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Long Ideas | Industrial | Russia

Polyus: Paper Losses Spoil Real Profits

Jun. 24, 2020 8:06 PM ET2 comments | 4 Likes

by: Danil Kolyako

Summary

- Polyus presented neutral Q1 results this June.
- The hedging strategy of Polyus looks flawed.
- The outlook is full of uncertainty, but the long-term prospects of Polyus still look bright.



Photo source: Polyus; image made by Author

There are three things you can watch forever: fire burning, water falling, and Polyus (OTCPK:OPYGY) recognizing paper losses because of its faulty hedging strategy. The company persistently hedges against the dollar and will keep losing money on this.

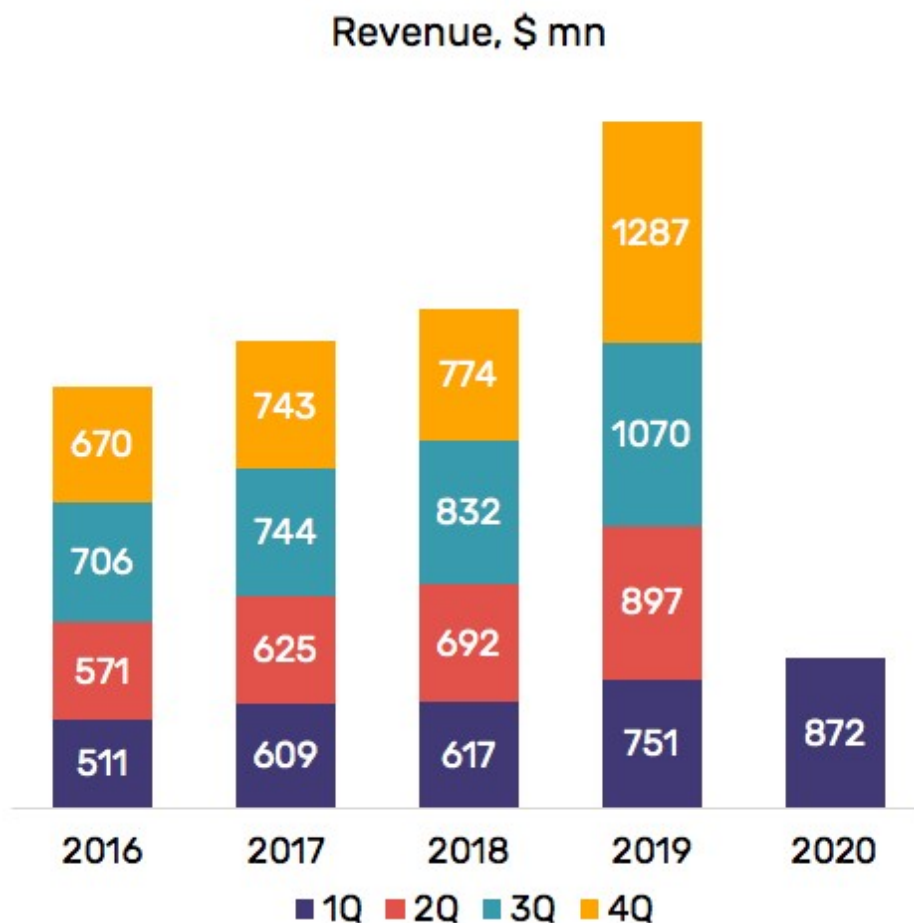
In the meantime, the coronavirus threat to the production has gone for now, partially because a significant part of employees at the Olimpiada mine now has anti-bodies due to not especially caring attitude of the management.

The stock isn't in a cheap zone, and the short-term outlook for gold miners is not very

favorable. This doesn't affect much the bullish case for Polyus though, which is primarily long-term focused. Therefore, I'm Bullish again on the company.

Q1 Results Highlights

Revenue decreased by 32% (+16% YoY) year-on-year to \$872 mn due to a decrease in production volumes of refined gold from the Olympiada, Blagodatnoye, Nataalka, and Kuranakh, as well as a seasonal decline in production at Alluvials.

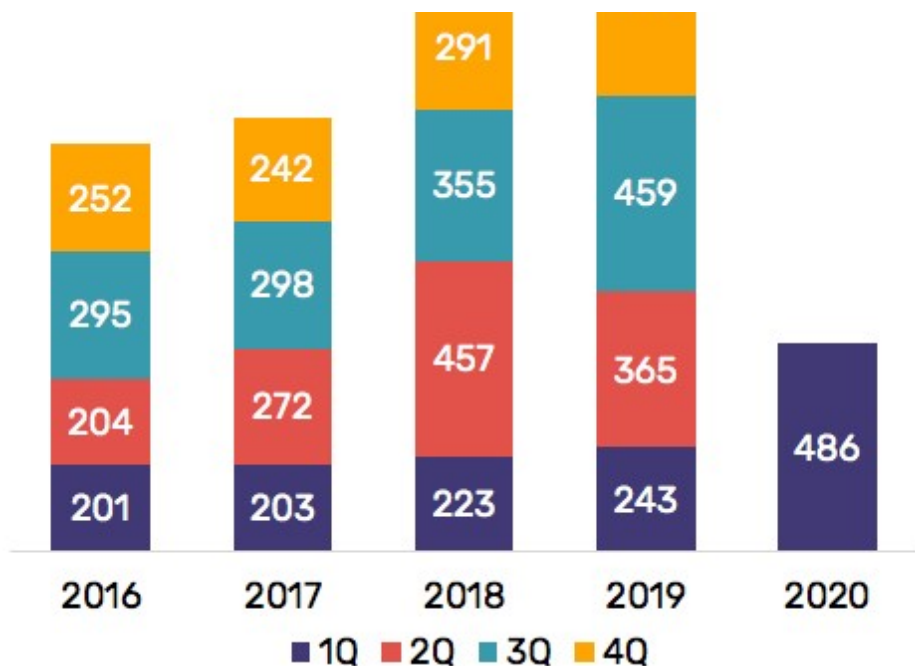


Source: Company data, Author's spreadsheet

Adjusted net profit decreased by 7% (+100% YoY) compared to the fourth quarter of 2019 and amounted to \$486 million. The company bears fruits of high sales and high margins to the full extent.

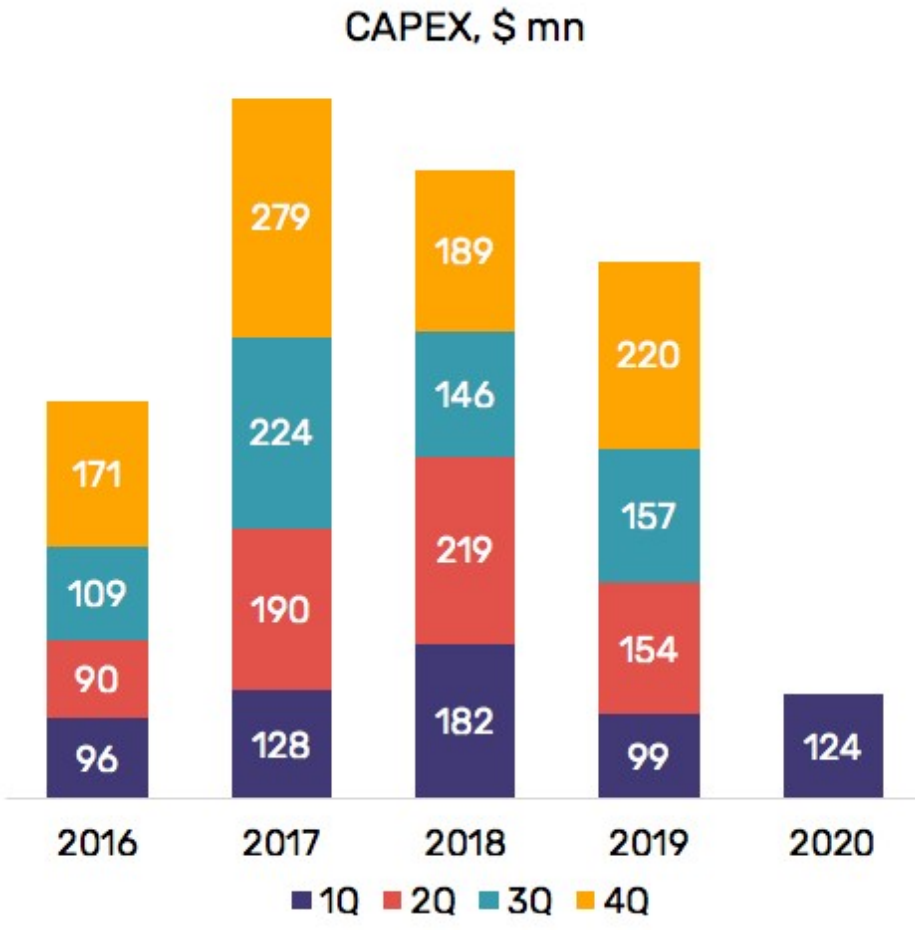
Adjusted Net Income, \$ mn





Source: Company data, Author's spreadsheet

CAPEX fell to \$124 million compared to \$220 million in the prior quarter.



Source: Company data, Author's spreadsheet

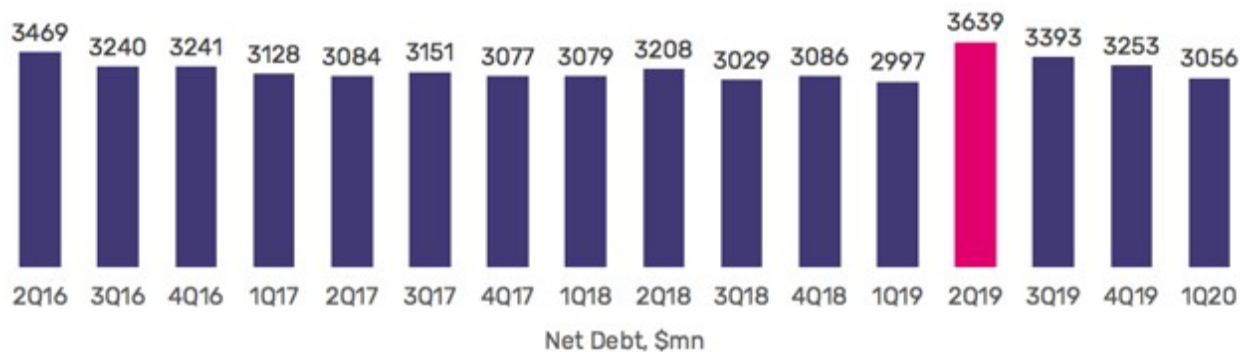
Net Debt amounted to \$3,056 mn, while Net Debt / Adjusted EBITDA decreased to 1.1x compared to 1.2x at end 2019 as net debt declined and adjusted EBITDA for the last 12 months increased.

In my previous article, I shared my concerns about the effect of the virus on production at Olimpiada mine. Since that time, the management admitted in the Q1 press-release that there's a "modest downside risk" to production guidance for 2020. The company will provide an update on this in Q2, and I personally don't expect anything serious because the company will likely maintain production at Olimpiada at all costs.

What's Wrong With Polyus' Hedging Approach

The FX volatility of recent months raised an issue known long before the coronacrisis - Polyus' hedging strategy. In late 2014, the company entered a currency swap agreement with an expiration date on April 9, 2019.

In April 2019, Polyus exchanged \$1,023 mn for 35,999 million rubles while the USD/RUB rate on April 9 was 64,92, losing over \$463 million in exchange differences. Earlier in 2018, the company signed a credit line with Sberbank to repay liabilities under the currency swap agreement. This led to a noticeable increase in the debt load.



Source: Company data, Author's spreadsheet

Also, the company practiced hedging a part of its sales volumes under its "revenue stabiliser" program. As a result, the company lost additional 32 million dollars.

As you can see below, the company demonstrates enviable persistence in its flawed approach. The company recorded \$534 million of losses on the revaluation of derivatives.

9. (LOSS) / GAIN ON REVALUATION OF DERIVATIVE FINANCIAL INSTRUMENTS, NET

	Three months ended	
	31 March	
	2020	2019
Revaluation (loss) / gain on cross currency swaps	(437)	90
Revaluation (loss) / gain on revenue stabiliser	(90)	17

Revaluation (loss) / gain on revenue stabiliser	(42)	11
Revaluation loss on interest rate swaps	(7)	(2)
Revaluation loss on conversion option (note 14)	(61)	(8)
Total	(534)	97

Source: Polyus

Where these losses came from? Let's take a look at page 42 of the recent financial results:

Revenue stabiliser

During the three months ended 31 March 2020, the group effectively closed out revenue stabiliser programme, with total premium of USD 32 million paid.

Gross currency swaps

The following terms were in place as of 31 March 2020:

Expiration date	Nominal		Frequency	Interest payments	
	Group pays (USD million)	Group receives (RUB million)		Group pays (in USD)	Group receives (in RUB)
July 2021	173	10,000	semi-annually	LIBOR + 4.45%	12.1%
July 2021	82	5,300	semi-annually	5.9%	12.1%
March 2024	125	8,225	quarterly	5.09%	MosPrime 3m + 0.2%
April 2024	965	64,801	quarterly	5.00%	MosPrime 3m - 0.45%
October 2024	310	20,000	semi-annually	3.23%	7.4%
March 2025	125	8,169	quarterly	2.8%	MosPrime 3m + 0.27%

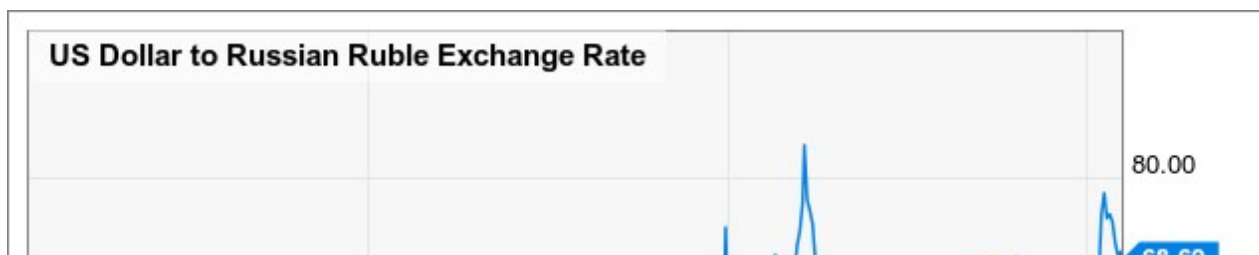
Interest rate swaps

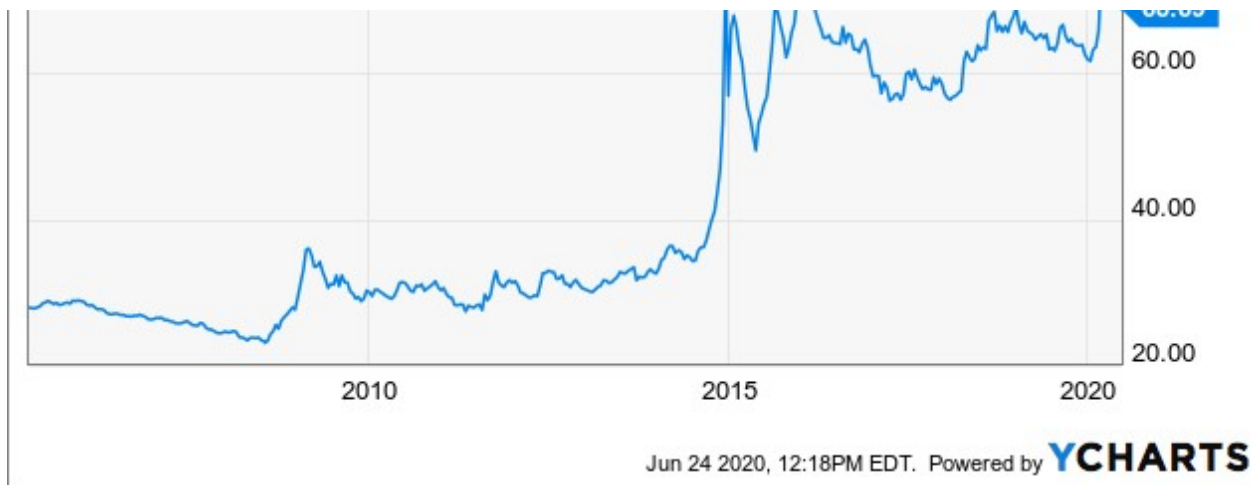
The following terms were in place as of 31 March 2020:

Expiration date	Nominal (USD million)	Frequency	Interest payments	
			Group pays	Group receives
February 2024	150	monthly	2.425%-2.44%	LIBOR
April 2020	750	semi-annually	LIBOR + 3.55%	5.625%
April 2020	750	semi-annually	5.342%	LIBOR + 3.55%

Source: Polyus

Under the terms of the swap contracts signed after April 2019, Polyus will pay in the sum of \$1.78 bn in exchange of 116,4 billion rubles on the expiration dates of these contracts. The average currency rate of the contracts is 65,44 rubles per dollar. I consider these terms absurd, because Russian ruble has a long history of devaluation towards the dollar, reflecting the structural weakness of the Russian economy after 1998, 2008, 2014, and 2020 crises, and the last one is still far from ending.





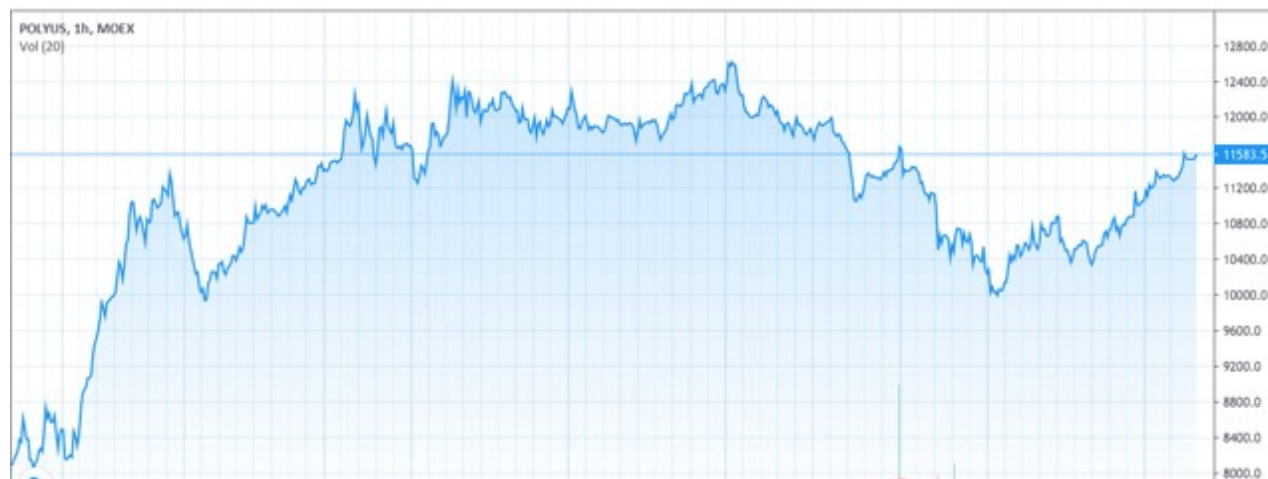
Data by YCharts

Ruble, the currency of a hydrocarbon exporter with an undiversified, shrinking economy, is destined to depreciate in the longer term even if all other countries except Russia will keep printing money in 24/7 mode until the rest of the century. High reserves, low debt load, and other positive sides Russia can boast prevent the economy from deeper crisis, but they have never ensured sustainable growth throughout the whole history of modern Russia.

To sum up on the issue:

- The losses mentioned in the Q1 results are not material, for now. It's quite likely, though, that these losses will materialize on expiration dates as it's extremely unlikely that we'll see USD/RUB rate at 65 in the medium to long term, in my opinion.
- The logic behind the hedging strategy remains unclear, and none of the analysts asked questions on the approach in the recent earnings call.
- The losses don't threaten the financial sustainability of the company but considerably slow down the process of deleveraging.

On The Stock





Source: *TradingView*

The stock has once again come close to all-time highs amid rising concerns about the actual state of the global economy. This factor is counterweighted by gradually reopening economies, negatively affecting investment demand for gold.

In the medium term, I also see the following reasons why gold prices may not go much higher from the current levels:

- While China, one of the largest jewelry markets in the world, is reopening, the second-biggest consumer of gold, India, is still suffering from the consequences of lockdown.
- I expect a long recovery in the jewelry market until the end of the pandemic. In Q1, the investment demand for gold compensated for the sharp decline in jewelry demand. This may change if the investment demand subsides amid the recovery of the global economy, causing a real decline in gold demand.

From the bullish side, continuous underinvestment of the gold mining industry and rising demand for usage of gold in manufacturing high-tech goods may serve as a long-term positive factor for gold miners.

The degree of uncertainty is still very high, so be cautious and prepare for volatility if you consider buying the stock.

Final Thoughts

Putting aside the strange hedging policy, Polyus is still a great gold mining company with solid fundamentals. In spite of the fact that the tendency of the company to create problems out of nowhere makes me sad, the overall track record of the management is still quite satisfying. The upcoming quarters promise to be interesting, so stay tuned for updates.

SUMMARY CARD: JUNE 2020

Polyus (OTCPK:OPYGY)

PROS

- Incredible profitability margins
- Steadily increasing production rates

CONS

- Low liquidity
- Don't expect high dividends

- The Sukhoi Log deposit will double up already high gold reserves

- Looks overbought in the short term

Rating

BULLISH

Upcoming Dividends

H2 2019 Payment: Summer 2020 (2,1% DY)

By Danil Kolyako For [Seeking Alpha](#)

Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

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Comments (2)

Alexander Schiller

Contributor **PREMIUM** Marketplace

Thanks for the article and in particular, clearing up the strange loss from financial instruments. They should really stop speculating and focus on creating shareholder value. Speaking of shareholder value - could you elaborate on the dividend? The comments in the earnings call were not quite clear to me.

25 Jun 2020, 07:11 AM

quantumphysxxx

Thanks Danil, without your coverage I would miss this pearl!!!

25 Jun 2020, 01:27 AM