genial | Equity Research

GERDAU

2Q23 Review: Forging steel with quicksand

LatAm Metals & Mining

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Company

GGBR4 BZ Equity
Neutral

Price: R$ 26.95 (08-Aug-2023)
Target Price 12M: R$ 32.00

Main takeaways:

(i) Marginally higher volume in Brazil, driven by foreign market dynamics; **(ii)** Higher quantity of semi-finished exported products brings reduction in Brazil's BD realized price; **(iii)** After adjustments of +US$50/t and longer than expected maintenance, North America BD encountered difficulties to advance in volume (down -11.7% q/q); **(iv)** Special Steels with growing volume and resilient prices; **(v)** Net revenue down by -3.2% q/q to R$18.2bn (-1.1% vs. Genial Est.); **(vi)** Slightly higher costs in the two main BDs; **(vii)** While better product mix helped Special Steels BD, it did not compensate for others business units, consolidating a EBITDA down -12.3% q/q, clocking in at R$3.8bn (+1.8% vs. Genial Est.); **(viii)** Net income down -33% q/q to R$2.1bn (+6.7% vs. Genial Est.); **(ix)** We prefer to recommend investors to remain cautious and wait for further hurdles to be cleared. Trading now at an **EV/EBITDA 23E** of **3.3x**, we reiterate our **Neutral rating**, at a **12M Target Price** of **R$32.00**, which implies an **upside** of **+18.74%**.

Gerdau released yesterday, 08th of August after market close, its 2Q23 results. In a quarter with a **slight deceleration in revenue**, most of its operations showed **decreases in EBITDA**, with a positive highlight for the performance of Special Steels BD, which even though it was already expected by us, was the only unit to post a sequential improvement in EBITDA of +21.3% q/q, while **North America brings a stronger drop of -24.5% q/q**. Brazil BD, on the other hand, although posting a -6.8% q/q decline, EBITDA came in slightly better than our estimates.

2Q23 Review

Brazil BD suffering in volume in DM, but offset by FM. With consolidated volume up in the BD, reaching 1.3Mt (+5.3% q/q; -12.0% y/y), we see a sequential rise in mid-single digit as the result of mixed dynamics between domestic market (DM) and foreign market (FM), in which the former was reported at 1.065kt (+0.6% vs. Genial Est.), falling a slight -2.1% q/q, while the latter stood at 280kt (+3.1% vs. Genial Est.), representing a rise of +47.5% q/q, creating a positive effect overall. Although we already expected an increase on a quarterly basis regarding the foreign market, the volume came slightly higher than our projections.

Higher volume in FM reflects in lower realized price for Brazil BD. Due to a greater relevance regarding the volume of foreign sales within Brazil BD, which usually symbolize semi-finished products with lower added value, the realized price stood at R$5,380/t (+2.1% vs. Genial Est.), falling marginally q/q. As we said in the earnings preview report, the split between markets (DM + FM) ended up keeping the realized price of the Brazilian operations stable during the period.

North America BD with momentary difficulty in volume after plant maintenance and new readjustments. Delivering a volume of 975kt (-3.9% vs. Genial Est.), we see a -11.7% q/q decline in sales. In our view, the sequential volume loss is explained by the following factors: **(i)** a +US$50/t price adjustment effective for 2Q23, causing clients to push forward their purchases last quarter, as it was announced a few months in advance; **(ii)** maintenance shutdowns in Canada and, mainly in Charlotte (NC) in the US, which was not scheduled, hurting volume in the current quarter; **(iii)** clients waiting for the metal spread to narrow to buy again.

Despite the positive adjustment, the decreasing of the USD/BRL exchange rate during the period brought a slightly negative compound effect in realized price, reaching R$7,000/t (-0.3% vs. Genial Est.), remaining basically in line with our estimates, imposing a mild deceleration of -0.7% q/q, due to a still strong metal spread. As we said in our last report, we do not believe that the metal spread will remain at such high levels going forward, given that some downstream sectors were holding back purchases due to the effect that the addition of ferrous scrap shipments should provide in the coming months, reducing input prices and at the same time, leading steelmakers to probably cut prices a bit. We believe that Gerdau should maintain price stability going forward, with pass-throughs to the North America BD likely to occur less frequently in 2S23.

Special Steels and South America bringing better volumes but losing price. Reporting a volume of 379kt (-1.6% vs. Genial Est.), the special steel unit shows a growth of +6.7% q/q, despite the -12.9% y/y pullback. As we expected, the unit saw a sequential improvement in volume, while its price remained resilient at ~R$8,200 in 2Q23.

We attribute a relevant share of the improvement to the automotive sector in the US, through a demand being recomposed by more stable dynamics in the production chains and inventory growth strategies, driven by a demand returning at the top-end, with emphasis on the large commercial vehicle segment. As for the Brazilian market, we believe that government discount policies (max. -10.8%) provoke just a tiny price retracting considering the levels archived today for the light vehicle segment, with the projected growth of +2% y/y occurring much more due to an extremely weak base in 2022, rather than necessarily presenting an increase in production compatible with a recovering sector. Nevertheless, the resumption of a good part of the automakers, after the announcement of the government measure, eased the pressures for Gerdau in Brazil.

In addition, South America BD brought better than expected volumes, reaching 311kt (+10.6% q/q; +6.3% y/y), but that was offset by a decrease in realized price, in the same amount, of -10.0% q/q. In its main markets (Argentina, Peru and Uruguay) there is still a positive outlook, with demand from construction sectors boosting volumes, and with good infrastructure projects to be approved in 2H23.

Revenue down marginally, in line with estimates. Gerdau's net revenue closed the quarter at R$18.2bn (-1.1% vs. Genial Est.), down by -3.2% q/q, despite the larger y/y reduction of -20.5%. North America BD proved to be the biggest culprit for the sequential decline, reaching revenues of R$6.8bn (-4.5% vs. Genial Est.), shrinking more than expected, by -12.7% q/q and -20.6% y/y, facing challenges that prevented volume growth in 2Q23, as we have already highlighted above.

On the flip side, delivering slightly better top line numbers, including vs. our expectations, Brazil BD posted revenues of R$7.2bn (+3.2% vs. Genial Est.), up moderately at +4.5% q/q. The rise was driven by a boost in volumes destined for the foreign market. However, despite the improvement in shipments, there was a higher sale of semi-finished products, which ended up, on the other hand, contaminating the price realization process. In the domestic market, the opposite was observed, with price dynamics proving partially resilient despite the drop in volume. Both situations created a compensatory effect on the weaknesses presented, bringing revenue slightly above expectations. Although the trends occurred exactly as we anticipated, the observed intensity was subtly higher than projected.

Consolidating another positive point, Special Steels ended up posting revenues of R$3.1bn (+4.7% q/q; -15.6% y/y), which came in line with our estimates for a better quarter, driven by volume recovery, this time tied to the US, resulting in a better top line in the operation. In addition, South America BD had net revenues of R$1.6b (+2.4% vs. Genial Est.), flat q/q, showing progress in volumes, but with negative prices dynamics.

Table 1. Net Revenue Gerdau (2Q23 vs. Genial Est.)

	2Q23	2Q23E		1Q23		2Q22	
(R$ millions)	**Reported**	**Genial Est.**	**% R/E**	**Reported**	**% q/q**	**Reported**	**% y/y**
Net Revenue	**18.265**	**18.477**	**-1,1%**	**18.872**	**-3,2%**	**22.968**	**-20,5%**
Brazil	7.236	7.014	3,2%	6.925	4,5%	9.588	-24,5%
North America	6.806	7.123	-4,5%	7.793	-12,7%	8.573	-20,6%
South America	1.609	1.572	2,4%	1.617	-0,5%	1.894	-15,0%
Special Steel	3.086	3.170	-2,6%	2.948	4,7%	3.657	-15,6%
Eliminations	(472)	(402)	17,3%	(411)	14,8%	(744)	-36,5%

Soure: Gerdau, Genial Investimentos

COGS/t in Brazil and North America BDs following partial rises. Within Brazil, we see a rise in coal costs, while iron ore and scrap showed declines. Therefore, clocking in at ~R$4,750/t (-2.1% vs. Genial Est.), the unit's costs remained at a similar level to what we saw last quarter, with better volumes helping fixed cost dilution, leaving it with marginally better-than-estimated efficiency.

For North America, the **(i)** drop in volume inhibiting the ability to dilute fixed cost and **(ii)** longer than expected maintenance at the Whitby melt shop, brought costs to a mild +2.2% q/q, reaching R$5,400/t (-1.8% vs. Genial Est.). Even though it occurred, the effect of the scrap cost increase, considering the 120-day delay for spot price, was slightly lower than we expected, helping to neutralize the repercussion of the maintenance on COGS.

Specialty Steel benefiting from a better product mix. As expected, the Company delivered a sequential recovery at Special Steel BD, due to an increase in volume linked to a higher value-added product mix, helping not only to bring in more revenue but also to cool the business unit's COGS/t, reaching the R$6,550/t mark (-7.4% q/q), slightly better than our estimates. In addition, South America BD also reported a shrinking volume diluted cost, falling -6.7% q/q to R$4,100/t.

Table 2. COGS Gerdau (2Q23 vs. Genial Est.)

(R$ millions)	2Q23 Reported	2Q23E Genial Est.	% R/E	1Q23 Reported	% q/q	2Q22 Reported	% y/y
COGS	**(14.987)**	**(15.393)**	**-2,6%**	**(15.244)**	**-1,7%**	**(17.065)**	**-12,2%**
Brazil	(6.430)	(6.434)	-0,1%	(6.031)	6,6%	(7.481)	-14,0%
North America	(5.277)	(5.533)	-4,6%	(5.848)	-9,8%	(6.121)	-13,8%
South America	(1.284)	(1.220)	5,3%	(1.244)	3,2%	(1.375)	-6,6%
Special Steel	(2.489)	(2.608)	-4,6%	(2.519)	-1,2%	(2.808)	-11,4%
Eliminations	493	402	22,5%	399	23,6%	720	-31,5%

Soure: Gerdau, Genial Investimentos

Consolidated nominal COGS stable q/q. Total nominal was posted at R$15.0bn (-2.6% q/q), broadly flat q/q with an upward dynamic at Brazil BD, with higher volumes resulting in a total cost of R$6.4bn (+6.6% q/q; -14.0% y/y), and a lower volume dynamic at ON North America reflecting in a figure of R$5.5bn (-9.8% q/q; -13.8% y/y), with the remaining operations also coming stable q/q.

EBITDA in line, with low double digit decline due to mixed dynamics across units. Adjusted EBITDA of R$3.8bn in 2Q23 came in line with our projections (+1.8% vs. Genial Est.). The trends we anticipated in our preview report were observed, but with relatively different intensities. In summary, in terms of operational delivery, we place among the highlights Brazil BD, which despite a -6.8% q/q retraction, our expectation was that the sequential reduction would be a bit sharper. For the unit, Gerdau delivered an EBITDA of R$992mn (vs. R$699mn Genial Est.), with a margin contraction of -1.6p.p q/q, reaching 13.7%. We emphasize then that the result was not good, but although it presented the difficulties of the more challenging macro scenario, the sequential loss was less intense than our estimates.

Nevertheless, on the other side, North America BD felt a bigger drop in volume than we expected, which resulted in an EBITDA of R$1.8bn (vs. R$2.0b Genial Est.), below our estimates and falling harder by -24.5% q/q, losing -4.1p.p q/q of margin, reducing it to 26.1%. For us, it was the negative highlight of the quarter.

In the opposite direction, it is worth highlighting Special Steels' performance, with an EBITDA of R$603mn, up +21.3% q/q on better sales and lower costs. However, as we expected a sequential recovery for the unit, we believe there were no surprises. As for South America BD, the unit delivered a similar result with 1Q23, at R$481mn EBITDA, slightly above our estimates.

Table 3. EBITDA Gerdau (2Q23 vs. Genial Est.)

(R$ millions)	2Q23 Reported	2Q23E Genial Est.	% R/E	1Q23 Reported	% q/q	2Q22 Reported	% y/y
Adjuted EBITDA	**3.792**	**3.724**	**1,8%**	**4.322**	**-12,3%**	**6.680**	**-43,2%**
Brazil	992	688	44,2%	1.064	-6,8%	2.288	-56,6%
North America	1.777	2.068	-14,1%	2.355	-24,5%	2.836	-37,4%
South America	481	404	19,1%	489	-1,6%	740	-35,0%
Special Steel	603	630	-4,3%	497	21,3%	928	-35,0%
Eliminations	(61)	(66)	-7,1%	(77)	-20,8%	(111)	-45,3%

Soure: Gerdau, Genial Investimentos

Net income down, as expected. In a financial result affected by the exchange rate variation of -R$288mn, with a worsening in the financial result also due to the comparative basis in the last quarter contemplating tax credits as a non-recurring event, however earning lower taxes than expected in this quarter, Gerdau's net income stood at R$2.1bn in 2Q23 (+6.7% vs. Genial Est.), falling -33.4% q/q, as its main units saw a drop in results, in line with our expectation of a weaker quarter.

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

(R$ millions)	2Q23 Reported	2Q23E Genial Est.	% R/E	1Q23 Reported	% q/q	2Q22 Reported	% y/y
Net Revenue	**18.265**	**18.477**	**-1,1%**	**18.872**	**-3,2%**	**22.968**	**-20,5%**
COGS	(14.987)	(15.393)	-2,6%	(15.244)	-1,7%	(17.065)	-12,2%
Adjusted EBITDA	**3.792**	**3.724**	**1,8%**	**4.322**	**-12,3%**	**6.680**	**-43,2%**
EBITDA Margin (%)	20,8%	20,2%	0,61p.p	22,9%	-2,14p.p	29,1%	-8,32p.p
EBIT	**2.884**	**2.815**	**2,5%**	**4.292**	**-32,8%**	**5.791**	**-50,2%**
EBIT Margin (%)	15,8%	15,2%	0,56p.p	22,7%	-6,95p.p	25,2%	-9,42p.p
D&A	(752)	(714)	5,4%	(715)	5,2%	(701)	7,2%
Financial Result	(423)	(165)	156,7%	(50)	744,4%	(361)	17,1%
Net income	**2.142**	**2.008**	**6,7%**	**3.215**	**-33,4%**	**4.298**	**-50,2%**
Net margin (%)	11,7%	10,9%	0,86p.p	17,0%	-5,31p.p	18,7%	-6,99p.p

Soure: Gerdau, Genial Investimentos

Our Take on Gerdau

Seeing a deteriorating global scenario for the steel, despite Gerdau having some important competitive advantages, we believe that the short term should be challenging, both regarding to volume and price. **Gerdau was our Top Pick, and we continue to favor the Company over other steelmakers**. However, the truth is that, by downgrading Gerdau in our preview report, **we currently have all Metals & Mining coverage rated Neutral, with the exception of Vale**, not because we believe the company is performing well, but because we think the market in general has penalized it beyond a fair point.

That being said, our downgrade of Gerdau is much more related to a macro structural decision and not necessarily to any resistance potentially encountered in the investment thesis development. Our assessment is that the long-term fundamental underpinnings for the Company remain intact, through partial resilience in its numbers in the less favorable parts of the commodity cycle compared to its peers. Conversely, for the time being, Gerdau seems to us to experience some difficulties in domestic volumes in its two main operations (Brazil and North America BDs), which reflect an impoverished short-term realized price dynamic.

China is relentless, no one gets away with it. Foreign trade with China shrank in July, with the trade balance standing at US$80.6bn in the month, according to data released on Tuesday. We believe slowing global demand for Chinese goods and a shaky economic recovery are weighing on consumption in the country, just as we have predicted since the start of the post-zero-covid policy. The total value of exports fell -14.5% m/m, showing the worst decline since February 2020, while imports regressed -12.4%. In both cases, the figures were worse than consensus expectations.

CPI numbers, which will be released later in the week, are expected to ratify the still sluggish consumption position, with data moving towards deflation.

Our assessment is that the deepening fall in imports reflects a weak domestic demand. The fall was the worst since January. The consensus initially expected China's economic recovery this year to be driven by domestic demand, but we have been against this view from very early on, precisely because we emphasize that the situation in the real estate market is structural, not just cyclical. We believe that the situation has been caused gradually, year after year, by measures that have expanded the sector beyond what is healthy, and today the consequences are being felt. Zero-covid only catalyzed the process further, making the wounds exposed earlier, but the fate seemed to us to be sealed for a long time already. As we understand it, the fifth consecutive month of falling imports has a strong correlation with the real estate market losing traction, as China needs to buy from other countries considerable amount of inputs for the construction process, including iron ore to make steel.

With economic activity still weak in China, domestic steel producers end up needing to spawn their slabs elsewhere, in a large volume. Thus, we see that these products arrive with great competitiveness in other markets around the world, given the extremely low margin in which Chinese steelmakers operated until 1H23. The result was the formation of an implicit premium of the imported product to Brazil domestic steel around ~10% for long (~2/3 of Gerdau's portfolio), and ~20-25% for flat steel (~1/3 of Gerdau's portfolio), making it difficult to make new price adjustments without a relevant loss of market share. Nevertheless, we emphasize the good work that the Company has done, suffering less than its sector peers. We agree with the argument that Gerdau, being less exposed to flat steel, shields it a bit more from these dynamics, but the sequential loss of -12.3% q/q in EBITDA, with margin compression of -6.95 p.p., as well as the -33.4% q/q and -50.2% y/y drop in net income reinforce our argument that Gerdau, no matter how good its competitive differentials are, is not immune to the effects that China causes in the global commodities market.

Recapping the downgrade. The stock appreciation movement, before our rating downgrade, seemed to be linked to the market's understanding that Gerdau was indeed discounted, considering that, looking at the scenario 3 months ago, the Company was running at 2.8x EV/EBITDA 23E. But when we downgraded, about a week ago, we were seeing the Company at 3.5x. Much of this upside gap closure occurred in 30 days, so the multiple was decompressed quickly, which highlighted to the loss of visibility of a discounted investment thesis. For us, it did not make sense for investors to pay a top-of-cycle price for the stock when in fact the international scenario for metal commodities remains quite uncertain. Upon our decision to downgrade the Company, in the subsequent days, Gerdau’s share prices ended up suffering a loss of -7.13% in just 5 days (until yesterday's close of trading section), showing that the Company had indeed become too overpriced for a bearish cycle. To check more details of our rationale, we reinforce the reading of the previous report, which is attached (Gerdau: Icarus' Wings Clipped).

Operational difficulties eroded cash generation, and the situation was upscaled by other unfavorable dynamics. We point out two main dynamics: **(i)** Ambitious expansion projects, among them the sustainable mining platform in Minas Gerais (MG), which standalone correspond to R$3.2bn in CAPEX over 3 years, and given that a portion of this amount is already being considered in the Company's budget for 2023, we believe that sequentially cash flow consumption was impacted in 2Q23, reaching a CAPEX of R$1.2bn (+28.8% q/q). **(ii)** The working capital requirement also increased slightly, causing its corresponding share of cash flow consumption of R$569m (+2.5% q/q). These two situations, added to the EBITDA decrease of -12.3% q/q, led to a strong reduction in Gerdau's cash flow generation, totaled at R$784mn (-70.9% q/q).

Dividends also decreased, but remain attractive. R$752mn was announced to be distributed, equivalent to R$0.43 per share (~1.5% of Market Cap) based on the shareholding position of 18th of august. Last quarter, the Company had announced R$0.51 per share of equity interest (JCP). Although the proceeds have reduced, we see Gerdau with a very interesting **dividend yield** of **12.3% 23E**. In our assessment, the liquidity position relative to debt is privileged, reinforcing the possibility of further distributions. After the payment of R$931m for the 2023 bond and R$600m of the first tranche of the 16th series debenture during 2Q23, the penetration of the long-term debt's profile jumped to 92% (vs. 78% in 1Q23), which we see as a great sign for the commitment in capital allocation, with a very healthy debt balance, better than peers. We are seeing a comfortable **Net Debt/EBITDA** of **0.37x**.

Forging steel with quicksand. Given the volatility in share prices, and the assertiveness of our downgrade, the upside in fundamental terms has returned. However, even though the safety margin has increased in these last 5 days, we see stocks still very reactive to the news flow coming from China, with a considerable amount of speculation about the next steps of the Chinese government and how this is reflected in the macro play that investors make through companies in the Metals & Mining sector. Therefore, we will not recommend making a long position in the stock just yet. As we have described throughout the report, the backdrop for the commodity is bearish and the Company did not perform well in 2Q23, so we see no signs that the Gerdau's share prices can develop in the short term in a rational way. We prefer to recommend investors to remain cautious and wait for further hurdles to be cleared. Trading now at an **EV/EBITDA 23E** of **3.3x**, we reiterate our **Neutral rating**, at a **12M Target Price** of **R$32.00**, which implies an **upside** of **+18.74%**.

Appendix: Gerdau

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

Income Statement	2023E	2024E	2025E	2026E	2027E	2028E
Net Revenue	**72.109**	**72.460**	**74.248**	**76.365**	**78.384**	**80.106**
(-) COGS	(59.434)	(58.522)	(60.235)	(61.955)	(63.381)	(66.068)
Gross Profit	**12.675**	**13.938**	**14.012**	**14.410**	**15.003**	**14.039**
(-) Expenses	(113)	(1.062)	(1.041)	(1.071)	(1.067)	(1.104)
Adjusted EBITDA	**15.159**	**16.454**	**16.742**	**17.284**	**18.032**	**17.182**
(-) D&A	(2.886)	(3.073)	(3.254)	(3.423)	(3.580)	(3.727)
EBIT	**12.561**	**12.876**	**12.972**	**13.339**	**13.936**	**12.935**
(+/-) Financial Result	(765)	(828)	(819)	(813)	(811)	(842)
(-) Taxes	(2.856)	(2.916)	(2.942)	(3.032)	(3.177)	(2.927)
Net income	**8.940**	**9.131**	**9.211**	**9.493**	**9.948**	**9.165**
Profitability						
Net margin (%)	12,40%	12,60%	12,41%	12,43%	12,69%	11,44%

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

Cash Flow (FCFF)	2023E	2024E	2025E	2026E	2027E	2028E
Net Revenue	**72.109**	**72.460**	**74.248**	**76.365**	**78.384**	**80.106**
(-) COGS	(59.434)	(58.522)	(60.235)	(61.955)	(63.381)	(66.068)
Adjusted EBITDA	**15.159**	**16.454**	**16.742**	**17.284**	**18.032**	**17.182**
EBIT	**12.561**	**12.876**	**12.972**	**13.339**	**13.936**	**12.935**
(-) Taxes	(2.856)	(2.916)	(2.942)	(3.032)	(3.177)	(2.927)
(+) D&A	2.886	3.073	3.254	3.423	3.580	3.727
(+/-) Δ WK	1.427	(877)	(261)	(412)	(451)	(453)
(-) Capex	(5.135)	(5.180)	(5.221)	(5.265)	(5.290)	(5.302)
FCFF	**8.884**	**6.975**	**7.802**	**8.053**	**8.599**	**7.979**

Disclosure Section

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Genial Rating

	Definition	Coverage
Buy	Expected return above +10% in relation to the Company's sector average	**49%**
Neutral	Expected return between +10% and -10% relative to the Company's industry average	**41%**
Sell	Expected return below -10% in relation to the Company's sector average	**5%**
under Review	Under review	**5%**

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