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USIMINAS

2Q23 Preview: To hell in a handbasket ...

LatAm Metals & Mining

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Company

USIM5 BZ Equity
Neutral

Price: R$ 7.16 (21-jul-2023)
Target Price 12M: R$ 7.50

Main takeaways:

(i) Despite sales expectation near the top of guidance at 983Kt Genial Est, reduction q/q of the target for the quarter is a point of attention (-3.4% to -13.0% vs. 1Q23 sales); **(ii)** Domestic Market suffering in volume at 912Kt Genial Est. (-2.4% q/q); **(iii)** Automotive segment still a concern; **(iv)** Realized price in the Domestic Market should continue to fall to R$5,983/t Genial Est. (-3.2% q/q); **(v)** External Market will bring even more disappointing results regarding volume at 72Kt Genial Est. (-28.8% y/y), but profitability should be better; **(vi)** Volume increase and price drop for mining; **(vii)** We expect total revenue to contract slightly (-1.6% q/q), driven by a weaker steel industry; **(viii)** COGS/t should accelerate (+2.9% q/q), compressing margin and will be the big villain of the quarter; **(ix)** EBITDA is expected to suffer a free fall of -52% q/q; **(x)** Cash effect on working capital release partially offset by EBITDA decline; **(xi)** Net income follows strong operational downward dynamics, reaching R$287mn Genial Est. (-31.9% q/q); **(xii)** We reiterate our **NEUTRAL rating**, with a **negative outlook for the short term** and no catalysts for the stock to rise, **we cut our 12M Target Price to R$7.50** vs. R$8.10.

Usiminas will report its **2Q23 results on 28th of July**, before the market opens. We expect a **quarter with almost none improvements**. Basically, the only potential positive changes are in relation to working capital relief on the purchase of slabs and improved profitability in the foreign market operation, which despite projecting a drop in volume the price should help the operation margin. But otherwise, **operating performance should be quite anemic, with price and volume declines in the domestic market**, a significant **increase in** the cost of purchasing slabs processed by **COGS** in the quarter and the hiring of temporary labor to carry out the reform of Blast Furnace 3, increasing the value of the payroll, causing a **sharp drop in EBITDA of -52.6% q/q and -92.3% y/y**, according to our estimates.

2Q23 Preview

Despite sales expectations close to the top end of guidance, a q/q reduction in the target for the quarter is a point of caution. We view the sales guidance that the Company disclosed for 2Q23 at 900-1000Kt (-3.4% to -13.0% vs. 1Q23 sales) as negative, as it indicates that the environment still remains challenging for Usiminas, which we believe should put a damper on any attempts to increase or even stabilize realized prices for the quarter.

The natural movement would be an improvement in volume as the year moves towards 3Q, the historically most favorable quarter in terms of appetite. The natural seasonality of the steel business is a progressive increase in volume between quarters, returning to reduce volume in the 4Qs. In other words, intuitively what was expected was a guidance that indicated an increase or at least a stability of volume for 2Q23 in relation to the last quarter, however, what was seen was a reduction. The shortening of guidance compared to 1Q23 can be partially attributed to fluctuations in the domestic market.

Our expectation is for total sales volume at 983Kt Genial Est. (-5.0% q/q -9.7% y/y), close to the top of the guidance, but still showing a sequential slowdown rather than an expected natural progression, as we commented above.

Domestic market suffering on volume. As per guidance contraction, we forecast for 2Q23 a small volume reduction q/q, with sales at 912KtGenial Est. (-2.4% q/q; -3.8% y/y). Usiminas started the year resiliently, with indicators last quarter that surprised consensus, through resilient demand in January and February, mainly. However, from March onwards, we noticed a decline of this spare movement, and the breath seems to be over.

For us, the domestic market still presents a challenging environment, with an overloaded flow. In recent months, credit has been in turmoil and, although the scenario has improved somewhat with the market pricing in a fall in SELIC, the environment remains tight and credit still scarce. Therefore, we foresee a reduction in demand y/y across all segments of the customer base, excluding automotive and white goods.

Automotive segment still a concern. Despite the unique characteristics of these two segments (automotive and white goods), due to their respective substandard performances last year, Usiminas could potentially post nominal growth this year. This possibility occurs because these two sectors are showing an improvement compared to last year's demand. There may be slightly increasing volume y/y for these specific sectors, however, we estimate that the automotive sector is nowhere near achieving a consistent recovery. This is evidenced, for example, by Volkswagen's recent decision to suspend the layoff of an entire factory shift (~800 employees) at the Taubaté (MG) plant, due to the sector's diminished consumption appetite.

We believe that interest rates remain a significant factor. Based on current information, our assessment is that the discount incentives offered (which can reach a maximum of 10.8% on a vehicle basis) would not substantially move the balance anywhere, still resulting in weak appetite. Our forecast anticipates only a marginal increase in demand relative to previous projections. However, it is important to note that our initial outlook for this sector was rather bearish.

Consequently, unless rebate measures are combined with interest rate-related consumer incentives, the economic situation will not fully recover from the current downturn.

The segment is expected to close the year with 2% y/y growth, representing a more substantial improvement in the supply of components, rather than necessarily a voracious appetite for the automobile at the high end. Light vehicles' prices, even with the reduction will still be stretched. Another piece to this low single digit growth is the recompositing of vehicle availability from car rental companies, which are slowly resuming buying from factories again.

Domestic realized price to continue to fall, but scenario is not as bad as we initially projected. Our preliminary analysis in the 1Q23 earnings review was suggesting that Usiminas' realized price of flat steel could continue to fall this year. It is important to note that the Company normally applies two price adjustments annually for the automotive division. Management had announced that the price reduction policy seen in 1Q23 would be extended to 2Q23, offering a 12% discount to 80% of the customer base, instead of 10%, which was applied to 20% last quarter. The market could consider this favorable, given an original forecast of a run-rate price with a total reduction equivalent to 40%, adding the two adjustments.

Our hypothesis was that this discount trend could persist in 3Q23 and 4Q23, considering that the Company has already deviated from its regular routine of price increases. We held this view since our expectation was for a movement without any sufficient strength to set up a stable recovery in the light and heavy vehicle markets in 2H23. Considering that the market has come to expect a fall in the SELIC rate in this period, as well as the policy of incentives to reduce the value of vehicles by up to 10.8%, our scenario has improved somewhat from the previous forecast.

We believe the government measure will generate an addition of close to 100k new vehicles by the end of 2023, which will not be enough to recover the sector, however, it has become enough to become less bearish about the discount policy applied by Usiminas, in the segment that makes up ~1/3 of the sales volume. We believe that the alternative scenario to the consensus 12% discount that was implemented in 2Q23 will no longer be necessary, so that we see 2H23 with potentially more stable negotiations between the Company and the automotive industry.

Our view is that the 12% discount policy for this quarter tends to be partially offset by the more favorable dynamics for the distribution segment, which helps dilute the impact on the realized price for Usiminas, considering also that we expect stable prices for the industrial segment. With this mix, we expect a realized price of R$5,983/t Genial Est. (-3.2% q/q; -18.2% y/y) for the Domestic Market, a number that demonstrates the current difficulty of the steel sector, which suffers from a parity spread with imported steel and the depreciation of the USD/BRL facilitating the penetration of imported steel within apparent consumption.

External Market will bring even more disappointing results regarding volume, but profitability should be better. We estimate a very robust drop in foreign market volume, despite the low representation in Usiminas' total. This worsening volume brings an improvement in price, which ends up reflecting positively in terms of profitability. To explain this duality, we believe that the Company was less selective last year, through some opportunistic sales of second-line material to Asia, which consecutively pressured the export price, something that we do not expect to occur now in 2Q23.

So, even with the downward international price movement, influenced by the successive rounds of cuts made by multiple steel mills in China throughout 1H23, our expectation is for a more favorable quarter in net revenue per ton in 2Q23, which even added to the effect of the USD/BRL depreciation improving import penetration, we believe that Foreign Market sales will bring margins in an expansive movement. We project the realized price in the External Market at R$6,285/t Genial Est. +2.8% q/q; +10.0% y/y), a substantial price improvement to compensate in the margin the drastic volume reduction, which we expect to reach 72Kt Genial Est. (-28.8% q/q; -49.0% y/y).

Volume increase and price drop for mining. Within Mineração Usiminas (MUSA) guidance of 8.5-9Mt by year-end still stands. In 2Q23, we anticipate a sequential increase in sales volume due to seasonal effects related to rainfall below last quarter, making it a typical quarter. However, when compared to the same quarter in 2022, volume is expected to decline slightly to 2.3Mt Genial Est. (+23.9% q/q; -2.4% y/y). Unlike volume, we expect the realized price for mining to move in the opposite direction, taking a q/q loss, as the benchmark curve declines 62% fe between quarters. We are modeling a realized price of US$79/t Genial Est. (-11.0% q/q; -18.4% y/y). We believe the sequential volume increase will partially offset this level of price decline, so mining revenues should improve in 2Q23 to R$907mn Genial Est. (+15.8% q/q; -21.8% y/y).

Regarding costs, with the maintenance of the Samambaia and Oeste plants already finalized, we believe that there will be no leftovers for 2Q23, also helping to boost production in double digits q/q. However, we still expect slightly worse cost dilution, mainly because we believe higher production volumes will not cushion fixed costs by a sufficient magnitude to offset the increase in sea freight, considering that SSY (Shark-Qingdao) rose ~11% q/q as an effect of the acceleration in Brent crude prices. That said, we expect COGS/t at R$274/t (+1.1% q/q; +0.1% y/y).

Table 1. Net Revenue Usiminas (2Q23 Genial Est.)

(R$ millions)	2Q23E Genial Est.	1Q23 Reported	% q/q	2Q22 Reported	% y/y
Net Revenue	**7.140**	**7.255**	**-1,6%**	**8.531**	**-16,3%**
Steel	5.906	6.390	-7,6%	7.738	-23,7%
Mining	907	784	15,8%	1.160	-21,8%
Steel Transformation	1.841	2.134	-13,7%	2.416	-23,8%
Eliminations	(1.514)	(2.052)	-26,2%	(2.783)	-45,6%

Soure: Usiminas, Genial Investimentos

We expect total revenues to contract slightly, driven by a weaker steel industry. We see a slightly worse revenue scenario than last quarter, given the reduction in sales guidance, as well as the falling realized price in the Domestic Market, which makes up the majority of the total volume for the Company. We arrive at a projection of R$7.1bn Genial Est. (-1.6% q/q; -16.3% y/y) for total revenue. Thus, contrary to what we saw last quarter, we believe that the more challenging scenario in the steel industry will affect more intensely the dynamics of 2Q23 for Usiminas, with our expectation to report a revenue of R$5.9bn Genial Est. for the segment, representing a decrease of -7.6% q/q and -23.7% y/y.

Table 2. COGS Usiminas (2Q23 Genial Est.)

(R$ millions)	2Q23E Genial Est.	1Q23 Reported	% q/q	2Q22 Reported	% y/y
COGS	**(6.599)**	**(6.370)**	**3,6%**	**(6.344)**	**4,0%**
Steel	(5.745)	(5.875)	-2,2%	(6.144)	-6,5%
Mining	(639)	(493)	29,5%	(654)	-2,3%
Steel Transformation	(1.749)	(2.054)	-14,8%	(2.110)	-17,1%
Eliminations	1.533	2.051	-25,2%	2.563	-40,2%

Soure: Usiminas, Genial Investimentos

COGS/t should accelerate and compress margin, being the big villain of the quarter. Given the natural process of purchasing slabs for restocking, we project an increase in cost due to the value pass-through by the acceleration in the cost of iron ore, which experienced rally days from February to April. This should negatively impact 2Q23 COGS/t, bringing it to R$5,842/t Genial Est. (+2.9% q/q; +3.5% y/y). According to our accounts, the same slab that was being traded by third parties at a spot price of ~US$550/t until the beginning of 1Q23, was acquired by Usiminas from February onwards, at the height of the euphoria over the Chinese trade resumption, for ~US$800/t.

In addition, Usiminas will benefit little from the cooling in coke costs, as Blast Furnace 3, its main fuel consumer, is already shut down. As this transition period results in a low sales guidance, we believe that fixed cost dilution in 2Q23 will be weak, another factor that leads us to an increasing COGS/t.

In line with this, we also forecast a rise in Usiminas' nominal COGS. With unit cost rising, the volume reduction is not enough to cool the COGS value in our estimates. Thus, we project COGS close to R$6.6bn Genial Est., which represents an increase of 3.6% q/q and 4.0% y/y. The biggest impact will be on EBITDA and margin, which will suffer more from the unit cost escalation.

Table 3. EBITDA (2Q23 Genial Est.)

(R$ millions)	2Q23E Genial Est.	1Q23 Reported	% q/q	2Q22 Reported	% y/y
Adjusted EBITDA	**371**	**783**	**-52,6%**	**1.930**	**-80,8%**
Steel	72	438	-	1.454	-
Mining	239	254	-5,7%	385	-37,9%
Steel Transformation	50	65	-23,9%	269	-81,6%
Eliminations	10	25	-60,7%	(179)	-

Soure: Usiminas, Genial Investimentos

EBITDA set to plummet. Although revenue will be impacted, we believe that the consequences on the top line will be softer than on costs. These will be the big villain that will steal the Company's margin. We believe that there will be a substantial degradation in operating income due to the cost dynamics with the plates. Although much of the program to reach the necessary inventory to cover the absence of production from Blast Furnace 3 has already been completed, the processing of these slabs at COGS at a higher stocking cost will severely impact EBITDA, which we project at R$371mn Genial Est. (-52.6% q/q; -80.8% y/y).

With the fortification of its inventory, Usiminas took advantage of favorable market circumstances to acquire slabs at an economical price. However, we believe margins will continue to come under some degree of pressure, contracting to 1.8% (-5.03p.p q/q) as steel prices are falling at a pace that outweighs the devalued cost of destocking existing slab. Simply put, although the company has been able to procure slabs at a lower cost by trending between 3Q22 and 1Q23, the recurring discounts on the realized steel price to the customer base result in margin corrosion. Consequently, the cost of slab destocking begins to diminish its appeal relative to profitability.

Although this dynamic of slab stock release does not directly affect COGS via an increase, but rather cash flow via decompression, the acquisition of new slabs for the continuity of the restocking process at higher prices will inevitably raise the COGS/t of steelmaking in mid single digit. We believe that COGS/t will rise due to **(i)** cost pressure from slab price inflation, which rose at the beginning of the year due to cost pass-through from the acceleration in iron ore prices, and takes around 90 days of delay to pass through COGS, as well as **(ii)** loss of dilution capacity due to lower sales guidance. In addition, the planned reform in AF3 is expected to bring some additional costs for 2Q23, mainly due to the increase in the workforce by temporary act, in order to execute the reform mobilization.

Cash effect on working capital release partially offset by decline in EBITDA. We believe that the operationally weak EBITDA result, influenced by the higher processing of acquired slab costs in the income statement, should inhibit a higher potential for unlocking value in working capital release, through our projection of a reduction in the inventory account by current assets, as well as a gradual improvement in the balance between receivables and payables by the process of destocking and selling the slabs that were being accumulated until then. We project operating cash flow generation (FCFF) at R$490mn vs. R$764mn in 1Q23, down -36% q/q, considering **(i)** the positive impact on cash generation from the release of working capital, however, cooled by **(ii)** the deep sequential negative impact on EBITDA caused mainly by a higher COGS/qty and **(iii)** with CAPEX gradually higher on a larger pool of expenditure regarding the refurbishment of Blast Furnace 3.

Net profit follows strong operational downward dynamics of -52,6%. Facing an expectation for a weakened operational performance on higher cost and sequentially weaker volume, net profit is expected to take a hard hit. Helped by the financial result, the total EBITDA shrinkage is not seen with the same intensity in the bottom line, yet we project the number at R$287mn Genial Est. (-31.9% q/q; -73.0% y/y), a vertiginous double-digit drop.

Table 4. Income Statement (2Q23 Genial Est.)

(R$ millions)	2Q23E Genial Est.	1Q23 Reported	% q/q	2Q22 Reported	% y/y
Net Revenue	**7.140**	**7.255**	**-1,6%**	**8.531**	**-16,3%**
COGS	(6.599)	(6.370)	3,6%	(6.344)	4,0%
Adjusted EBITDA	**371**	**783**	**-52,6%**	**1.930**	**-80,8%**
EBITDA Margin (%)	5,2%	10,8%	-5,6p.p	22,6%	-17,43p.p
EBIT	**129**	**495**	**-25,2%**	**1.661**	**-92,3%**
EBIT Margin (%)	1,8%	6,8%	-5,03p.p	19,5%	-17,67p.p
D&A	(242)	(249)	-2,7%	(220)	9,8%
Financial Result	200	193	3,6%	(248)	-
Net Income	**287**	**544**	**-31,9%**	**1.060**	**-73,0%**
Net Margin (%)	4,0%	7,5%	-3,48p.p	12,4%	-8,41p.p

Soure: Usiminas, Genial Investimentos

As we said in our sector report, published last month and attached below (Metals & Mining: A sign of relief for the steel industry), we had a rather negative feeling about Usiminas' 2Q23 result. We believe that **the movement of cost increase by absorbing the pass-through** of the higher iron ore curve in the slab price **is temporary**, as the acquisition cost has already cooled from the US$800/t level, which should circulate in this 2Q23, to US$600/t that should circulate in COGS between 3Q23 and 4Q23, **considering the delay effect and low perspective that the iron ore price will rise again.** We have a curve of US$95/t for the 62% Fe reference for the end of the year, considering the typical movement of Brazilian mining companies in the 2H of each year to increase the global supply of the commodity and the appetite difficulties that China is still experiencing.

To hell in a handbasket... The scenario for Usiminas is extremely challenging, and the discounted thesis argument is falling apart as we have priced in a substantial worsening in 2023 EBITDA since last month. At the time, we mentioned in the previous report that the prevailing consensus had not yet reconciled projections for 2Q23. So, we were right that the market would still closely evaluate the assumptions and would come to the same conclusion we did, reflecting a decline in 2023 EBITDA and consequently leading to an expansion of the multiple. In recent days, as analysts have been updating projections, Usiminas' shares has returned to bitter losses, causing the Enterprise Value (EV) to drop by -8%.

Today we see Usiminas trading at an **23E EV/EBITDA** of **3.8x,** and **3.6x for 24E**, with little discount from one year to the next since our projections indicate **an almost flat 24E EBITDA.** The multiple has fallen back from the 4.9x we identified in the previous report, but this seems to have happened precisely because of the market pricing in the EV of the scenario we warned about, about estimates not yet being updated by consensus at the time, and not because of an operational improvement. In other words, it was EV that went down and not EBITDA that went up.

If the company fail to perform better on costs during 2H23, **our negative bias will likely open room for a rating downgrade**. For now, we believe that this 2Q23 will be the worst quarter of the year for Usiminas, so we will wait a little longer to have more visibility on the dynamics of the effect of the cost of slabs on the company's COGS. Therefore, we reiterate our **NEUTRAL rating**, with a **negative outlook for the short term and no catalysts for the stock's upside,** we **cut our 12M Target Price to R$7.50** vs. R$8.10 in our previous recommendation, which would lead the stock to have a very narrow **upside of +4.75%.**

Appendix: Usiminas

Figure 1. Usiminas – Income Statement in R$ Millions (Genial Est. 2023-2028)

Income Statement	2023E	2024E	2025E	2026E	2027E	2028E
Net Revenue	**28.619**	**29.885**	**31.815**	**32.864**	**34.653**	**37.003**
(+) Domestic Market	23.665	24.546	26.476	27.399	29.110	31.395
(+) Extern Market	4.954	5.339	5.339	5.465	5.543	5.609
(-) COGS	(25.631)	(26.828)	(27.150)	(27.818)	(29.377)	(30.337)
Gross profit	**2.988**	**3.057**	**4.665**	**5.046**	**5.276**	**6.666**
(-) Expenses	(1.615)	(1.680)	(1.728)	(1.749)	(1.822)	(1.943)
EBIT	**1.373**	**1.378**	**2.936**	**3.297**	**3.454**	**4.723**
(+/-) Financial Result	749	827	963	1.219	1.336	1.553
EBT	**2.366**	**2.469**	**4.163**	**4.780**	**5.054**	**6.540**
(-) Taxes	(667)	(736)	(1.312)	(1.522)	(1.615)	(2.120)
Net income	**1.699**	**1.733**	**2.851**	**3.258**	**3.439**	**4.420**
Profitability						
Net margin (%)	5,94%	5,80%	8,96%	9,91%	9,92%	11,94%

Figure 2. Usiminas– Cash Flow in R$ Millions (Genial Est. 2023-2028)

Cash flow (FCFF)	2023E	2024E	2025E	2026E	2027E	2028E
Net Revenue	**28.619**	**29.885**	**31.815**	**32.864**	**34.653**	**37.003**
(-) COGS	(25.631)	(26.828)	(27.150)	(27.818)	(29.377)	(30.337)
Adjuted EBITDA	**2.420**	**2.462**	**4.042**	**4.410**	**4.568**	**5.841**
EBIT	**1.373**	**1.378**	**2.936**	**3.297**	**3.454**	**4.723**
(-) Taxes	(667)	(736)	(1.312)	(1.522)	(1.615)	(2.120)
(+) D&A	1.008	1.084	1.105	1.113	1.114	1.118
(+/-) Δ WK	1.986	(125)	268	(293)	(550)	(121)
(-) Capex	(3.137)	(1.553)	(1.276)	(1.150)	(1.126)	(1.203)
FCFF	**564**	**48**	**1.721**	**1.444**	**1.277**	**2.398**

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	Definition	Coverage
Buy	Expected return above +10% in relation to the Company's sector average	**46%**
Neutral	Expected return between +10% and -10% relative to the Company's industry average	**44%**
Sell	Expected return below -10% in relation to the Company's sector average	**5%**
under Review	Under review	**5%**

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