

Expropriation of the Entities in Donbass: Entire Ukraine Will Feel the Loss of These Enterprises by the End of Summer, Says Metinvest CEO

Rinat Akhmetov and Vadim Novinsky's Metinvest Group announced the loss of control over all enterprises located in the temporarily occupied territories in mid-March. This had been preceded by the trade blockade, ongoing fighting in the ATO area and continuing shelling of Avdiivka, where Group's coke and by-product plant is located. Yuriy Ryzhenkov, Metinvest's CEO, spoke to HB Business about the meaning of the lost entities to Metinvest and actions Group intends to take to sustain the operation of other entities.

– When did you find out about the takeover of the company's entities in so-called DNR/LNR, and what was your reaction?

– I guess we need to take a look back. We have been hearing about the expropriation of these entities since 2014. As soon as these formations emerged, from day one they started making statements, such as: "take away from oligarchs, nationalize and so on". So, this was nothing especially new to us. This time, however, armed people entered the plants and took control of property that did not belong to them. That is the main difference. It should be borne in mind, though, that this did not happen overnight. First mentions about this date back to December or November last year. Later, there was another scenario, where this would have happened unless blocked railway tracks had been released by 1 April. After that, they started speaking of 1 March, but nothing happened. While on 15 March, they started expropriating SCM's entities. Separatists came to Komsomolets Donbassa mine (belongs to DTEK - *Ed.*) and started to take coal away. They came to our Yenakieve Iron and Steel Works, and this was when we realized that the control was lost. One cannot say this came as a surprise. We looked at different scenarios of likely developments since the blockade started. At that point, we had already made a decision to recognize the loss of control as soon as someone starts to take away our products from the enterprises or bring in their raw materials and make attempts to process them, and give orders to dispose of our property. This happened on 15 March, and we decided that we can no longer be accountable for developments in that territory.

– Losing these enterprises - how critical is it?

– These enterprise represent a sizable part of our Group. They accounted for 5% of Metinvest's EBITDA in 2016. Furthermore, some of them, for example, Yenakieve Steel, were a focus of Group's investments in the last decade. These were ones of the most state-of-the art enterprises.

– I heard you had invested one billion US dollars in Yenakieve Steel ...

– When it comes to Yenakieve, the only thing that was left unfinished there was building a new sinter plant (works commenced at the beginning of 2014, but were not finished – *Ed.*). Had we built the new sinter plant, Yenakieve plant would have become an absolutely state-of-the art facility. Everything else had been put in order already. The plant had new blast furnaces in operation, complete with pulverized coal injection that was launched in 2014. There was a new oxygen plant that was built together with French Air Liquide. There were continuous casting machines in operation that were built in the last decade. This was, indeed, a modern plant and a very good asset from the technological standpoint. Unfortunately, all of it has been lost. On the other hand, one should put things into perspective. In the last three years, these plants would be repeatedly shut down and relaunched. Total losses incurred by Metinvest's enterprises located in the temporarily non-controlled territory over this period exceeded USD 210 million. In the last three years, these plants did not generate income to Group. This was rather about our social responsibility and our commitment to retaining assets for the future. So, the answer to the question about the extent of damage depends on what happens to Donbas over time.

If the situation in Donbas continues to be as it is now and as it has been in the last three years, then we, in practice, incurred all losses already in 2014. And from that moment on, we simply deferred the moment to recognize that the value of these entities had been lost. If the situation works itself out somehow in the next half a year or one year, I am sure we will be able to return and claim our rights to the property that is lawfully ours back. And we will develop these enterprises further. Having said that, there is another point I would like to make. All mass media wrote that Rinat Akhmetov had lost property. In practice, when it comes to losses incurred by Mr. Akhmetov, SCM Group, Metinvest Group or DTEK, I repeat myself saying that these losses actually occurred back in 2014, when the situation went out of control and it spiralled into an armed conflict. While, at this point in

time, it is not only Mr. Akhmetov who has been affected by the blockade and the idling of these enterprises. Major losses have been incurred by Ukraine as a state. Tax proceeds from Metinvest's enterprises located in the non-controlled territory exceeded one billion Ukrainian hryvnias for the last year alone. We estimate currency proceeds these enterprises would have contributed to Ukraine in 2017 at \$700 million. 20 thousand jobs were lost; behind these lost jobs are people who lost income and who paid taxes and social contributions to Ukraine. It was, therefore, not the business that suffered the biggest losses. Business lost some and gained some since it would always find ways to evolve and ways to make money. It is the country that has definitely suffered a loss.

– How much are those who imposed a blockade responsible for what happened? Did they trigger this expropriation, and would it have happened had there been no blockade?

– This is rather a political issue. Whether they could have propelled this... Yes, it might have been the case. Whether they could have been exploited... Yes, they might have been taken advantage of. Most likely, it is a little bit of this, and a little bit of that. Some sincerely believed that routes needed to be blocked and were simply used, while others acted as agents provocateurs to trigger this story. For whose benefit? This question remains open.

– Speaking of specific process chains, you had Krasnodon Coal, the company's largest coking coal mining entity, there. What was its share of coking coal deliveries? Can it be substituted? Will it be more expensive and how much more expensive?

– It accounted for 8% of our coking coal supplies last year. Of course, it can be substituted. We looked at different action plans subject to the occurrence of this or that risk. We have been working on this since 2014, when it became clear that such things were likely, and the likelihood was high. As such, we started diversifying our supply chain already at that point in relation to the raw materials supplied from the occupied territory. Essentially, two key raw materials, such as limestone and coking coal, were sourced from there. As far as coking coal is concerned, we have ramped up seaborne imports - we take in practically all products of UCC, our subsidiary in the United States. Until January this year, when we decided to utilize the entire volume in-house, we would sell almost half of it locally in the United States and take another half for internal use. Furthermore, we have well-established relationships with other coking coal suppliers from Australia, Canada, and Indonesia. Nowadays, this coal is delivered via Yuzhny port. There is also the third source, as we buy almost all coking coal that is produced in the territory controlled by Ukraine. Unfortunately, there is not much of it. Mainly, it comes from Pokrovskoye Mine Group, i.e. former Krasnoarmeyskaya-Zapadnaya mine (owned by Donetssteel – *Ed.*). We buy from them all the material that they have available. And the fourth source is represented by the coal deliveries from Russia. Logistically, Russia is the source of coal with the shortest haul for us, right after Ukraine. This is often called re-export of Ukrainian coal from the non-controlled territories, but this is not true! The coal that we buy from Russia is of high quality, and it is simply not produced as such in the non-controlled territory of Ukraine.

– Can it be distinguished by quality?

– Absolutely. The origin of coal can be identified based on its quality. It is impossible to sell coal from Donbas as coal from Kuzbass. The difference is quite obvious. The coal from Kuzbass is higher ranked compared to the one from Donbas in terms of quality. Based on sulphur content and abrasive wear resistance of coal, it is possible to identify where it came from. The coal from Kuzbass is softer and has a lower sulphur content. The coal from Donbas is harder and has a higher sulphur content. Therefore, we know exactly what we buy.

Currently, Ukraine that is faced with a shortage of this raw material cannot stop buying it abroad. Of course, we should have an alternative in case Russia decides to discontinue its deliveries. Should this be the case, we will source from Canada and Australia and will promptly substitute this raw material. That being said, if we can buy high-quality raw materials cheaper from Russian suppliers, we should do so.

– With regard to coal, it's clear. What is the plan to substitute limestone, which was supplied from the non-controlled territories and from the Crimea?

– Before the blockade and the nationalization in the non-controlled territories, the volumes from the Crimea could be easily swapped for products of Dokuchaesk Plant or Komsomolske Flux Plant that was part of Group. Upon the onset of the blockade, operations of these plants were halted. Today, we have four possible sources of this raw material. First of all, this is Novotroitske Flux Plant near Volnovakha that is located in the controlled territory. We buy practically all volumes produced there. In addition, there are producers in Western Ukraine, but their limestone is less suitable for the steel making process. We are currently looking for the techniques to maximise its use. We also need high-quality limestone equivalent to the one that was previously supplied from Komsomolske Flux Plant. It represents 15% of our needs. There are only two or three sources of such a material, not counting those in the non-controlled territory. This is essentially the same seam that extends from Donbass to Lipetsk. It should be mentioned, though, that there are alternatives, as we have recently bought the material from the UAE. In terms of its main properties, the raw material is on par with the Russian one, so we have diversified our sourcing. Purchasing from Poland and Slovakia is also possible, but their limestone is similar to the one from Western Ukraine in terms of its quality. Therefore, when it comes to the diversification of the supply chain, we have solved the issue of limestone sourcing.

– **What is your estimate of the losses suffered?**

– It will be appropriate to speak about this once we have published the half-year results, since there are two sides to any crisis. Crisis is also an opportunity. Now, when we buy coal of higher quality (as the coal from Donbas was much inferior), this allows us to produce substantially higher quality coke. Yes, theoretically, we can see a price difference of 30-50 USD per ton between the coal from Donbas and the seaborne coal. However, in practice, some part of it can be offset by a higher performance thanks to a better quality of coke.

Furthermore, we are strongly focused on the production of high-quality IORM with Fe content above 65% at our mining enterprises. Now, summing it all up and we want estimate the ultimate effect in the blast furnaces of all our steel plants. It may happen that we will be able to offset a substantial part of losses thanks to higher performance due to a better quality of raw materials.

– **Let's come back to the issue of Yenakieve Iron and Steel Works. You used to supply captive iron ore there and exported finished rolled steel products from EMZ. Now, you will simply export the ore. How critical is it?**

– In normal times, Yenakieve Steel had EBITDA of \$100-150 million per annum in stable operating conditions. Iron ore was supplied to EMZ at a market price; likewise, its rolled steel was sold at a market price. And the margin would be up to 150 million! On the other hand, the plant was not generating income to the company over the last years. As such, we, in fact, regret losing the entity, in which we invested a lot of money. However, I repeat myself that the country's economy suffered much bigger losses. We will re-orient iron ore to export markets and minimize our losses, and, in doing so, we will try to compensate for the loss of this plant to the maximum extent possible, whereas losses to Ukraine are inevitable.

– **Your products were used for downstream processing in your European mills. How will this be handled now when it comes to the European re-rolling mills?**

– Indeed, one European rolling mill - Bulgarian Promet Steel - used EMZ billets. Nowadays, this mill operates as a conventional European re-roller. We are investigating sourcing of square billets for its needs. Last month, for example, we bought square billets from Kurakhovo-Steel, supplied them to Promet and produced rebar. We are currently negotiating with ArcelorMittal in Kryvyi Rih and Belarus mills that produce square billets. I believe we can supply this mill with square billets by buying them in the market. Of course, this will be less efficient compared with the in-house production of square billets from iron ore, yet this product can be procured.

– **Have you thought about developing in-house production of square billets in the controlled territory?**

– We have a project for the revamp of Continuous Casting Machine-4 at Azovstal Iron and Steel Works. The plan is to convert it from a slab caster into a bloom caster that will produce blooms and square billets, which are suitable for Promet. We are carefully reviewing this project. It may happen so that we will expedite its execution.

– **What about people living in the territory that is presently not under control of Ukraine? Is there anything the company can do for them?**

– People suffered most from this situation. They lost their jobs and income. The loss of these enterprises will take its toll on the entire Ukraine by the end of summer. These people felt it from day one. What did we do first? We founded a center in Mariupol to provide jobs to those who are willing to move from the temporarily non-controlled territory to the controlled one. Jobs were offered in Kryvyi Rih, Zaporizhzhya and Mariupol. Very few - about 500 people - have decided to move so far but I think this is just the beginning. As the situation gets worse - and I think it will - people will be moving out from there. What else will they have to do there? As far as I know they were promised to be paid, so they stay there for now. I don't know how long this will last.

– **There were some publications saying that Russian oligarchs were gathered and told to supply raw materials to Yenakieve Steel. They say the owner of Novolipetsk Iron and Steel Works (NLMK) Vladimir Lisin and the owner of Severstal Aleksey Mordashov were instigated to do this. Is it possible that they will take so huge a risk and begin to supply raw materials to your enterprises?**

– Let's look into this. NLMK does not have enough captive raw materials to cover the needs of its own entities. Therefore, they have to purchase raw materials from outside. So hypothetically, two main candidates who might supply the raw materials to the non-controlled territories are Severstal and Metalloinvest. Let's not forget, however, that Severstal is a public company with securities listed at London Exchange and it has important international projects. Metalloinvest is also a large international company that uses credit facilities in the external markets and works with financial institutions in different countries. I doubt that any of these corporations would risk all it has, or risk its global reputation, or risk to fall under sanctions. While smuggling will inevitably lead to that.

– **They may come up with a scheme...**

– It will be known anyway where the raw materials are delivered from. The world community does not care whether it is done through Kurchenko's or some Ossetian firms. What will matter to the world community is that one of the lead representatives of the Russian business elite illegally supplies its goods to the stolen enterprises while clearly understanding where these goods will go. The truth is that all mills in Russia and Ukraine and all iron ore consumers are known. To say that a hypothetical mining enterprise in Russia supplied its iron ore to a company in Southern Ossetia or Rostov not knowing where it will be directed afterwards is to speak a myth, which may be acceptable to tax authorities of the Russian Federation yet will not be accepted by the world community. It will certainly not go unnoticed by us or the Ukrainian government. We will use every legal tool available to prevent this, or to make sure sanctions are imposed, appropriate penalties are executed and the loss is recovered. Knowing Metalloinvest, Severstal and NLMK, I doubt they will go for it. This will basically kill their reputation and all the work they have been doing world-wide so far.

– If these entities cannot be utilized, why then the terrorist leader of the so-called Donetsk People's Republic Aleksandr Zakharchenko took them away?

– I have not talked to Zakharchenko, therefore cannot comment on this.

– What is now happening to Avdiivka Coke? Is it in operation? What is its condition? Does the shelling continue?

– The shelling does continue. Unfortunately, shelling is an everyday occurrence there. The plant faces power failures every week. I would like to thank power engineers and the regional authorities for their commitment in restoring Avdiivka power transmission lines every time they are damaged. The situation there is quite critical. However, Avdiivka Coke continues its operation, and it's been a while since we had to stop it last time. About one third of our production facilities have been mothballed, and we use the power that is generated in-house. When power from the external grid becomes available, the plant uses excess electricity for the needs where in-house power is not sufficient.

– Why have the alternative power supply lines not yet been built?

– The construction of main lines is the prerogative of the state companies, and the construction plans are developed by the state. I believe they should be built and they need to be there. Why they haven't been built is not the question to be directed to us. We hope the alternative power lines will be eventually built, and this will add to our security at least on that end.

– Let's talk about the restructuring of your debts. First, congratulations on the completion of this process. I understand this has been the largest case of refinancing in Ukraine. How did you manage to finally reach an agreement with the investors?

– I think that the bulk of the agreement was attributable to the fact that we approached investors with the so-called open book. We sat down together and shared the operation model of Group's enterprises for the next 10 years. After that we looked together at the available market forecasts. We superimposed the forecasts on the models to see what impact each of the operation scenarios would have in terms of cash flow. Our key message was as follows: we don't want our investors to lose money. We are not talking about a write-off or a waiver of debt. We say we will be fully responsible for our debt and are committed to repaying it. The issue is that the market is volatile, and it was especially challenging at the start of our discussions. So we came up with a proposal to provide for certain level of flexibility in the company-creditor relations. If the market is high and the company has money, it expedites its debt repayment. If the market is normal, we follow the schedule that had been agreed upon with the investors. If the market is low, we have the right to transfer 70% of the interest to the future period payments during the first two years after signing the restructuring agreement. This constitutes an absolutely transparent arrangement that is understandable to each of our creditors. If everything goes well, the company will be generating cash flow and repaying its debt. If problems arise, they will know what they agreed to in order to help the company overcome temporary challenges.

– How is the deal structured and what secures the liabilities?

– We converted all our bonds into one type of Eurobonds that have terms and conditions I referred to and a new maturity date of 31 December 2021. All bank loans were also converted into one bank loan with a phased approach to repayment from 2019 to 30 June 2021. We have a standard type of collateral that we had before in the form of export contracts; we have a collateral in the form of guarantees of Ukrainian companies, and we now have a collateral in the form of a pledge of shares of some of our enterprises. These are, namely, Ilyich Steel, Ingulets GOK and 50% of shares of Central GOK. At the same time, our list of defaults in case of which these pledges can be charged is limited. The limitation is basically our inability to follow the agreed payment schedule.

– Moody's and Fitch upgraded your credit rating at the end of last week. They upgrade your rating while you lose your assets in Donbas. How is that possible?

– Ratings were downgraded when the company basically defaulted on its liabilities. We had discussions with our

creditors about the restructuring. Now when these discussions are over and the company has a clear-cut action plan for the next 5-6 years and a clear view of liquidity, there are no reasons for a low rating.

– Producers complain that Ukrzaliznytsya is making yet another attempt to raise the tariffs. What is the outcome of your today's discussion with the railway company representatives? Will they increase the tariffs?

– Given the level of quality, infrastructure and efficiency the state monopoly has, the rail freight tariffs are greatly overrated. Yet even this is not our major concern. We are more concerned that the spending of funds Ukrzaliznytsya receives from enterprises through an increased tariff is not transparent. We had a similar situation last year. We were told that investments would be made into infrastructure and equipment would be modernized. The tariffs were indeed increased, the funds were collected yet we have not seen any changes.

– An then the Dubnevykh brothers who oversee the procurement in Ukrzaliznytsya benefit from its proceeds...

– This question should not be addressed to me but to the National Anti-Corruption Bureau of Ukraine. I would rather refer to a different example. Kamysh Zarya - Volnovakha railway section in Mariupol, which was repaired by Ukrzaliznytsya last year has been our pressing issue. This is a very small repair project in terms of the cost vs. tariff comparison. Proceeds from tariff increase amount to billions, while the expenses I think were UAH 40 mln or 50 mln. We were promised 22-27 trains per day, whereas the maximum we've had so far was 20 trains. The average throughput capacity is 16-17 trains. This still hampers output at our Mariupol sites. We are not concerned by the size of the tariffs but rather by absolutely non-transparent and unclear distribution of funds. We have no way to control it. It is not clear which ministry ought to do this. It was the Ministry of Transport at first, and now it is the Ministry of Economics. As a result, we do not understand how this tariff will improve the efficiency. At the same time, our performance is simply killed by an increase in tariffs. Especially now when we have lost our customers in Donbas. Alchevsk Steel that used to buy our iron ore materials is lost along with Donetskstal and Yenakiieve Steel. Dneprovsky Iron and Steel Works is idle. A 25% increase of tariffs in such conditions will lead to a decrease in tax payments and in freight, and potentially to shutdown of some ore mining entities in Kryviy Rih. I don't think today is a good time to speak about the tariffs raise. It is time now to speak about Ukrzaliznytsya's investment plans and objectives, about the clear control of their fulfilment, about the tariff structure and principles of its formation, and about the anti-corruption actions that need to be taken by Ukrzaliznytsya. These are the things that are written in the contract of the current Ukrzaliznytsya CEO, so nothing is new. These are the things he ought to be doing. I hope Ukrzaliznytsya will begin doing it and will show the results soon. If corruption is removed and the tariff structure is streamlined, there will be enough money for adequate salaries for their employees, for investments and infrastructure modernization without raising the tariffs. When we all see it, that will be the time to sit down and discuss what the tariff should be, and how it will be priced and indexed.

– Last year, the export duty for Ukrainian scrap was increased. Has it helped you and is there enough scrap in the market?

– We are a stakeholder in this whole process, therefore I can speak on behalf of steel-makers. The situation has definitely improved. For the first time in the last three years Metinvest lived through the winter without any major shortage of scrap at its enterprises or failure in scrap supply. We have been able to create a good stock level, and this is quite representative. Is our demand for scrap fully met? No. In 1Q, the internal scrap deficit was still about 156 ths. t. What would we suggest? First, we believe it would be the right thing to extend the export duty for this strategic raw material given its shortage in the domestic market. It is not appropriate to take the strategic material out of the country when it is short. Second, and more important, is to understand how the scrap market can be deregulated in terms of scrap collection, acceptance and some other things to stimulate scrap collection. Third, but not the least, is we need professional scrap supply companies in Ukraine that will not only collect scrap but also demolish the old buildings and recover scrap from reinforced concrete structures, and so on. Such companies exist in Ukraine but they are very few. Something needs to be done to trigger their development so we have more players in the market willing to do this business.

– Former managers of Metinvest enterprises were recently appointed at Dneprovsky Iron and Steel Works. How did they come there and what is the purpose?

– As we all know coke was mainly supplied to Dneprovsky Iron and Steel Works from Alchevsk Coke (located on the temporarily non-controlled territory – *editor*). When the supply was blocked, the enterprise was left without coke and had to stop its operation. I want to emphasize that it is important for us that this enterprise continues to operate. It is a key consumer of our iron ore materials on the controlled territory of Ukraine and it is a crucially important client for us. I think it is an important asset for its owners. As I understand this is the first time the enterprise faces a full stop, and they are looking for ways to recover it. I think this might be the reason for inviting the former general director of Yenakiieve Steel to work for them. Aleksandr Podkorytov has, unfortunately, gained vast experience in re-starting operations since he had to do it many times in the last three years. His contract expired in the early April. Taking into account that Yenakiieve Steel is not presently under our control and its further operation is not clear, we reached a mutual agreement with Aleksandr not to extend his contract. That