Equity Research

GERDAU

1Q23 Review: All said and Done

LatAm Metals & Mining

Main takeaways:

(i) Recovering market share, as expected; **(ii)** Positive highlight on volume from North America BD (+10,2% Genial Est.); **(iii)** Other BDs misses volume estimates; **(iv)** Realized prices in Brazil BD disappoint (-8,1% vs. Genial Est.), but resilience in North America BD pays off; **(v)** Total revenue up +5,1% q/q with volume recovery; **(vi)** Lower COGS/t at Brazil BD (-9,5% vs. Genial Est.) also helps consolidate an above expectations result; **(vii)** At North America BD, we see COGS/t on an opposite dynamic, rising +3,7% q/q; **(viii)** EBITDA margin recovery in all BDs, total at +7,1% vs. Genial Est.; **(ix)** Even with good operational, Net Income was also driven by non-recurring effects (+96% q/q).

Today, on May 3th, Gerdau released its 1Q23 results. The numbers came in higher than expected, due to a **recovery in market share**, even with **prices below our projections at Brazil BD**. Despite a **non-recurring effect helping to boost net income**, we see **another strong quarter**, with margin recovery from a significant drop in COGS/t at Brazil BD, **delivering a cost efficiency that surprised positively**, as well as being supported by operational growth through **demand resilience at North America BD**.

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Company

GGBR4 BZ Equity
Buy

Price: R$ 24,71 (03-may-2023)
Target Price 12M: R$ 31,00

1Q23 analysis

Recovering market share, as expected. 1Q23 sales volume came in slightly higher than expected for the main BDs, which was already seeing a good recovery in volume; with Brazil BD clocking in at 1,277kt (+1.2% vs. Genial Est.), up +10.9% q/q. The major responsible for the better volumes was the Domestic Market, reporting 1,087kt (+13.0% q/q; -7.7% y/y), fully in line with our estimates. As for the External Market, sales were apartment q/q, at 190kt (+8.6% Genial Est.), showing a stability that exceeded our estimates for a quarter with cooling demand.

Positive highlight on volume from North America BD. The unit's volume came above our projections, contributing positively to the consolidated result, as reported sales was 1,104kt (+10.2% Genial Est.), showing a great market recovery on +22.5% q/q, while flat on a y/y basis, seeming to us a good sign, in face of peers suffering from the end of the steelmaking bullish cycle.

Other BDs misses volume estimates. Despite a good performance in North America BD, the other BDs showed retraction. With downward highlights to **(i)** Specialty Steel, delivering a volume of 355kt (-9.3% vs. Genial Est.), consolidating a sharper drop of -11.5% q/q and **(ii)** South America, which brought sales of 281kt (-3.1% q/q), slightly below our estimates.

Realized prices in Brazil BD disappoint, but resilience in North America BD pays off. Our expectation was that realized price would be almost flat q/q in the two largest BDs, but what was seen was a more significant price detraction in Brazil BD than estimates, clocking in at R$5,423/t (-8.1% vs. Genial Est.), consolidating a decline of -9.2% q/q and -6.4% y/y.

As for the North America BD, in a similar trackway as expected, with only a slight drop, Gerdau delivered a realized price of R$7,059/t (-2.3% vs. Genial Est.), decelerating only -3.3% y/y, practically flat, which we understand to be a positive point of the result considering the top of the consumption cycle for steel came it to an end.

It is worth mentioning what was seen in the Special Steel and South America BDs, which increased their realized price, in line with what was expected. With the former up +1.8% q/q, while the latter up +6.6% q/q, mainly linked to the loss of volume, with the Company prioritizing price for these units.

1Q23 analysis

Total revenue up q/q with volume recovery. In line with our projections, net revenues were R$18.8bn (-2.3% Genial Est.), but formed by a slightly different composition than expected, with **(i)** Brazil BD posting R$6.9bn (-7.0% vs. Genial Est.), performing worse than excepted due to the realized price dropping more intensely than estimate, while **(ii)** North America BD came in at R$7.7bn (+7.6% vs. Genial Est.) due to the positive surprise in sales volumes, even with flat prices.

In the others, we see delivery in South America BD perfectly in line, at R$1.6bn (+3.3% q/q) but with Special Steels BD lower than expected (-11.3% vs. Genial Est.), decelerating to R$2.9bn (-9.9% q/q), reflecting a larger retraction in both price and volume.

Table1. Net Revenue Gerdau (1Q23 vs. Genial Est.)

(R$ millions)	1Q23 Consolidated	1Q23E Genial Est.	% R/E	4Q22 Consolidated	% q/q	1Q22 Consolidated	% y/y
Net Revenue	**18.872**	**17.964**	**5,1%**	**20.330**	**-7,2%**	**20.330**	**-7,2%**
Brazil	6.925	6.877	0,7%	8.022	-13,7%	8.022	-13,7%
North America	7.793	6.472	20,4%	8.222	-5,2%	8.222	-5,2%
South America	1.612	1.561	3,3%	1.753	-8,0%	1.753	-8,0%
Special Steel	2.948	3.274	-9,9%	3.219	-8,4%	3.219	-8,4%
Eliminations	(406)	(219)	85,4%	(885)	-54,1%	(885)	-54,1%

Source: Gerdau, Genial Investimentos

Lower COGS/t at Brazil BD also helps consolidate an above expectations result. Despite marking a stable total cost q/q, at -R$15.2bn (-4.0% vs. Genial Est.), COGS/t showed a significant deceleration at Brazil BD, therefore performing well in terms of efficiency even in facing less visibility of cost dilution, being the major responsible, in our view, for flat delivery of the consolidated total cost despite a scenario of inflationary pressure.

Thus, the COGS/t at Brazil BD was R$4,723/t (-9.5% vs. Genial Est.), with a reduction of -13.4% q/q caused by lower accounting costs with **(i)** iron ore, where it seems to us that Gerdau saw itself in good timing purchasing iron ore before the hikes, dribbling the +26% q/q increase of the reference curve 62% Fe; as well as **(ii)** lower spending with coal (considering the 120 days delay) and the more focused production in scrap Mini-mills; and **(iii)** natural gas also in decline in the energy transformation process. As a reflection, the unit scored total COGS of -R$6.0bn in 1Q23 (-8.5% vs. Genial Est.), coming in significantly better than expected.

At North America BD, we see COGS/t on an opposite dynamic, rising q/q. If on the one hand North America BD outperformed Brazil BD for revenue, on the cost side, the opposite occurred. Reported a +3.7% q/q rise, marking a delivery of R$5,297/t, despite coming in slightly below our estimates (-2.4% vs. Genial Est.), North America BD was not able to keep up with Brazil's efficiency gain.

Therefore, consolidating a total cost for the unit at -R$5.8bn (+7.7% vs. Genial Est.), pushed up by higher-than-expected volumes, which increased total cost as a counter to revenues exceeding our estimates. Delivery shows a +14.5% q/q increase in costs due to resilient inflation in the US and lower ferrous scrap availability, raising the COGS/t level compared to last quarter.

In addition, South America BD had COGS in line, at -R$1.2bn (flat q/q; -11.5% y/y), while Special Steel BD had cost at a reduced level, at -R$2.5bn (-13.5% vs. Genial Est.), driven by lower-than-expected sales.

Table2. COGS Gerdau (1Q23 vs. Genial Est.)

	1Q23	1Q23E		4Q22		1Q22	
(R$ millions)	**Consolidated**	**Genial Est.**	**% R/E**	**Consolidated**	**% q/q**	**Consolidated**	**% y/y**
COGS	**(15.243)**	**(15.870)**	**-4,0%**	**(15.036)**	**1,4%**	**(15.149)**	**0,6%**
Brazil	(6.031)	(6.591)	-8,5%	(6.275)	-3,9%	(6.226)	-3,1%
North America	(5.848)	(5.430)	7,7%	(5.106)	14,5%	(5.856)	-0,1%
South America	(1.244)	(1.238)	0,5%	(1.241)	0,2%	(1.405)	-11,4%
Special Steel	(2.519)	(2.911)	-13,5%	(2.855)	-11,8%	(2.601)	-3,2%
Eliminations	399	300	32,9%	441	-9,5%	938	-57,5%

Source: Gerdau, Genial Investimentos

EBITDA margin recovery in all BDs. Reporting a consolidated Adjusted EBITDA of R$4.3bn (+19.1% q/q; -25.8% y/y), the operating performance came in above our expectations (+7.1% vs. Genial Est.), even considering individually all BDs and their particularities regarding geographies. The operating performance showing an important improvement q/q occurred due to:

(i) **Brazil BD**: Delivering EBITDA of R$1.0bn (+11.2% Genial Est.), marking a strong upside of +40.5% q/q, by recovering volumes (even with disappointing prices), and by highlighting efficiency in a progressive state, reflected in COGS/t slowing down more than we expected; beating an EBITDA margin of 15.4% (+4.4p.p q/q)

(ii) **North America BD:** Reaching an EBITDA of R$2.3bn (+6.0% Genial Est.), another strong rise of +29.1% q/q, due to market share recovery and exposure to a more resilient customer segment, as we reported in our earnings preview, even with a slightly higher COGS/t playing against it, the business unit increased its EBITDA margin to 30.2% (+2p.p q/q).

For the other units, Special Steel BD reported an EBITDA of R$497mn (+2.4% Genial Est.), in line with our expectations, to beat a margin of 16.9% (+1p.p t/t). Meanwhile, South America BD reported EBITDA of R$489mn in 1Q23 vs. R$425mn Genial Est., above our expectations due to good cost management.

Table3. EBITDA Gerdau (1Q23 vs. Genial Est.)

(R$ millions)	1Q23 Consolidated	1Q23E Genial Est.	% R/E	4Q22 Consolidated	% q/q	1Q22 Consolidated	% y/y
Adjuted EBITDA	**4.322**	**4.035**	**7,1%**	**3.630**	**19,1%**	**5.827**	**-25,8%**
Brazil	1.064	957	11,2%	757	40,5%	1.951	-45,5%
North America	2.355	2.221	6,0%	1.824	29,1%	2.711	-13,1%
South America	489	425	15,1%	354	38,3%	483	1,3%
Special Steel	497	485	2,4%	525	-5,3%	692	-28,2%
Eliminations	(83)	(53)	57,9%	170	-	(10)	770,7%

Source: Gerdau, Genial Investimentos

Even with good operational, Net Income was also driven by non-recurring effects. From some recoveries and updates of tax credits and provisions, we see a positive effect going through Gerdau's P&L, which also helped its net income besides a solid operational mark up, reported at R$2.3bn (+42.3% vs. Genial Est.). Excluding non-recurring effects, which amount to ~R$1bn, we see that the Company should have reported a bottom line only slightly higher q/q, following the dynamics seen in EBITDA.

There for, net margin stood at 12.7% in 1Q23 (+3.97p.p. vs. Genial Est), with a great recovery due to the effect explained above, since in 4Q22 the Company had a net margin of 6.8%. Despite this, we still see a y/y drop, with EBITDA cooling down on a yearly basis.

Table4. Income Statment Gerdau (1Q23 vs. Genial Est.)

(R$ millions)	1Q23 Consolidated	1Q23E Genial Est.	% R/E	4Q22 Consolidated	% q/q	1Q22 Consolidated	% y/y
Net Revenue	**18.872**	**19.320**	**-2,3%**	**17.964**	**5,1%**	**20.330**	**-7,2%**
COGS	(15.243)	(15.870)	-4,0%	(15.036)	1,4%	(15.149)	0,6%
Adjusted EBITDA	**4.322**	**3.696**	**16,9%**	**3.254**	**32,8%**	**5.672**	**-23,8%**
EBITDA Margin (%)	22,9%	19,1%	3,77p.p	18,1%	4,79p.p	27,9%	-5p.p
EBIT	**4.292**	**2.921**	**46,9%**	**2.485**	**72,7%**	**5.014**	**-14,4%**
EBIT Margin (%)	22,7%	15,1%	7,62p.p	13,8%	8,91p.p	24,7%	-1,92p.p
D&A	(715)	(775)	-7,8%	(769)	-7,0%	(659)	8,5%
Financial Result	(50)	(379)	-86,8%	(498)	-90,0%	(503)	-90,1%
Net income	**2.388**	**1.678**	**42,3%**	**1.218**	**96,0%**	**2.940**	**-18,8%**
Net margin (%)	12,7%	8,7%	3,97p.p	6,8%	5,87p.p	14,5%	-1,81p.p

Source: Gerdau, Genial Investimentos

Our Take on Gerdau

Gerdau posted solid figures in 1Q23, above our expectations and the market consensus, with a great market share recovery due to increased sales volumes at its main units, with an important efficiency gain helping to cool down COGS/t at Brazil BD, which was felt due to the accounting drop (considering delays) in the price of commodities used as inputs for steelmaking.

If on one hand, Brazil BD gained prominence for its cost efficiency, despite a weak realized price, on the other hand North America BD accelerated COGS by high single digit, but nevertheless, obtained a gain above what we expected to see in the realized price, beating our estimates that already considered the positive effect of the exposure to more resilient segments, such as infrastructure projects, oil and gas and the automotive industry in the US, continuously gaining relevance in the Company's EBITDA.

Diverting from the macroeconomic slowdown and with the support of the US government Infrastructure bill (US$1.2 trillion) directed to construction and infrastructure, we believe that Gerdau should continue to maintain a satisfactory performance throughout the year, facing the tradeoff volume vs. price with a dynamic that we believe is quite attractive and that will offset the increase observed in the price of ferrous scrap due to the continued slowdown of availability in the US, putting pressure on the COGS/t of North America BDs for quarters ahead.

All Said and done. Commenting on the conference call, management made it clear that demand remains strong in both Brazil BD and North America BD, causing no major concern during the quarter, while the order backlog remains strong, with more than 60 days of visibility. We also highlight the economic activity in Mexico within North America. On the opposite side, the Special Steels division, which is more exposed to the automotive market, still faces some difficulties with the slowdown of the segment, especially in Brazil. We have better perspectives for the same segment in the USA dough.

With a solid quarter in performance, even in the face of expectations already higher than peers, the Company marked in this 1Q23 a consolidated EBITDA +7% above our estimates and a growing net income q/q even excluding non-recurring effects, which also boosted the numbers. In this way, Gerdau goes explaining, through the delivery of its own results, why we have chosen it as **Top Pick** for the **Metals & Mining sector**. All said and done...

Excellent cash generator, dividends on their way. From our perspective, Gerdau generated R$1.7bn of cash flow (FCFF) in 1Q23 (+42% vs. Genial Est.), equivalent to ~4% of the total Company's market cap in just one quarter, which we see as an excellent number. Our account considers the tax declared in the P&L (different from the release's illustration), but from the Company's perspective, the cash generation would have been even higher, reaching R$2.7bn (1.6x more than our calculation).

It is worth pointing out that even with a cooler CAPEX in relation to our expectations for the next quarters (we were not expecting an equal distribution of the R$5bn guidance for 2023), the Company was negatively impacted by a higher working capital need than it probably will have in the next few quarters. We understand that this requirement for working capital seems to be normal behavior for 1Qs, due to the pressure suffered between falling inventory and rising accounts receivable, in face of a sales volume more boosted than last quarter (which is usually seasonally weaker for steelmaking).

Considering this performance, the Company announced the **(i)** distribution of equity interest (JCP) in an amount of R$892mn, equivalent to R$0.51 per share, **(ii)** capital increase with stock bonus in the order of 1 to 20, and also announced **(iii)** the consolidation of 81% of its share buyback plan, which reaches 5% free float, at an average price of R$24.08 per share, putting another yellow sign that the stock prices are discounted.

We observe Gerdau trading at an **EV/EBITDA 23E** multiple of **2.9x**, below the historical average, **consolidating our view that the market is paying shallow premium for a Company with several competitive advantages** and that is already delivering today what it promises, even in the face of the cyclical adversities natural to the steel manufacturing business. We project a **FCF Yield** of **12.2%** for this year, which reinforces our **BUY recommendation** for the stocks, maintaining the **Target Price 12M** of **R$31.00**, which implies an **upside** of **+25.46%**.

Appendix: Gerdau

Figure 1. Gerdau – Income Statment in US$ Millions (Genial Est. 2023-2028)

Income Statement	2023E	2024E	2025E	2026E	2027E	2028E
Net Revenue	**80.555**	**83.882**	**85.383**	**85.479**	**85.981**	**86.020**
(-) COGS	(65.545)	(67.416)	(69.247)	(69.596)	(70.364)	(70.659)
Gross profit	**15.010**	**16.466**	**16.136**	**15.883**	**15.617**	**15.361**
(-) Expenses	(2.160)	(2.249)	(2.287)	(2.297)	(2.292)	(2.274)
EBITDA	**17.575**	**19.218**	**18.920**	**18.665**	**18.414**	**18.177**
(-) D&A	(3.155)	(3.293)	(3.328)	(3.325)	(3.297)	(3.268)
EBIT	**12.850**	**14.217**	**13.849**	**13.586**	**13.325**	**13.087**
(+/-) Financial result	(1.273)	(1.039)	(973)	(945)	(898)	(924)
(-) Taxes	(3.936)	(4.481)	(4.378)	(4.298)	(4.225)	(4.136)
Net income	**7.641**	**8.698**	**8.498**	**8.343**	**8.202**	**8.028**
Profatability						
Net margin (%)	9,49%	10,37%	9,95%	9,76%	9,54%	9,33%

Figure 2. Gerdau– Cash Flow in US$ Million (Genial Est. 2023-2028)

Cash Flow	2023E	2024E	2025E	2026E	2027E	2028E
Net Revenue	**80.555**	**83.882**	**85.383**	**85.479**	**85.981**	**86.020**
(-) COGS	(65.545)	(67.416)	(69.247)	(69.596)	(70.364)	(70.659)
Adjusted EBITDA	**17.575**	**19.218**	**18.920**	**18.665**	**18.414**	**18.177**
EBIT	**12.850**	**14.217**	**13.849**	**13.586**	**13.325**	**13.087**
(-) Taxes	(3.936)	(4.481)	(4.378)	(4.298)	(4.225)	(4.136)
(+) D&A	3.155	3.293	3.328	3.325	3.297	3.268
(+/-) Δ WK	(1.790)	(561)	42	(46)	(402)	150
(-) Capex	(5.123)	(4.102)	(3.152)	(3.023)	(2.997)	(2.971)
FCFF	**5.157**	**8.366**	**9.690**	**9.544**	**8.998**	**9.399**

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