November 14, 2012

Q3 2012 - Management Discussion and Analysis

The third quarter of 2012 brought a significant deterioration in the steel industry worldwide and in Europe in particular. Major steel producers posted very weak results and decided to revise their operational and financial targets in many cases. Such market development has also hit Cognor S.A. (Cognor, the Company, the Group), thus bringing down its business performance. In the last quarter we saw the demand declining in all areas of our activity coupled with the fact that steel product prices continuing to fall. At the same time, the costs of scrap metal held up unreasonably strongly thereby maintaining the grip on our profitability. Consequently, we decided to reduce the utilization of our production capacities which resulted in the decrease of revenues.

Despite those harsh market conditions, Cognor managed to maintain positive operational and net results. In our opinion the relatively positive performance during this market downturn as compared to the previous one back in 2009, has its roots in the right decision to divest the Company’s distribution arm in 2011 and concentrate solely on steel production and scrap trading instead. Our higher operational flexibility and the cost discipline have helped us to limit the negative impact of the current recessionary environment on our figures. Judging by the latest fluctuations in terms of scrap metal and steel products, as well as certain early market indicators, we believe that the last quarter may have been probably the weakest in the current cycle. Nevertheless, our predictions with regards to this years’ financial targets are not sustainable at the previously assumed levels.

I. Reported Statement

1. Income Statement (continued operations)

The Group’s revenues fell by PLN 90.2 million and 22.5%, while gross profit decreased by PLN 26.0 million and 55.6% as compared to Q3 2011. EBIT and EBITDA performance were also weaker with 90.0% and 70.4% decrease respectively. The FX development had a negative effect on our operations as the EUR/PLN average exchange rate fell by approximately 2.4% in the last quarter as compared to Q2 2012. It had an even more significant influence on our net financial costs with the exchange gain related to the Company’s indebtedness at PLN 13.5 million driven mostly by the strengthening zloty against the euro: EUR/PLN at 4.11 as of September 30, 2012 and 4.26 as of June 30, 2012.

END OF PERIOD EXCHANGE RATES	30 Sep 2012	30 Sep 2011	30 Jun 2012
PLN			
EUR/PLN	4,11	4,41	4,26
% change 30 Sep 2011	-6,7%		
USD/PLN	3,18	3,26	3,39
% change 30 Sep 2011	-2,4%		

AVERAGE EXCHANGE RATES	Q3 2012	Q2 2012
PLN		
EUR/PLN	4,14	4,24
% change Q2 2012	-2,4%	
USD/PLN	3,30	3,35
% change Q2 2012	-1,5%	

In the previous quarter (Q2 2012) we saw an improvement in the pricing environment which we rightly assessed to be just a seasonal phenomenon rather than an indication of any "real" market pick-up. We expected that seasonal improvement to last into the next quarter which would match the usual seasonality pattern. Instead, Q3 2012 brought the unexpected price softening which was a clear signal of the next step in the deterioration of the steel business that began in mid 2011. This time however, unlike in a few previous quarters, scrap metal reacted quickly and accordingly – thus, by the end of the last quarter a sizeable decrease in scrap metal prices followed to the extent of an even larger scale than the decline in the prices of finished products for Q3. Therefore, we believe this might have been the last downward phase in the current cycle.

The declining prices for finished products as compared to the stable or even slightly increasing prices for scrap metal created pressure on our margins and so our profitability fell both in comparison to Q2 2012 and Q3 2011. Once again, the HSJ steel products were particularly hit which was due to the difficulties of the European automotive industry. HSJ's shipments of finished products were down as compared to both quarters, however the pace of the decline has slowed down noticeably. A similar situation related to our finished products manufactured by Ferrostal where sales have even increased in comparison to Q2 2012. In terms of billet sales however, the situation was much worse since steel prices worldwide collapsed in August and so we decided to reduce the utilization of our production capacities and limited our sales activity to the domestic market of semi-finished products only. The decline in shipments was not limited to just billets, as sales for both scrap metal and finished products were lower as well.

UNIT PRICES		Q3 2012	% YoY	Q3 2011	Q2 2012
	PLN / Tonne				
Scrap metal		1 073	5%	1 022	1 060
Billets FERR		2 049	2%	2 016	2 142
	billet - scrap spread	976		994	1 082
Bars FERR		2 312	2%	2 262	2 412
	bar - scrap spread	1 239		1 240	1 352
Bars HSJ		3 133	-8%	3 423	3 302
	bar - scrap spread	2 060		2 401	2 242
Sheets HSJ		5 043	-5%	5 318	5 318
	sheet - scrap spread	3 970		4 296	4 258

The weakness of our operational profits in Q3 2012 was partially offset by FX gains related to the Group's indebtedness. Therefore, not only the Group's EBIT and EBITDA indicated profits but the net result was positive too.

INCOME STATEMENT	Q3 2012	Q2 2012	Q3 2011
'000 PLN			
Revenue	311 332	428 763	401 496
Cost of sales	-290 615	-386 409	-354 823
Gross profit	**20 717**	**42 354**	**46 673**
Other income	2 536	2 198	12 977
Distribution expenses	-5 510	-10 833	-9 989
Administrative expenses	-9 099	-11 887	-12 013
Other gains/(losses) – net	136	2 865	3 256
Other expenses	-5 108	-1 506	-3 879
EBIT	**3 672**	**23 191**	**37 025**
Financial income	15 370	-11 069	552
Financial expenses	-15 278	-17 094	-56 206
Net financing costs	**92**	**-28 163**	**-55 654**
Profit before tax	**3 764**	**-4 972**	**-18 629**
Income tax expense	-2 393	1 406	4 744
Profit/loss for the period from discontinued operations	0	0	0
Profit for the period	**1 371**	**-3 566**	**-13 885**
Depreciation and amortization	-10 443	-10 434	-10 719
EBITDA	**14 115**	**33 625**	**47 744**

The non-recurring items had a negligible effect on EBITDA with a more significant impact on our net profit. The adjusted EBITDA and net profit figures facilitate an analogous assessment of the Group's results apart from the ordinary course of business:

DESCRIPTION	**Q3 2012**	**Q3 2011**
'000 PLN		
Reported EBITDA	**14 115**	**47 744**
Non-recurring items including:	803	3 579
- costs of sales	*0*	*0*
- other income	*1 514*	*912*
- distribution expenses	*2 645*	*-693*
- administrative expenses	*-400*	*0*
- other gains/losses	*1 600*	*1 359*
- operational FX result	*-1 464*	*2 147*
- other impairments	*-3 092*	*-146*
Adjusted EBITDA	**13 312**	**44 165**
Reported net result	**1 529**	**-13 885**
Non-recurring items including:	12 808	-30 334
- EBITDA adjustments	*803*	*3 579*
- FX result on debt minus the FX result on assets	*13 528*	*-41 087*
- result from discontinued operations	*0*	*0*
- cancellation of bonds	*1 481*	*59*
- pro-forma income tax adjustment	*-3 004*	*7 115*
Adjusted net result	**-11 279**	**16 449**

According to the above adjustments, the Q3 2012 EBITDA stood at PLN 13.3 million and the adjusted net result at PLN (-) 11.3 million - less by PLN 30.9 and 27.7 million accordingly in comparison to the figures for Q3 2011.

The entities of the Major Group made the following contribution to the consolidated results for Q3 2012:

'000 PLN	FERR	ZW-WB	HSW-HSJ	ZLMET
Revenues	129 311	6 912	111 181	121 019
- incl. Internal	*746*	*6 596*	*384*	*60 122*
EBIT	1 942	493	3 063	-1 443
EBITDA	5 633	708	8 423	-301
Profit for the period	**-171**	**374**	**1 666**	**-1 905**

2. Balance Sheet

The amount of total assets decreased by 6.9% in comparison to Q2 2012 primarily due to the 12.0% decrease of value in the current assets. The decrease was mostly fueled by a 10.1% decrease in the value of receivables and by a 42.1% decrease in our cash position. As compared to Q3 2011, the Company saw an even greater reduction of current assets, mostly due to the 30.7% decline in the value of receivables. The reduction of total assets by 9.7% as compared to Q3 2011, was partially off-set by the increase in the amount of other long-term receivables.

ASSETS	Q3 2012	Q2 2012	Q3 2011
'000 PLN			
A. TOTAL NON-CURRENT ASSETS	**477 886**	**485 835**	**469 837**
I. Intangible assets	14 571	15 339	17 880
II. Property, plant and equipment	325 489	332 848	349 170
III. Other receivables	41 398	42 870	247
IV. Investment property and other investments	7 604	4 363	4 598
V. Prepaid perpetual usufruct of land	19 059	19 164	20 897
VI. Deferred tax assets	69 765	71 251	77 045
B. TOTAL CURRENT ASSETS	**445 139**	**505 616**	**552 355**
I. Inventories	**182 325**	**183 851**	**203 499**
II. Receivables	**202 039**	**224 746**	**291 636**
1. Trade receivables	198 319	221 005	254 172
2. Current income tax receivable	6	6	101
3. Other investments	3 714	3 735	37 363
III. Cash and cash equivalents	**48 898**	**84 475**	**40 505**
IV. Assets classified as held for sale	**11 877**	**12 544**	**16 715**
TOTAL ASSETS	**923 025**	**991 451**	**1 022 192**

The positive FX development which brought PLN 13.5 million of gains related to the Group's indebtedness in Q3 2012 helped to decrease the amount of gross debt by PLN 16.2 million in comparison to Q2 2012 and by PLN 21.2 as compared to Q3 2011. At the end of Q3 2012 the gross debt value was at PLN 571.6 million and the net debt stood at PLN 522.7 million. The equity figure remained pretty much unchanged in comparison to both quarters. The current liabilities fell by 18.7% as compared to the end of the previous quarter and 21.6% in comparison to Q3 2011. This was primarily due to the decrease in trade liabilities.

EQUITY AND LIABILITIES	Q3 2012	Q2 2012	Q3 2011
'000 PLN			
A. EQUITY	**188 486**	**187 144**	**185 421**
I. Issued share capital	132 444	132 444	132 444
II. Reserves and retained earnings	43 348	41 948	43 895
III. Minority interest	12 694	12 752	9 082
B. LIABILITIES	**734 539**	**804 307**	**836 771**
I. Non-current liabilities	**504 308**	**521 145**	**543 180**
1. Employee benefits obligation	6 560	7 151	10 093
2. Interest-bearing loans and borrowings	488 751	505 130	526 810
3. Other	8 997	8 864	6 277
II. Current liabilities	**230 231**	**283 162**	**293 591**
1. Interest-bearing loans and borrowings	69 353	74 972	39 617
2. Bank overdraft	13 534	7 687	26 423
3. Trade payables	143 369	195 076	220 801
4. Deferred government grants	1 768	3 502	2 825
5. Employee benefits obligation	1 667	1 232	1 951
6. Income tax payable	5	6	1 599
7. Provisions for payables	535	687	375
TOTAL EQUITY AND LIABILITIES	**923 025**	**991 451**	**1 022 192**

3. Cash flow (continued operations)

The Group had a negative operating cash flow in Q3 2012 as a result of weaker profits and the outflow to working capital at PLN (-) amounted to 26.9 million. Cash from investing activities was slightly positive, primarily due to the excess in disposals of fixed assets over expenditures related to newly acquired ones. Financing activities contributed negatively with interest expense payments as the major use of cash.

CASH FLOW	Q3 2012	Q2 2012	Q3 2011
'000 PLN			
OPERATING	-21 849	40 000	-816
INVESTING	128	6 281	15 289
FINANCING	-19 701	-26 572	-7 768
NET INCREASE IN CASH	**-41 422**	**19 709**	6 705

II. Main Metrics

Most of the main metrics remain at very favourable levels with the leverage ratio deteriorating due to weaker EBITDA in 2012 as compared to 2011.

MAIN METRICS	Q3 2012	Q2 2012	Q3 2011
Liquidity ratio	1.93	1.79	1.88
Quick ratio	1.14	1.14	1.19
Inventories turnover (days)	56	43	52
Receivables turnover (days)	57	46	57
EBITDA margin	4.5%	7.80%	11.9%
Net profit margin	0.4%	-0.80%	-3.5%
Equity	188 486	187 144	185 421
Net debt	522 740	503 314	552 345
Net debt / LTM EBITDA	6,0	4,2	5,4

III. Future capital structure

For the past few quarters Cognor has been analyzing the available options in terms of acquiring new long-term financing sources for the needs of the existing business. The intended primary use of those funds shall address the upcoming maturity of the currently outstanding EUR 118 million of the Company’s senior notes (the Notes). As the repayment of the Notes is due in February 2014 Cognor intends to finalize its new financing platform in the first half of 2013. During the past few quarters Cognor has been considering financing on the Polish debt market. Although quite shallow and immature, it looked promising in the first half of the year. Unfortunately, several instances of large scale bankruptcies involving construction companies and the related defaults, together with the general slowdown of the economy has resulted in the closing of the local bond market. We think it might take some time before it reopens again.

In light of the above and taking into consideration our mid-term expansionary CAPEX plans, we believe that the Group requires further deleveraging. Therefore, we are planning to propose a new share offering at the value of at least PLN 100 million. We assume that the remaining portion of the resources necessary to fund the Company’s needs will be acquired by means of a new Eurobond offering. We plan to carry out both issues simultaneously. We believe this refinancing approach will be assigned with the least execution risk, while it should also result in a lower level of indebtedness and thus, lower financing costs going forward. We also expect that such a combination of the new long-term debt with a significant equity component will also secure access to cheap vendor financing connected with our business development plans.

IV. Business development

Alongside the considerations on the optimal capital structure, the Group’s management have been working on mid-term business development. As a result of the divestiture of all our distribution segment back in 2011, the Company’s strategy required its redefinition. Consequently, we decided on Cognor’s organic growth, strengthening of our presence on highly specialized niche markets, production of high-alloy steels, as well as development of direct relations with end customers. We have also the ambition to become a quality leader in the production of our main and most profitable steel products - high-alloy bars (big rounds) used by the automotive industry. The ultimate rationale behind the said strategy is to bring Cognor’s profitability potential at a much more elevated point in two years’ time.

We believe Cognor is a highly flexible and cost efficient steel producer present in a fast growing and very prospective Polish market. We think that the relatively small sized steelmakers will maintain their competitive advantage over the big scale manufacturers in certain market areas. The Group is integrated upstream with secured access to scrap sources and it avails of advanced IT solutions in the management and control of operations. We are convinced that Cognor is very well positioned to become a leading steel producer in this part of Europe in terms of quality and profitability within the segment of high-alloy and specialized steels. Our weakness so far has been insufficient rolling capacities resulting in a large part of our production output being sold as semi-finished products (billets). This makes the Group’s profits more vulnerable to the steel market cyclicality.

With consideration to Cognor's further growth we have tried to assume all our strengths while addressing the issue of insufficient capacities in terms of finished products. We have visited many steel production facilities worldwide and analyzed the latest technological trends. Our views were also influenced by the current macroeconomic turmoil and its potential impact on the demand for steel products in the near future.

We have decided to invest in a new rolling line for long products in order to double our capacity in the production of big rounds and to significantly increase our product portfolio. We have analyzed the existing market potential and have come to the conclusion that the risk associated with the sales increase is acceptable since much of the incremental revenues could potentially come from our present clients. In terms of technical feasibility we would rely on the existing buildings and facilities at one of our steel plants. The project will not threaten the continuity of production in terms of the currently operated rolling mill. Apart from the capacity increase and the product portfolio expansion, the projected new rolling line is going to bring significant cost efficiencies and will enable Cognor to set up a new quality standard for these types of products.

As a result of the completion of the new line we will require more feedstock material (billets) for the rolling processes. Certain upgrading with respect to the present melting capabilities of Cognor will be necessary in order to make sure that all the billet supplies required by the new rolling line can be sourced internally. This is a very important assumption in order to make sure that higher quantities of our billets are further processed into finished products which as a consequence, should result in the further reduction in the volatility of our profits. We have assessed the scope and feasibility of the necessary enhancements and have come to the conclusion that such work could be fairly easy to carry out at one of our steel melting shops at relatively low costs. In addition, the planned upgrading will not only secure adequate feedstock material for the new rolling line, but it will also open a completely new market potential for the remaining quantities of our steel which we intend to continue selling as semi-finished products.

For the purpose of the realization of the afore-mentioned plan, Cognor has opened a tender and started negotiations with potential machinery suppliers based on the offers received. We plan to conclude this process very soon, considering the technical specifications provided, as well as the price offered, the references of supplier so far, the accessibility and the terms of potential long-term vendor financing for the aforesaid project.

Irrespective of the decision with relation to the supplier, the new rolling line could be operational by the end of 2014 and the upgrading of the melting shop could be finalized even a bit earlier. Taking into consideration the overall project costs, together with the expenditure on the necessary maintenance, we initially assume the following CAPEX for the next three years to come: 2013 – PLN 70 million, 2014 – PLN 150 million and 2015 – PLN 130 million. In return, we expect a very significant increase in profitability starting soon after the commencement of the operations of the new rolling line.

V. 2012 Financial Targets

In the release of June 14, 2012 Cognor provided an insight into its performance this year. In light of the unpredictably difficult market conditions during the last few months we had to consider a revision of the numbers that we had previously forecasted. Currently, we expect our financial performance in 2012 to be the following (PLN in millions):

- revenues: 1.450
- EBITDA: 75
- Capex: 20
- Interest expense: 50
- Gross debt: 550
- Net debt: 500.

The projected numbers assume the EUR/PLN exchange rate at 4.1 and they factor in similar Q4 2012 market conditions as the ones recorded in the last quarter. The revised figures constitute best-knowledge assumptions of Cognor's management and their realization remains subject to a number of internal and external risk factors and therefore, by no means can they be treated as any performance promise or guarantee.

VI. Earnings call

The conference call on our Q3 2012 results will be held in English language on Tuesday 20 November 2012, at 16:00 CET (15:00 London). Also on that day a special presentation will be made available for a download on the Company's website at: www.cognor.eu.

All participants are kindly requested to register in advance using the following link: https://eventreg1.conferencing.com/webportal3/reg.html?Acc=803090&Conf=185999