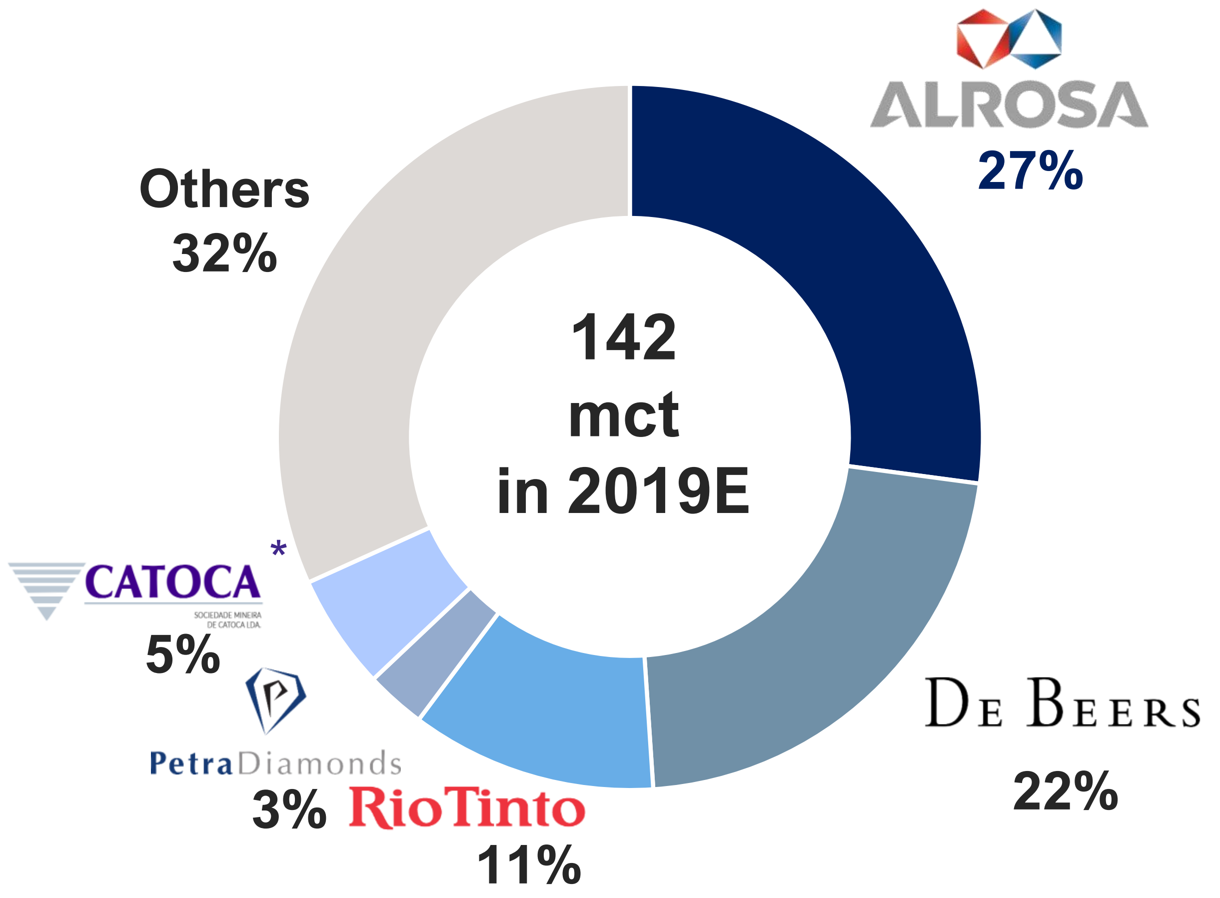
Middle class Size Forecast 2015–2030



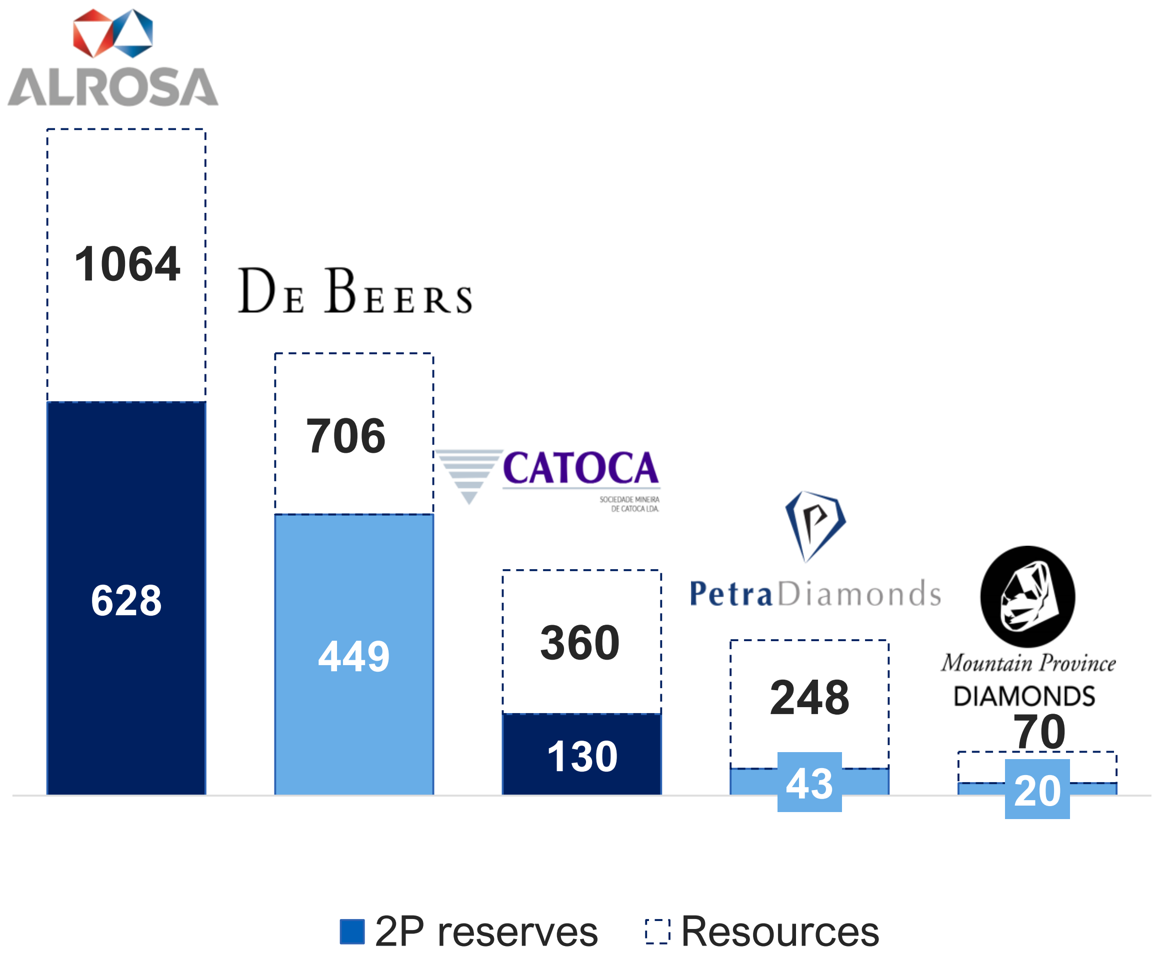
Sources: Bain, GJEPC, Brookings

MARKET POSITION

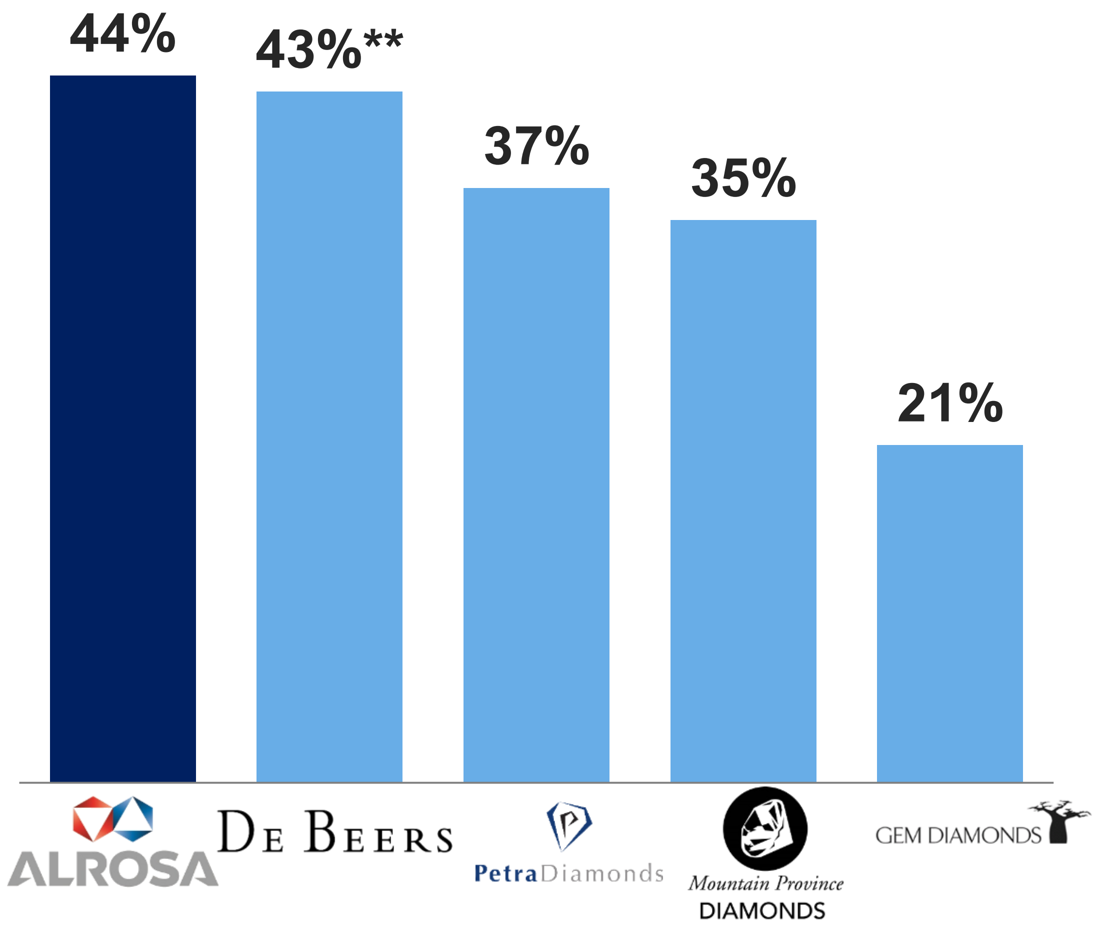
Global rough diamond production in 2019E,%



ALROSA vs peer in Resources, mct



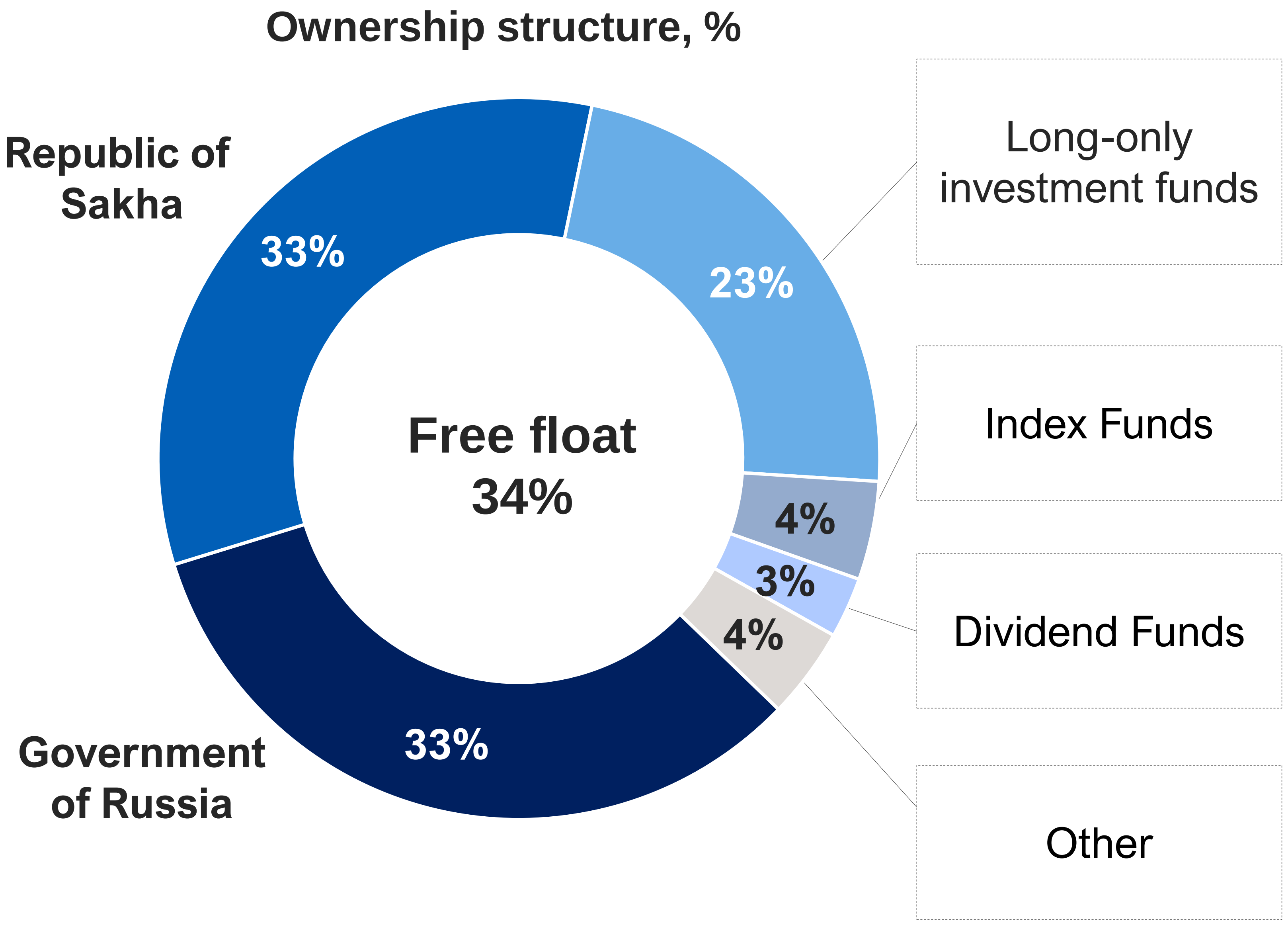
EBITDA Margin in 2019E, %



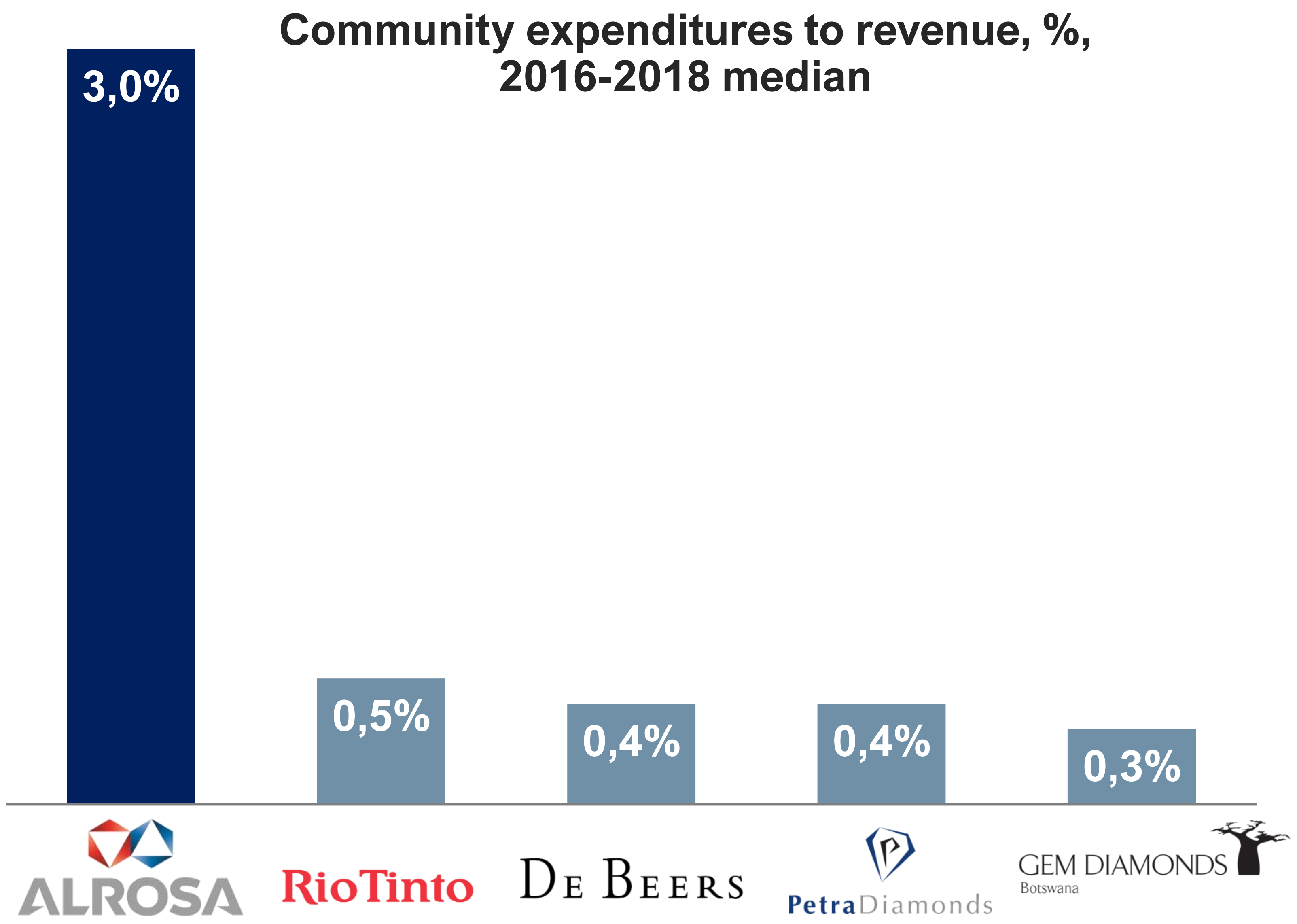
Sources: Team Analysis, Company Data, Capital IQ

ALROSA IS OWNED BY FEDERAL AND REPUBLICAN GOVERNMENT, WHICH IMPOSES ADDITIONAL COSTS

Federal and regional government collectively own a 66% stake in the company and control the supervisory board



Regional authorities are interested in high level of social expenditures on ALROSA's side

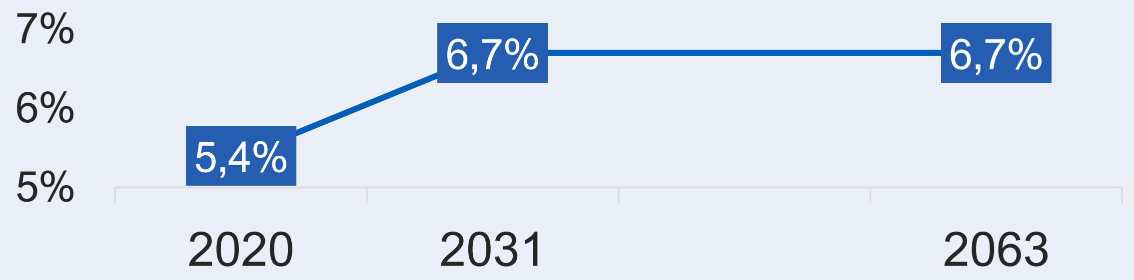


Sources: Team Analysis, Company Data, Capital IQ

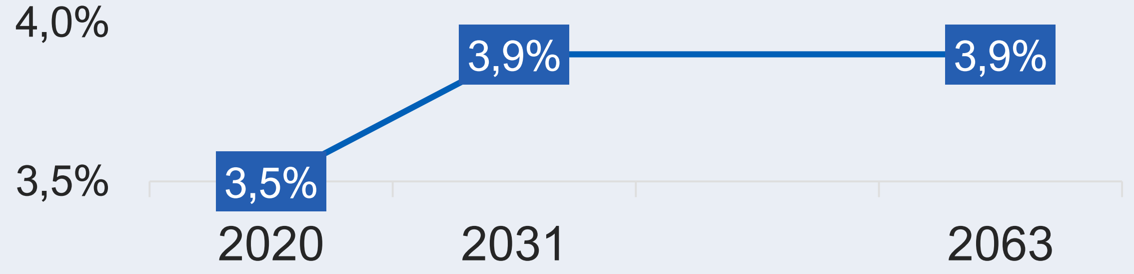
USD EXCHANGE RATE INCREASE AS A COMPETITIVE ADVANTAGE

Cost-related Assumptions

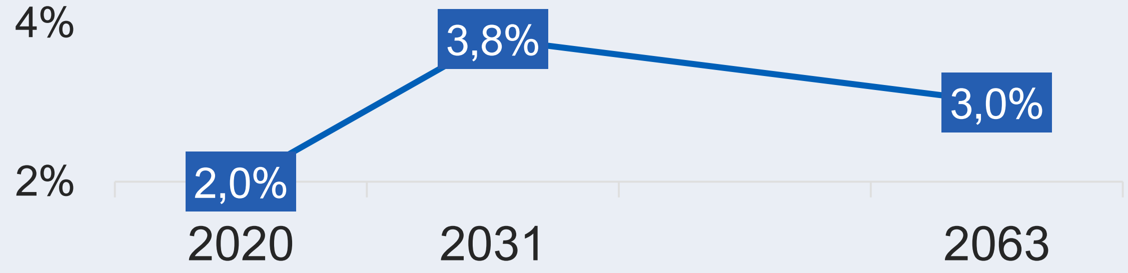
Nominal wage growth



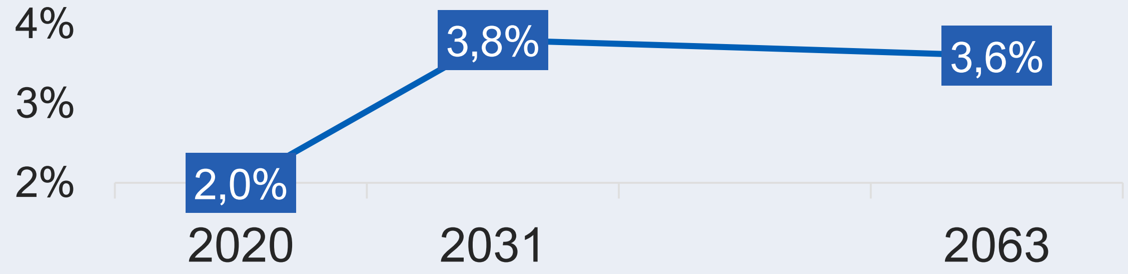
Railway transportation



Electricity



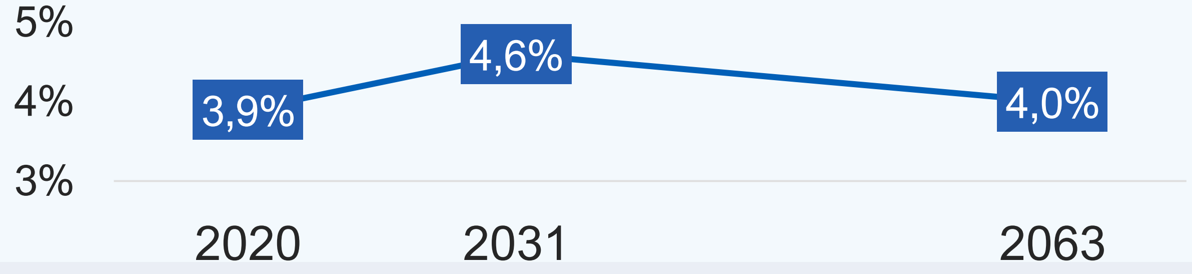
Fuel



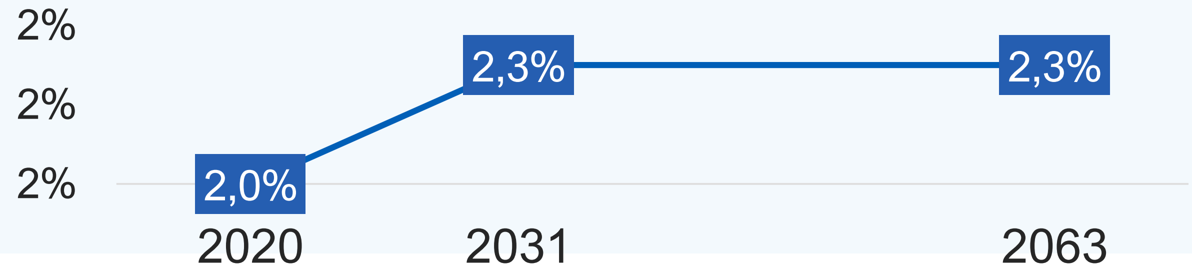
Macroeconomic variables

RUB/USD FX rate forecast 2020–2023

RUB inflation

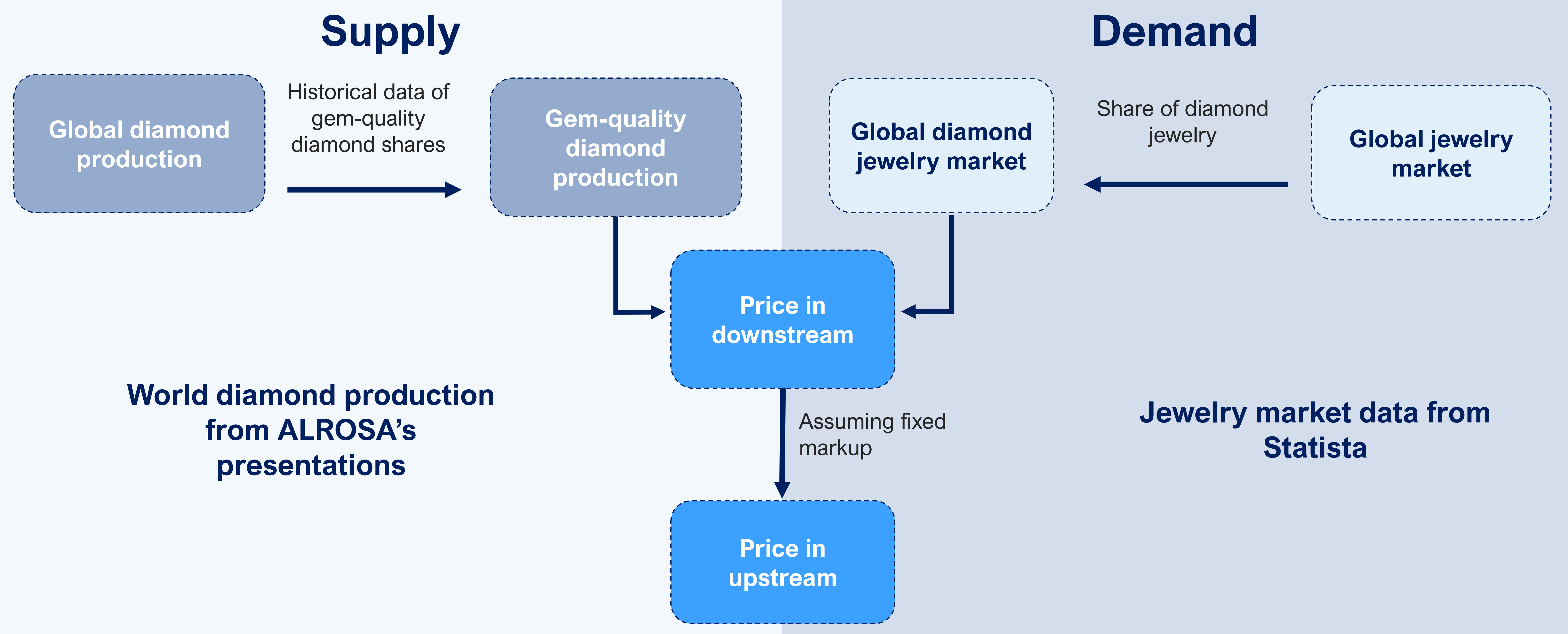


USD inflation

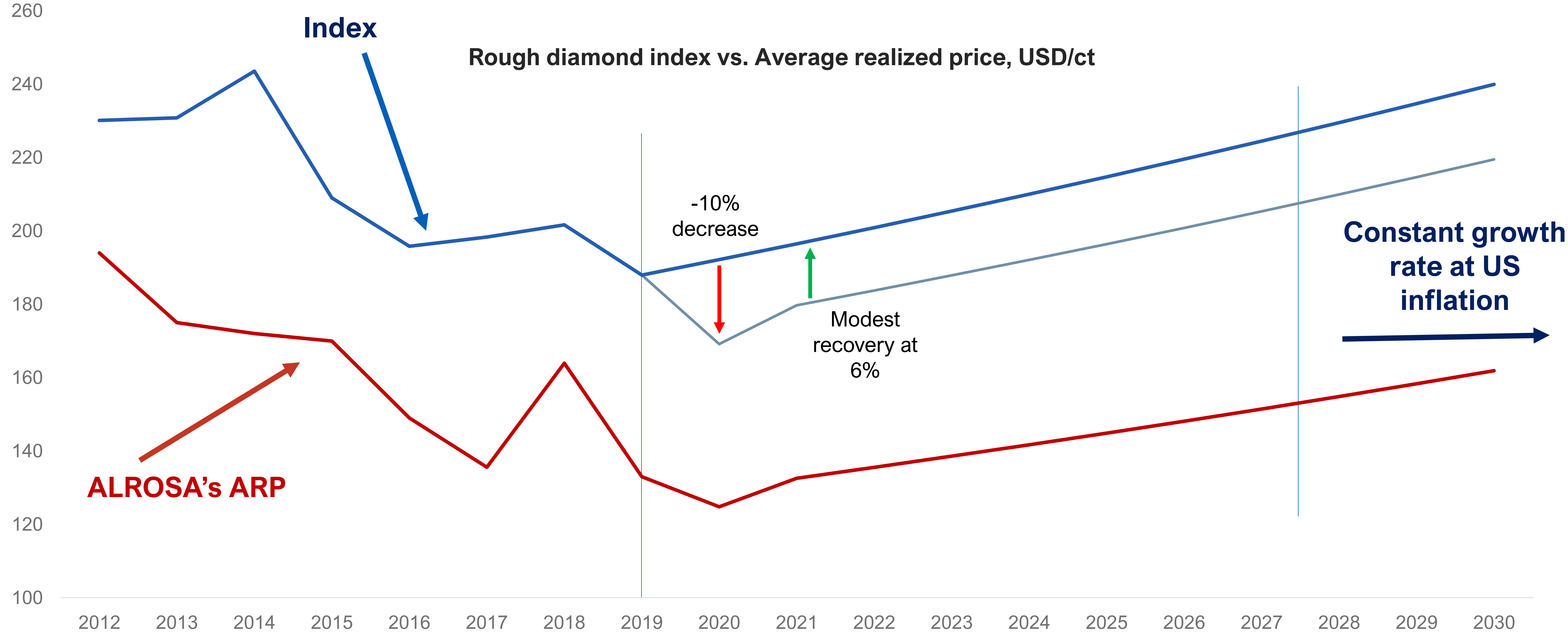


Sources: ACRA, Ministry of Economic Development of the Russian Federation

DIAMOND PRICE IS FORECASTED FROM JEWELRY MARKET FUNDAMENTALS

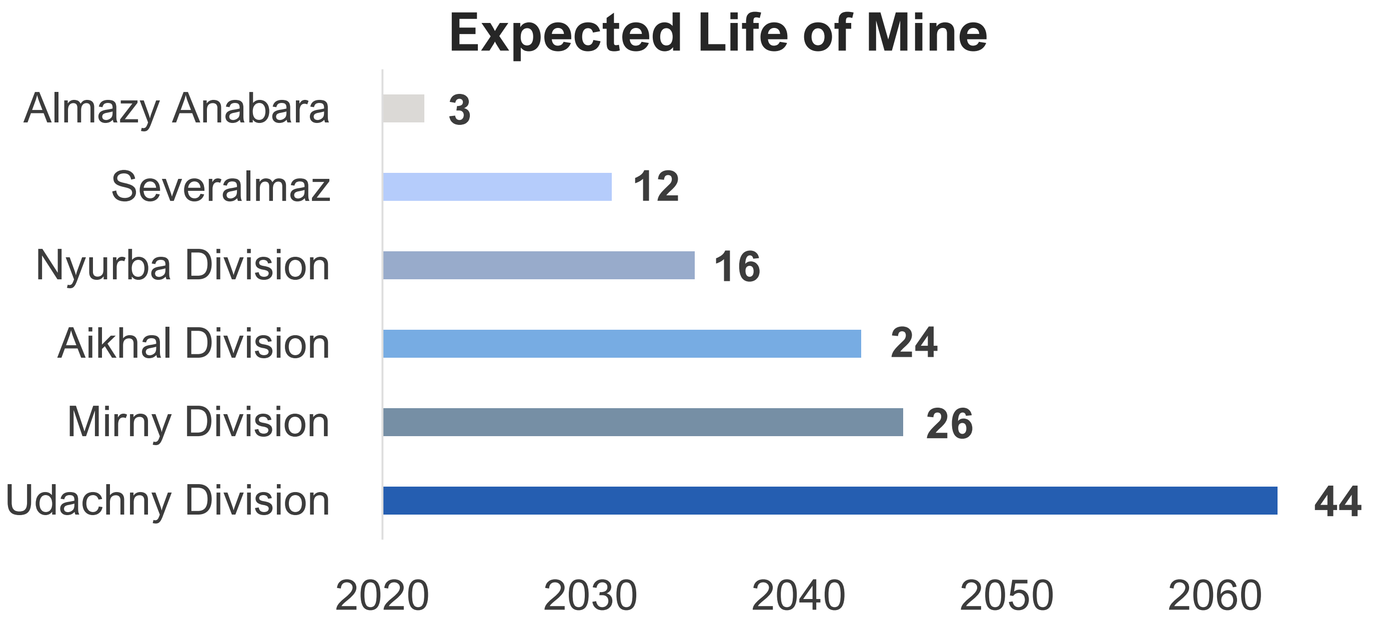


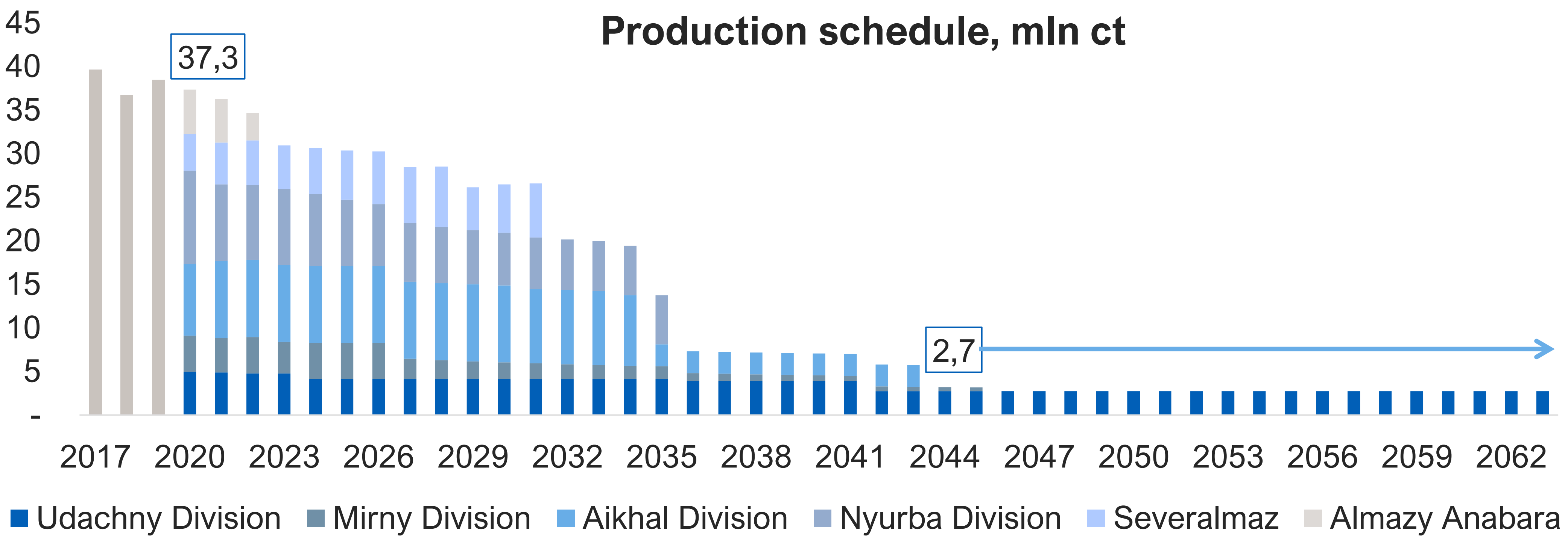
AVERAGE REALIZED PRICE FOR ALROSA IS DERIVED FROM ROUGH DIAMOND INDEX



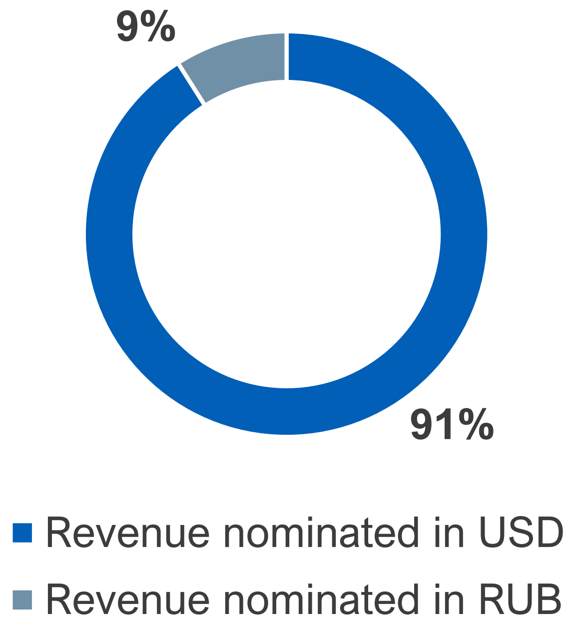
Sources: Statista, Company Data, Team Analysis

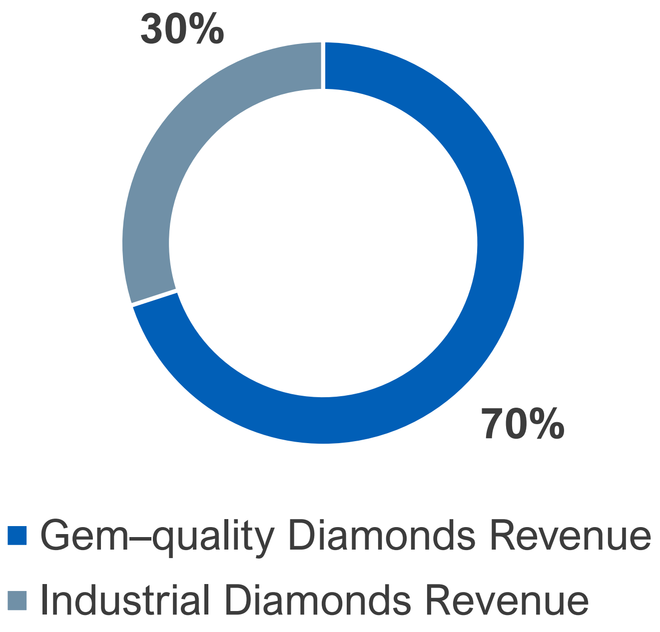
PRODUCTION

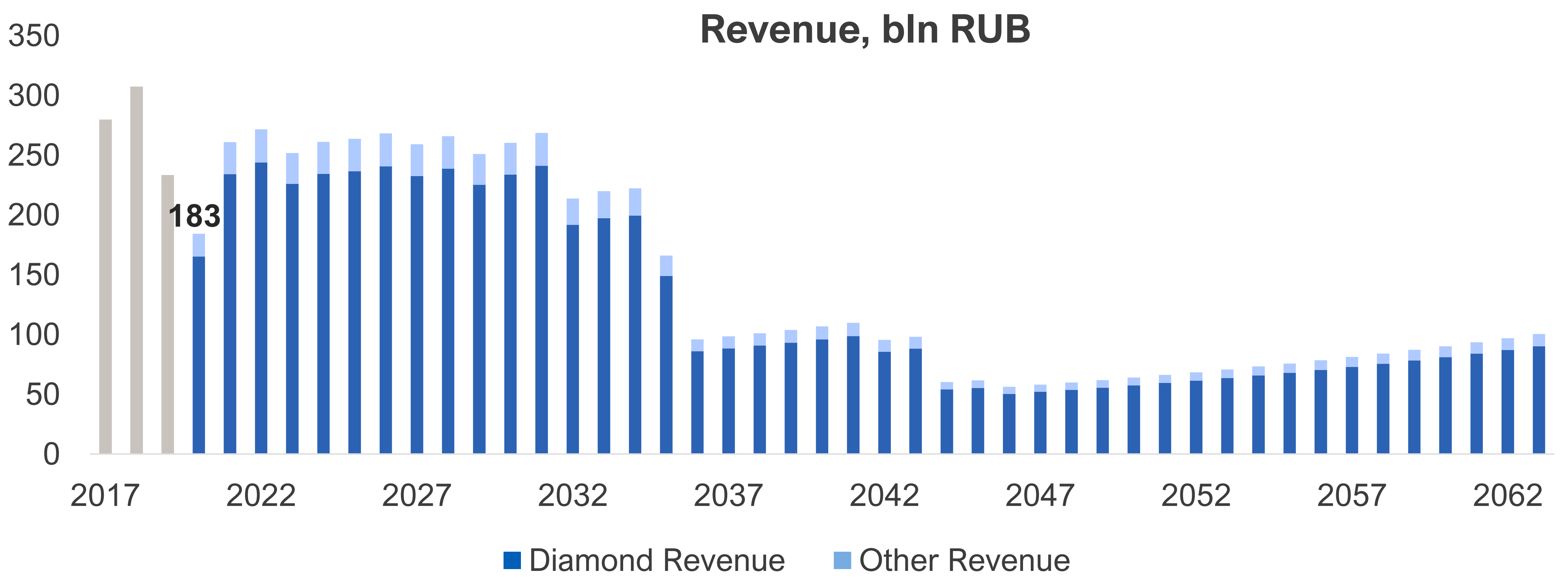




KEY ASSUMPTIONS FOR REVENUE

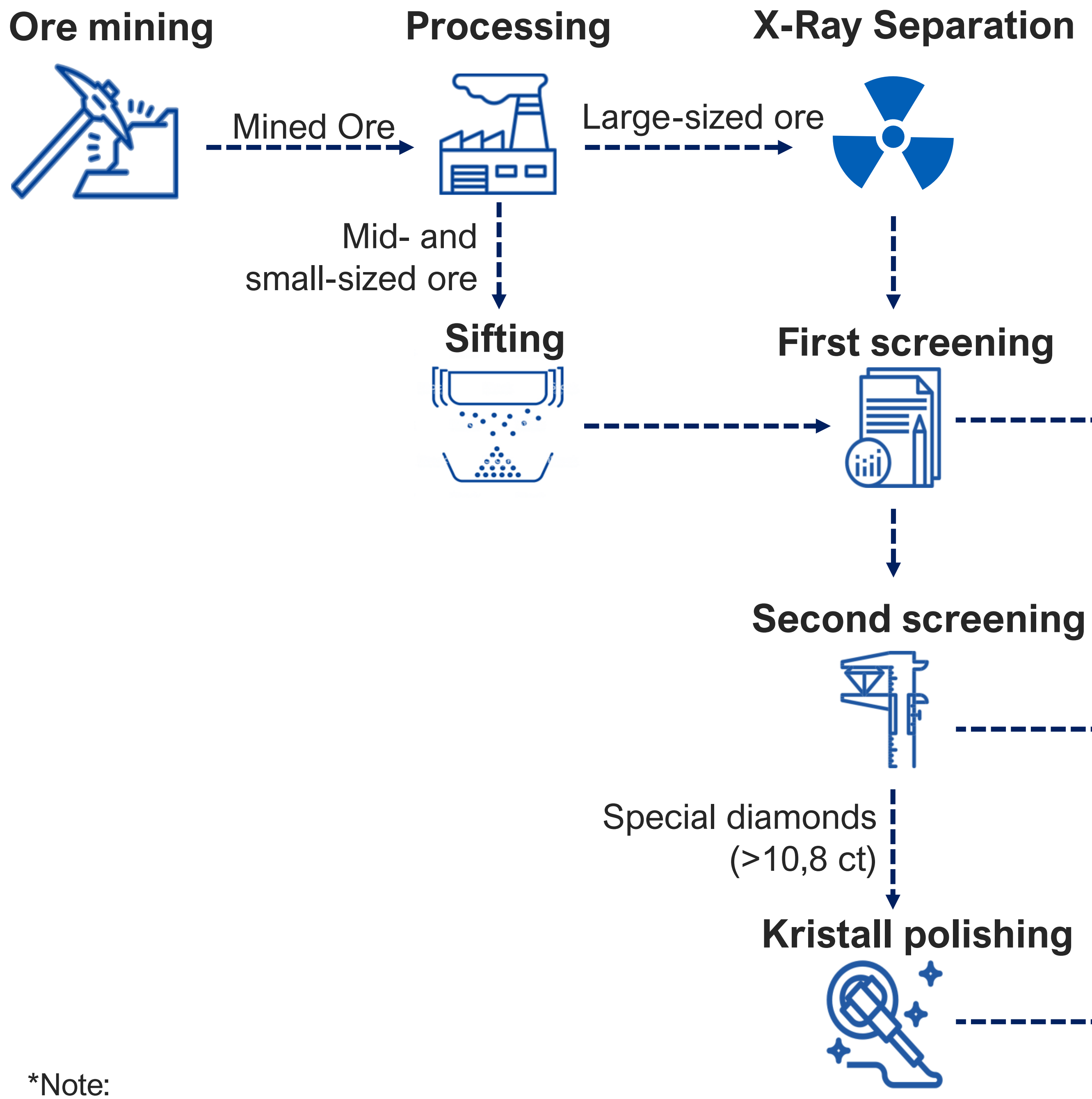






Sources: Company Data, Team Analysis

ALROSA IS VERTICALLY INTEGRATED RUSSIA BASED MINER

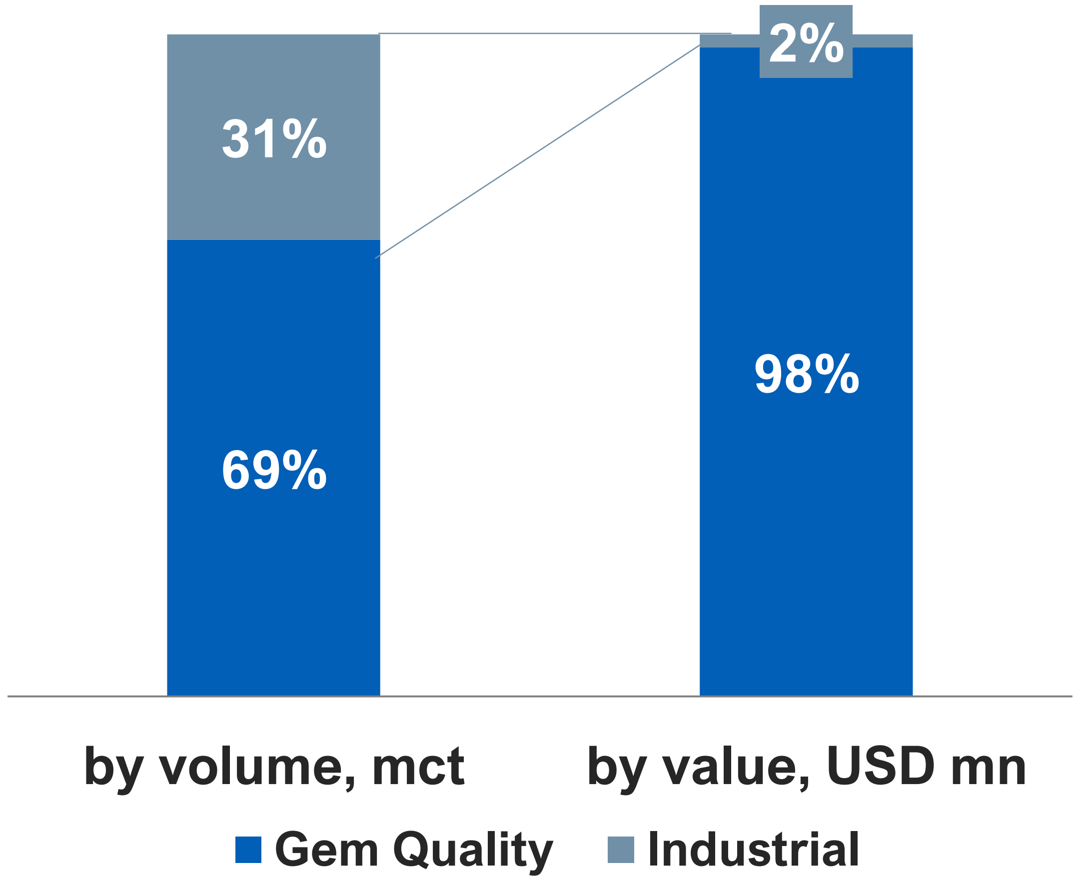


Sales breakdown by volume

	ALROSA	DE BEERS
Industrial Diamonds Sales	31%	1%
Rough Gems Sales	68%	99%
Polished Gems Sales	1%	0%

Industrial diamonds are cheap providing only 2% of revenue for 31% of volume

ALROSA sales breakdown by stone type in 2018



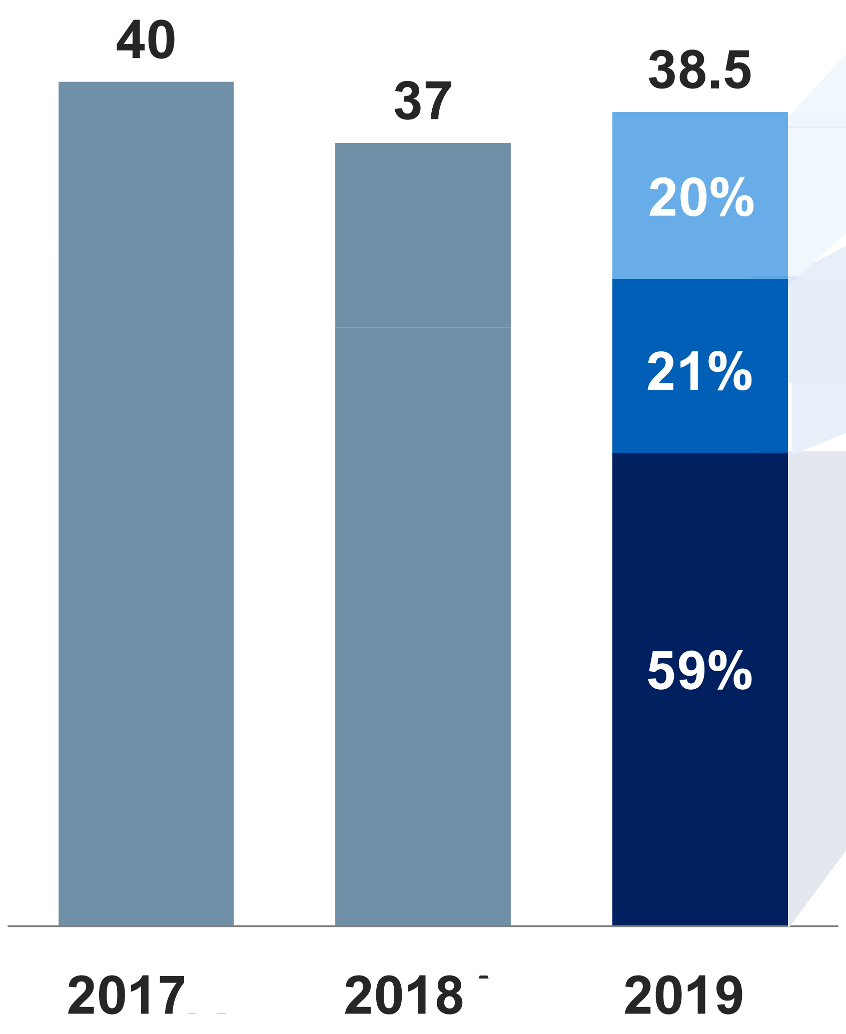
*Note:
Mostly, rough diamonds are polished in India, due to cheap workforce

Sources: Company Data, Team Analysis

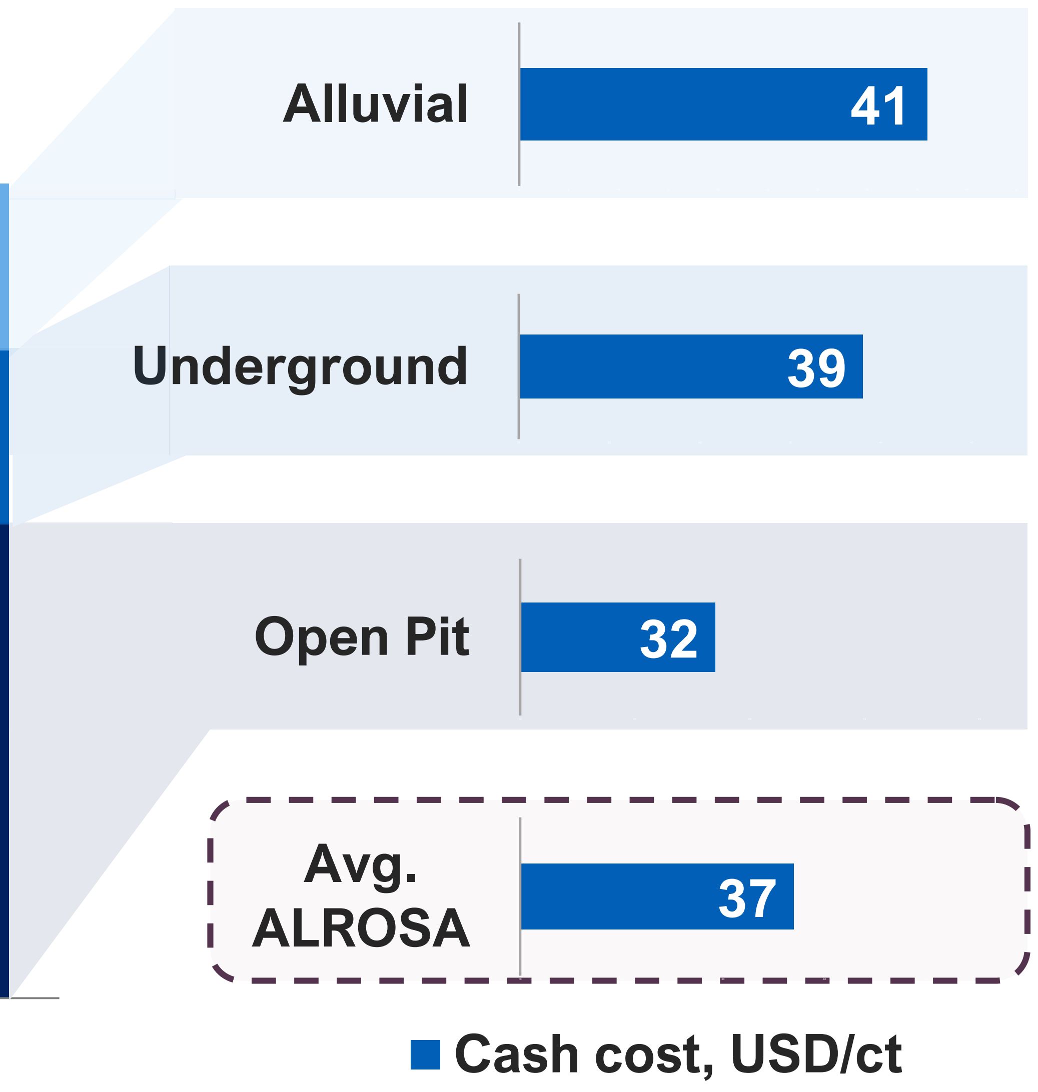
STABLE PRODUCTION VOLUMES ARE MATCHED BY SALES CHANNELS DIVERSIFICATION

Large share of open pits allows ALROSA to maintain low average cash cost

Production by years, mct

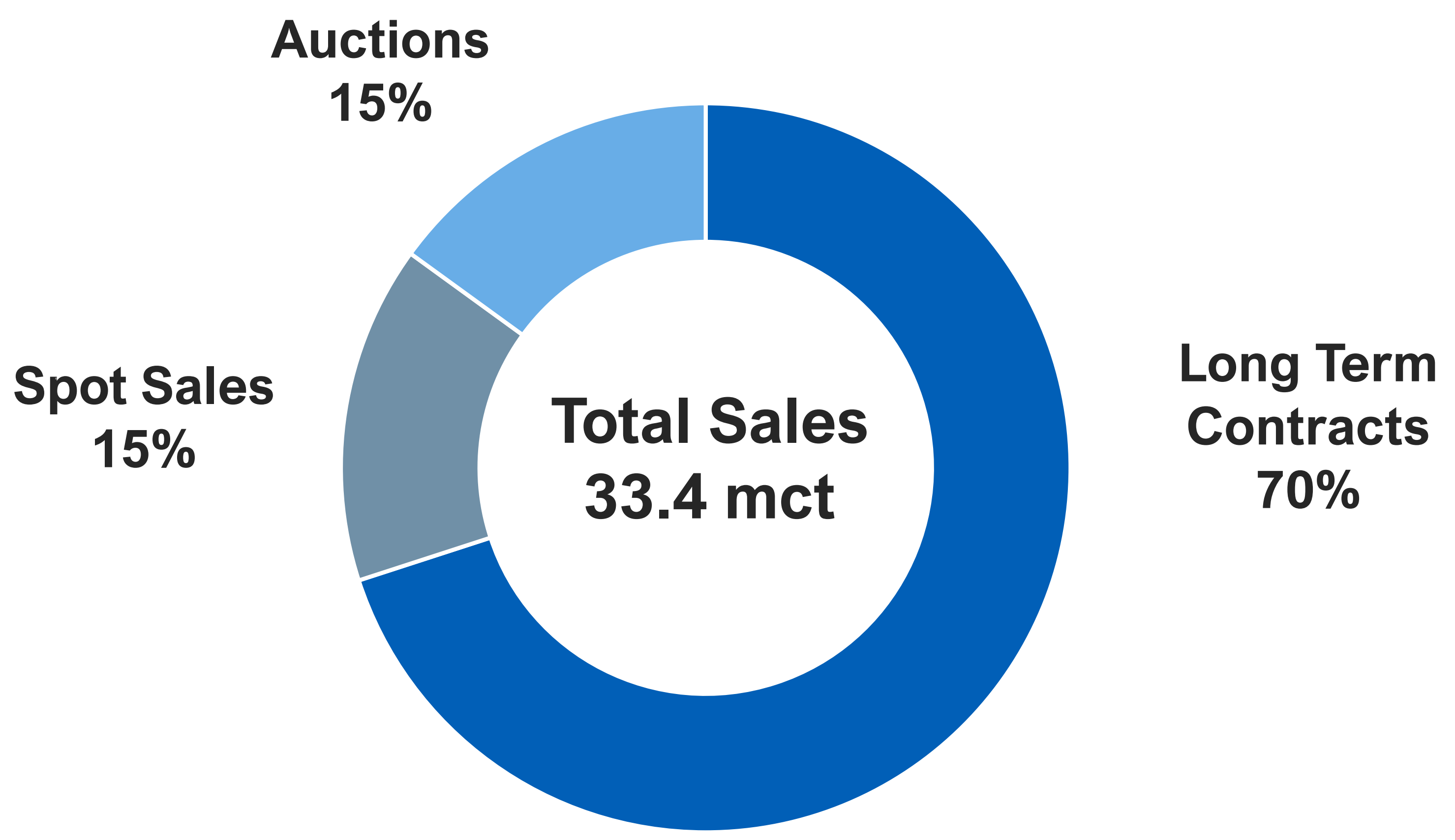


Cash cost by type of mine in 2019



Different Sales channels cover the entire market and provide stable realization on industry cycles

Sales channels breakdown by type in 2019, %



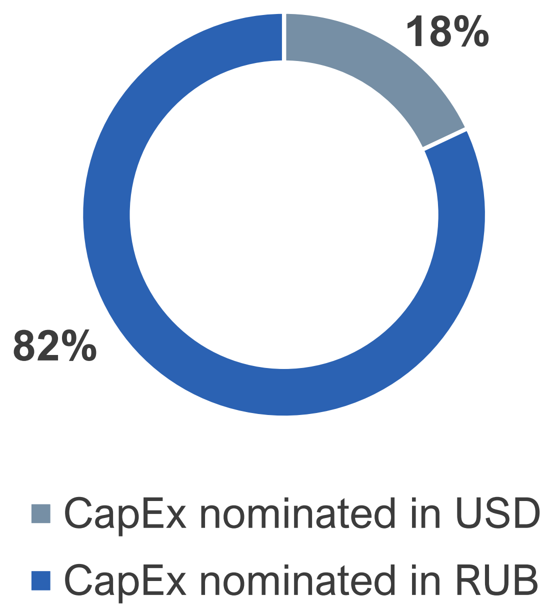
Sources: Company Data, Team Analysis

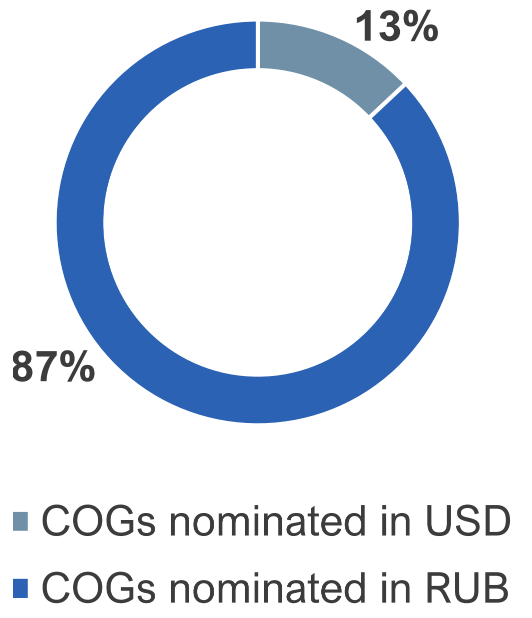
COGS / SG&A

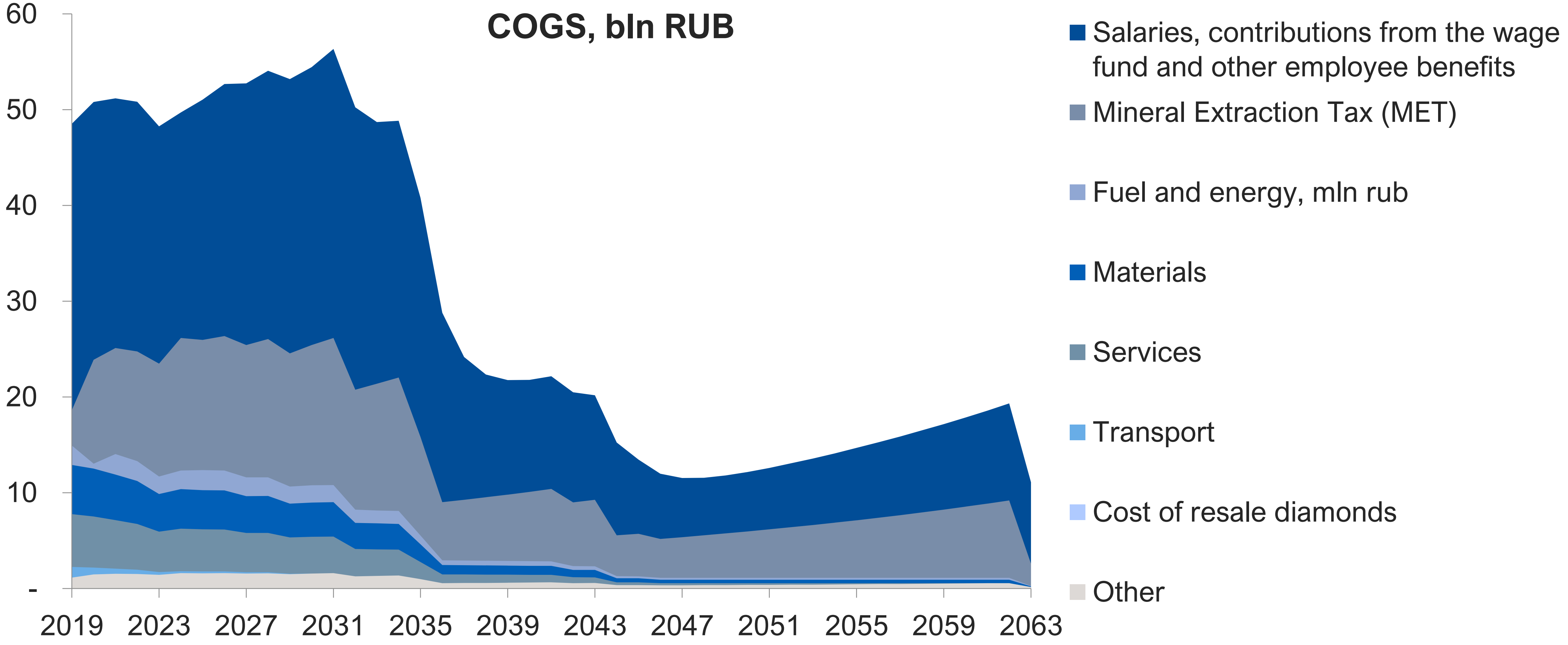
COGS FORECASTING METHOD:
Production growth rate
+
Inflation rate
(for corresponding item)

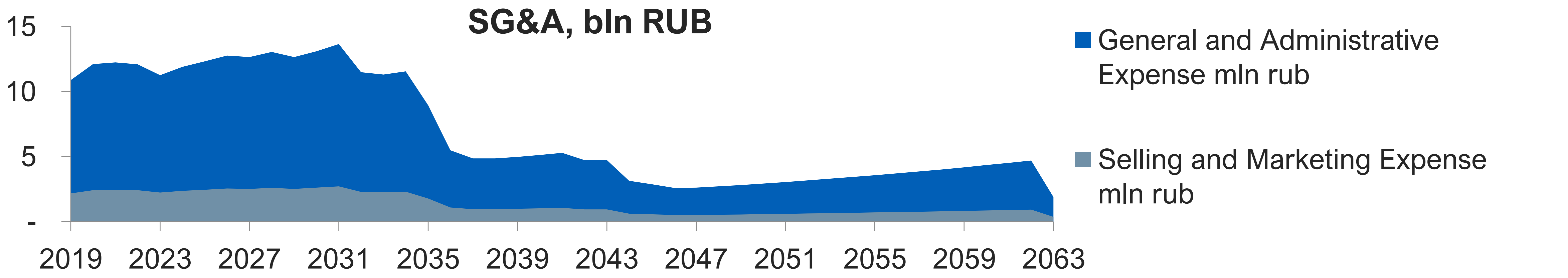
SG&A FORECASTING METHOD:
Inflation RUB

KEY ASSUMPTIONS FOR CAPEX & COGS









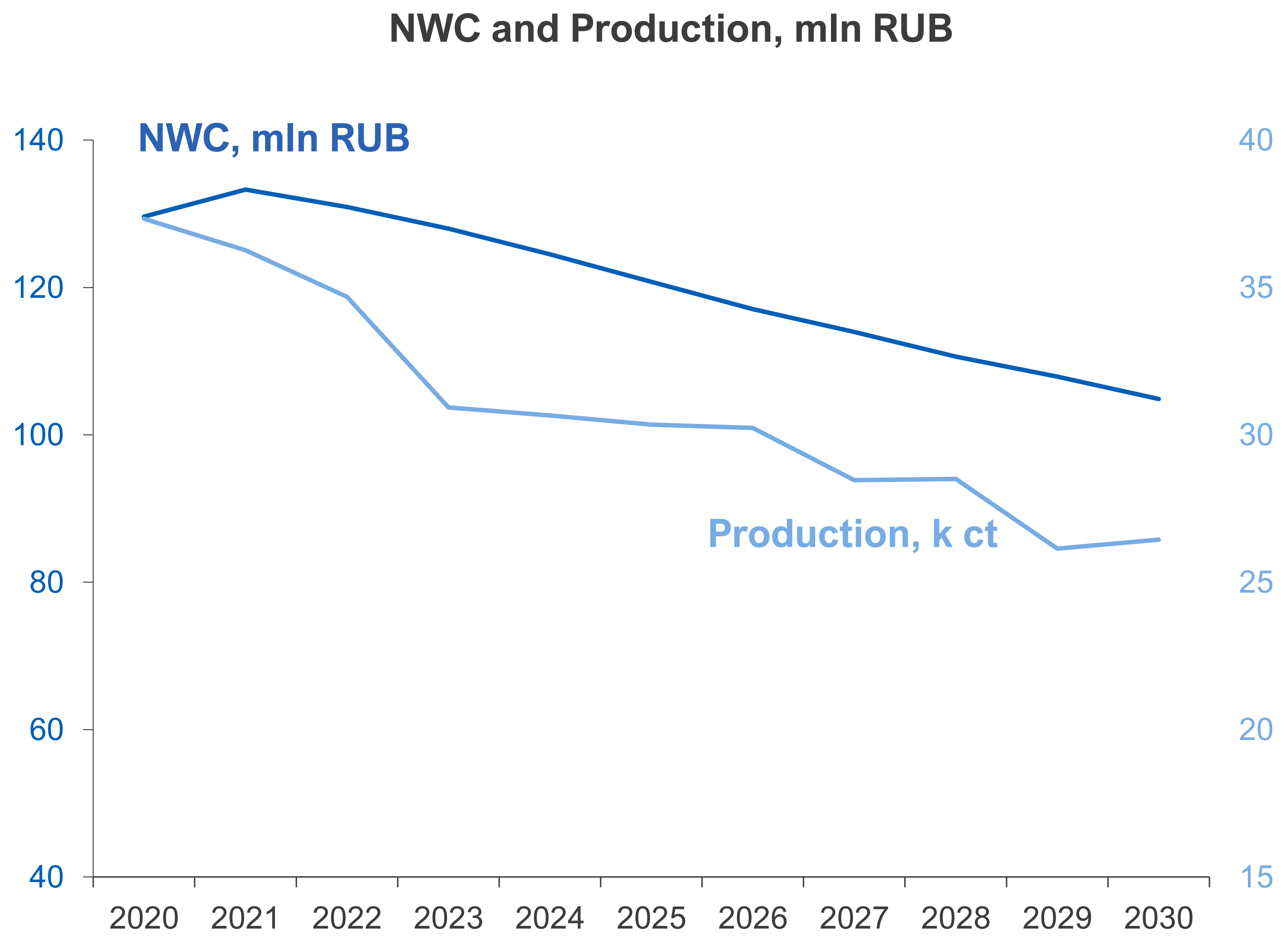
Sources: Company Data, Team Analysis

WE ASSUME GRADUAL DECREASE OF INVENTORIES

Accounts receivables and payables are calculated from historical turnover

Turnover	Median
Days Payable Outstanding	89
Days Inventories Outstanding	322
Days Receivable Outstanding	30

We assume 5% inventory decrease per annum



Sources: Company Data, Team Analysis

CAPEX

ALROSA CapEx forecast

- Capital-intensive phase is **over**
- CapEx over five years (2020 – 2024) is expected to **be 128 bn RUB**

Key investment projects 2019 – 2024

Infrastructure: RUB 35 bn

- Reconstruction of Mirny Airport
- Gasification of production facilities in Udachny
- Sales Division Facilities
- Gas processing facility by ALROSA-Gaz

Mining capacity: RUB 38 bn

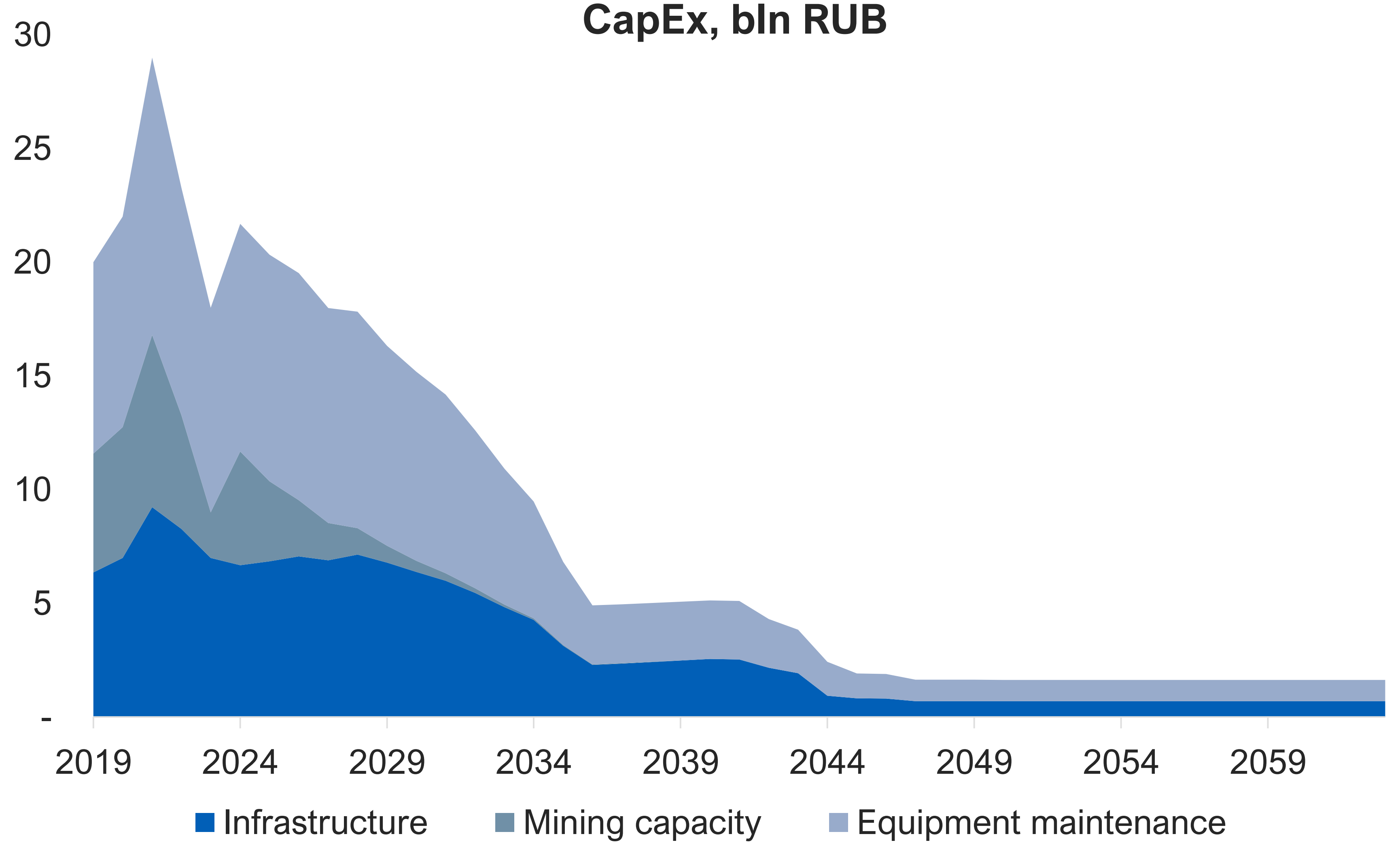
- Completion of Udachny underground mine construction
- Completion of Verkhne-Munskoye diamond deposit development
- Construction of Maiskaya pipe
- Construction of Zaria pipe

Equipment maintenance: RUB 55 bn

Forecasting method

2019 – 2024	2025 – 2063
Alrosa forecast	• **In line with production** • **In line with USD change**

CapEx, bln RUB



Sources: Company Data, Team Analysis

STRONG BALANCE SHEET

HIGHLIGHTS

Conservative long-term financial targets in line with investment grade criteria

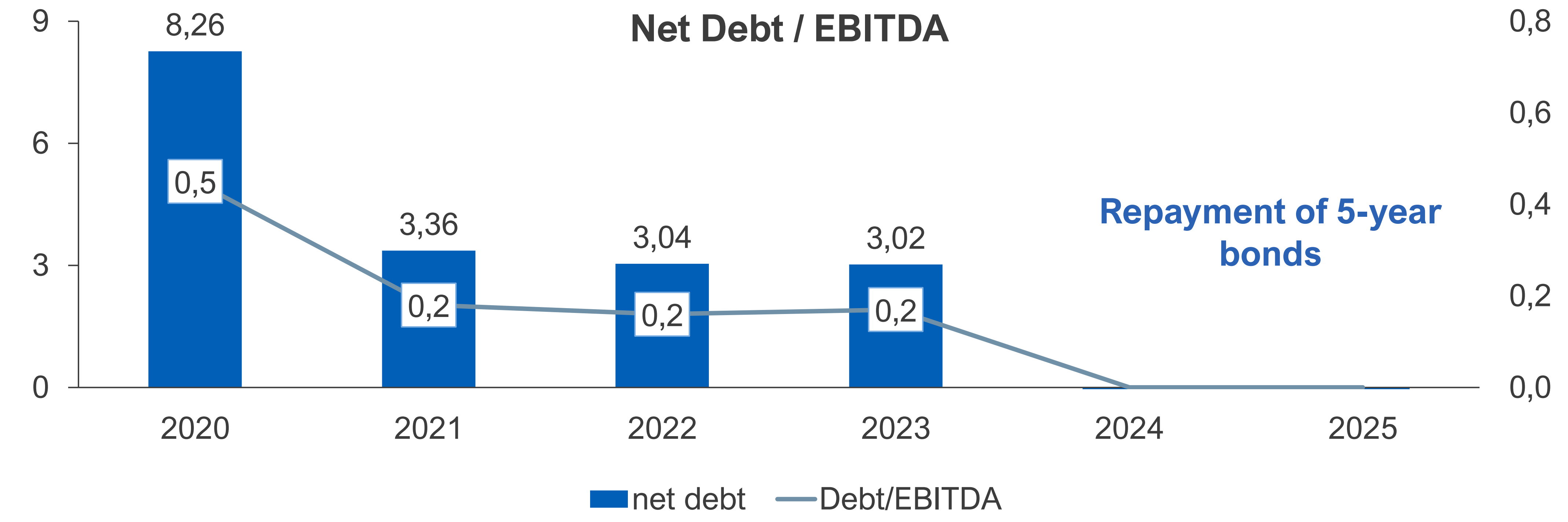
Target Net Debt / EBITDA range: 0.5-1.0x
Minimum liquidity reserves of over 35 bn RUB
Solid track record with fixed income investors

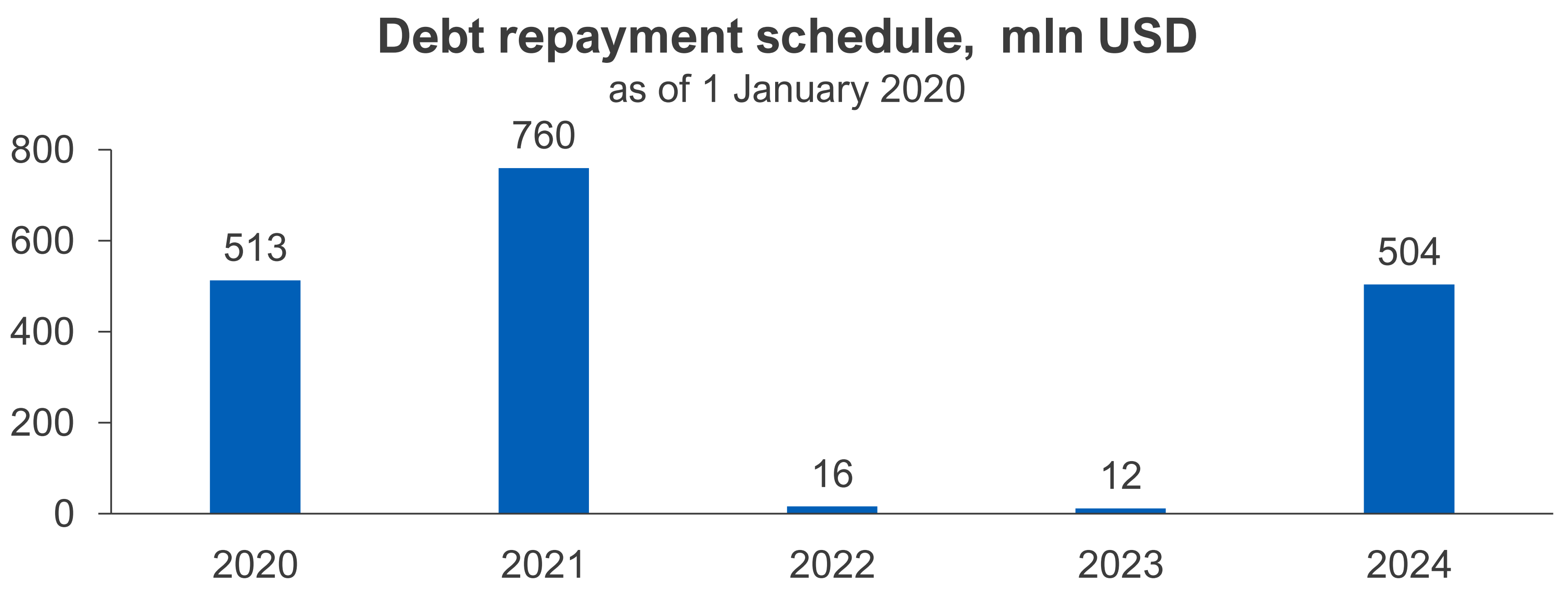
Investment grade credit rating

S&P – BBB- (Stable)
Fitch – BBB- (Stable)
Moody’s – Baa2 (Stable)

New opportunities

New class of investors
Low cost financing
Stable dividend payments





Sources: Company Data, Team Analysis

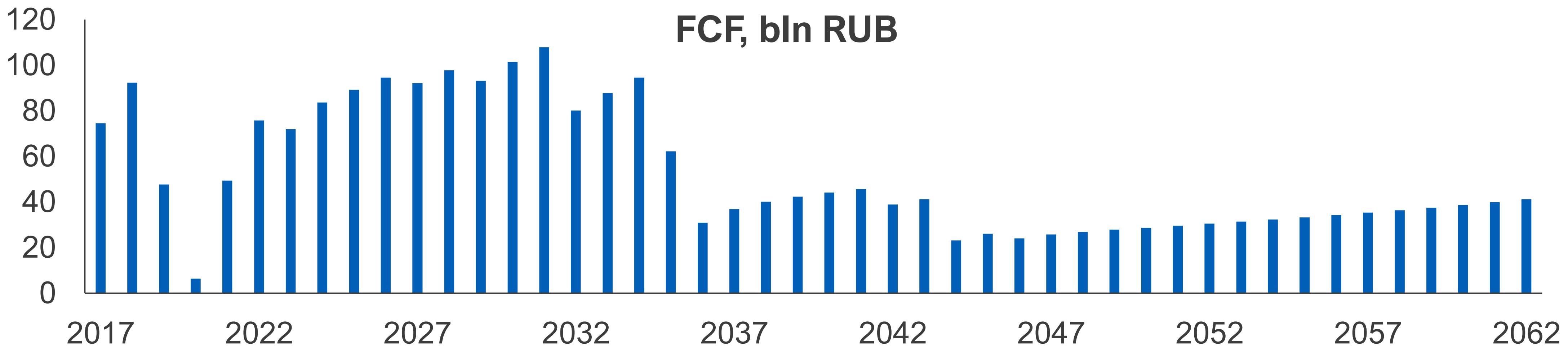
KEY FINANCIALS

HIGHLIGHTS

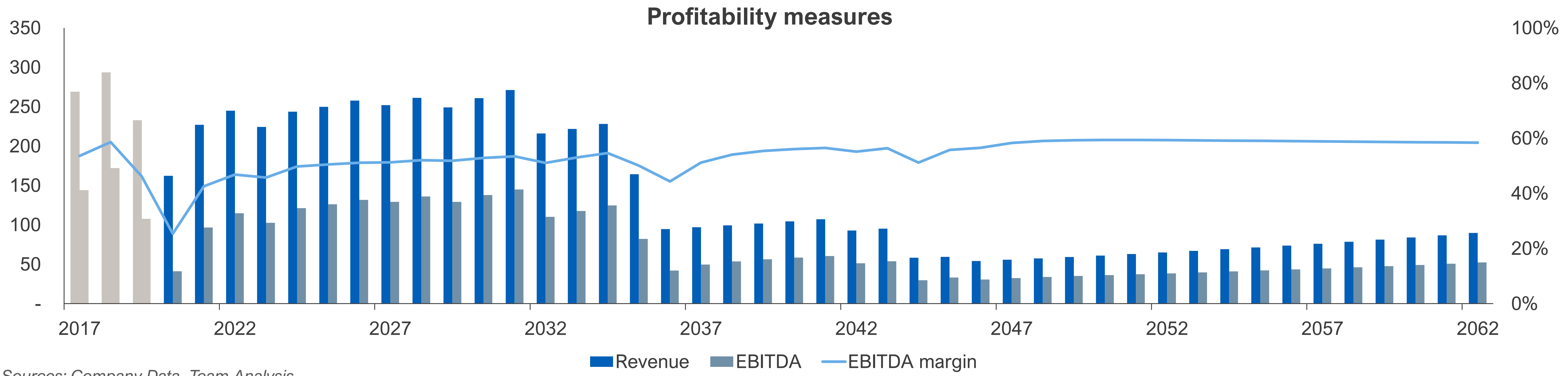
Company demonstrates stable – above 45% margins (best-in-class)

Positive long-term cash flow

STRONG FREE CASH FLOW GENERATION



PROFITABILITY



Sources: Company Data, Team Analysis

VALUATION SUMMARY AND MARKET APPROACH

WACC calculation

Cost of equity	
Risk-free rate	2,2%
ERP	5,2%
Unlevered Beta	1,02
Target D/E	29,8%
Levered Beta	**1,26**
Country risk premium	4,0%
Size premium	-0,4%
Cost of Equity	**14,82%**

Cost of Debt	
Pre-tax Cost of debt	**5,08%**
Tax rate	20,00%
After-tax cost of debt	**4,06%**

WACC

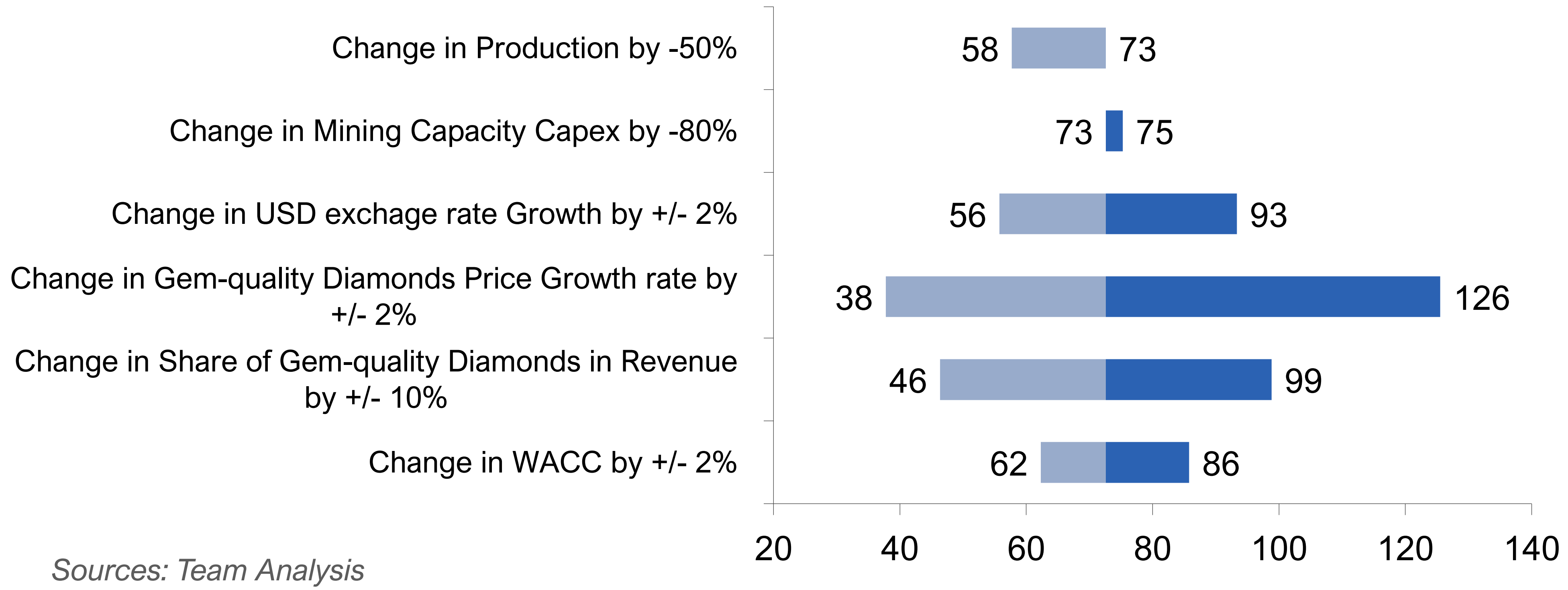
77% x 14.82% (Equity) + **23% x 4.06%** (Debt) **= 12%**

Comparable companies are on average priced higher, than ALROSA

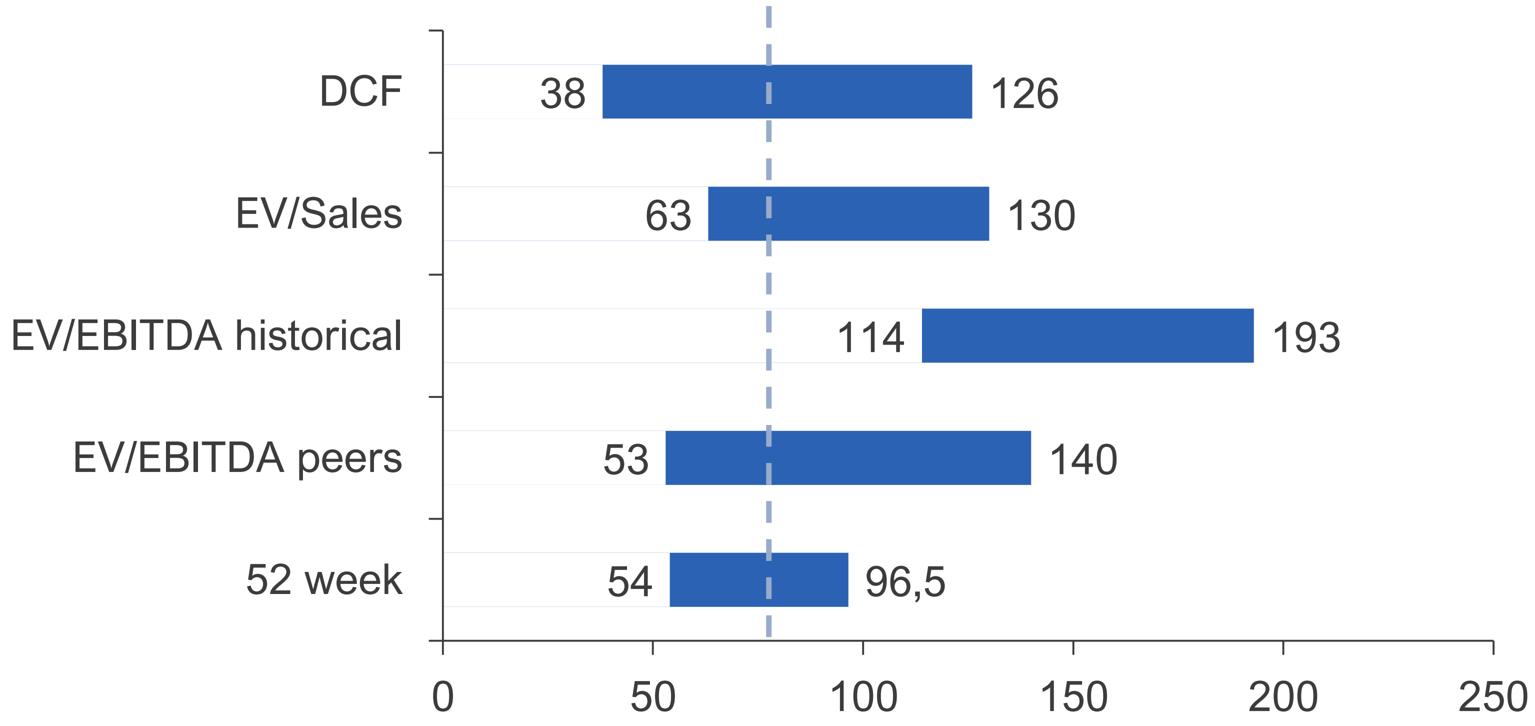
	Avg	Median
EV/EBITDA	8,22	7,56
EV/SALES	1,87	1,85
EV/EBITDA (Alrosa)	5,26	5,21

DCF model gives us estimate, which is in line with industry multiples

The effect of changes in parameters on the Share Price, RUB



Closing price as of 22.04.2020, **RUB**



Sources: Team Analysis

INVESTMENT OPPORTUNITIES

22.04.2020	2020 – 2025	Exit on 22.04.2025
Acquiring 5% Alrosa Price per share = 63 RUB per share **(23 071) mln RUB**	**5-year sum of Disc Dividends** Cost of Equity = 14,8% **7 650 mln RUB**	**Exit at EV / EBITDA = 6.02** **Disc 5% Share = 25 865 mln RUB** **NPV = 10 444 mln RUB** **IRR = 17.8%**

22.04.2020	2020 – 2025	Exit on 22.04.2025
Acquiring 5% Polyus Price per share = 162 USD per share **(1088) mln USD**	**5-year sum of Disc Dividends** Cost of Equity = 10,7% **265 mln USD**	**Exit at EV / EBITDA = 8** **Disc 5% Share = 1516 mln USD** **NPV = 693 mln USD** **IRR = 16.2%**

Sources: Company Data, Team Analysis

BUY RECOMMENDATION WITH THE TARGET PRICE OF 72.59 RUB

5 REASONS TO BUY

1. Solid business with high-quality assets
2. Ahead of competitors by production, margin and reserves
3. Strong cash generation capacity due to highly-marginal product
4. Liquid and stable for Russian stock market
5. Great credit quality, with low Net Debt level
6. Sustainable and clean miner

PRICE UPSIDE
15.9%

DIVIDENDS YIELD
7.2%

TOTAL RETURN
14.7%

2020

62.65 RUB
As of April 22

72.59 RUB
Target price