VALE

3Q23 Review: Cash Cow

LatAm Metals & Mining

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Company

VALE US Equity
Buy

Price: US$ 13.03 (26-Oct-2023)
Target Price 12M: US$ 16.75 (NYSE)

VALE3 BZ Equity
Target Price 12M: R$ 82.50 (B3)

Main takeaways:

(i) Iron ore production strong, despite drop y/y due to ROM dynamics; **(ii)** Base metals struggling to increase production, with unexpected maintenance causing copper guidance downgrade; **(iii)** Realized fines price helped by higher provisioned price, while pellets continue to lose premium vs. the 65% Fe curve; **(iv)** Revenue in line with expectations, up +9.8% q/q; **(v)** C1 cost cools to US$25.6/t (+7.1% vs. Genial Est.), with a weaker than expected deceleration; **(vi)** Freight cost rises and outweighs any gain that the C1 cooling brought; **(vi)** Adjusted EBITDA lower than expected at -13% vs. Genial Est, in the face of a C1/t missing estimates; **(vii)** Net income as the major positive highlight, up +98.5% q/q, and +7.5% vs. Genial Est.; **(viii)** With boosted net income, a **23E EPS** of **R$10.45** and a **23E FCF Yield** of **11%**, we see the announcement of **R$2.33 per share in dividends + equity interest** as another **attractive point for investors**, considering that we expect a distribution of earnings very close to what was seen in 4Q23 and even better in 2024, given the extraordinary dividend that we see as likely to be distributed; **(ix)** We see Vale trading at a **24E EV/EBITDA** of **4.3x** (vs. a historical average of 4.8x), which reinforces our **BUY rating**, with a **12M Target Price** of **R$82.50** for **VALE-B3**, and **US$16.75** for **NYSE ADRs**, demonstrating an **upside** of **+26.34%**.

Vale released its 3Q23 results yesterday, after the market closed. The **figures came in mixed with expectations**, with **revenue in line, EBITDA down vs. estimates and net income up.** Even though EBITDA was reported below our projections (-13% vs. Genial Est.), Vale still showed a recovery, sequentially at +7.8% q/q and +11.2% y/y.

We believe that the improvement is linked to **(i)** positive seasonality for production, typical of the 3Qs, which not only boost sales, but also generates a dilution of fixed costs, **cooling down C1/t sequentially**. In addition, we see as another important component in the result the **(ii)** 62% Fe iron ore price increase, which encouraged Vale to reinforce the pace of destocking now in 3Q23 of the volume that had been accumulated by the restrictions on shipments at the Ponta da Madeira (MA) terminal during 1Q23.

Table1. Income Statement Summary (3Q23 vs. Est.)

(US$ millions)	Reported	Genial Est.	
Income Statement	**3Q23A**	**3Q23E**	**% Diff.**
Net Revenue	10.623	10.732	**-0,9%**
Proforma EBITDA	4.482	5.153	**-13,0%**
Net Income	2.836	2.638	**7,5%**

Source: Genial Investimentos, Vale

Table2. Reported vs. 2Q23 and 3Q22

Reported				
3Q23A	**2Q23A**	**% q/q**	**3Q22A**	**% y/y**
10.623	9.673	**9,8%**	9.929	**7,0%**
4.482	4.157	**7,8%**	4.031	**11,2%**
2.836	1.428	**98,5%**	4.484	**-36,8%**

Source: Genial Investimentos, Vale

How did demand help Vale when the real estate market continues to struggle? Despite a challenging scenario for Chinese demand on the commercial housing market side, we saw an average of US$114/t for the 62% benchmark during the course of 3Q23, up +2.7% q/q. The price continued to rise until the end of September to ~US$120/t, which is ~30% above the historical average of the last 10 years. As a result, the realized price for 3Q23 was added to the forward provisioning mechanism, which in our model corresponds to ~35% of Vale's pricing system.

We believe that this ended up helping the price composition to improve Vale's performance in 3Q23, with the company reporting a realized price for iron ore fines of US$105/t (+6.7% q/q; +13.5% y/y). In our assessment, this more favorable movement in iron ore prices was sustained by a number of factors. Among them, we highlight: **(i)** civil construction linked to infrastructure, which is experiencing heated demand for steel in China, as well as the **(ii)** increase in the construction of social housing financed by the Chinese government; **(iii)** the automotive industry breaking records in Asia; as well as an **(iv)** increase in the export of Chinese crude steel to global markets (including to Brazil).

The 4 pillars of demand pointed out are therefore exogenous to the private housing development market, as we published in our mining sector report in September, which is attached (Metals & Mining: Sector Report).

Valuation and rating. Within this context, we address some points of concern regarding Vale's investment thesis. We can mention uncertainties in relation to demand from China as well as rising C1 costs as the main drivers for the shares' depreciation during 1H23. However, we see iron ore demand still at a resilient level and C1 costs falling by -3.4% q/q now in 3Q23.

As we've been saying for a long time, Vale's 2H23 had everything it needed to demonstrate a much better operating performance than what happened to the company in the first two quarters of the year. We see not only sequential gains, but also an improvement compared to 2022, with EBITDA reaching US$4.4bn (+11.2% y/y). As for net income, Vale reported R$2.8bn in the bottom line, a spectacular growth of +98.5% q/q. Looking at the year-on-year basis, we don't see a fair comparison, because 3Q22 had a non-recurring effect that boosted profit. If we exclude the non-recurring effect linked to the capital reduction in a foreign subsidiary, 3Q22 net income would have been R$2.9bn (vs. R$4.5bn including the non-recurrence), basically stable with the one reported now in 3Q23.

Therefore, we see no reason for the market to penalize the company as much as it has been doing since the beginning of the year. Obviously, the uncertainties linked to lower growth expected for China from that moment on would bring some downside to stock prices. We don't question this; we even agree with this view. However, in our opinion, the figures reported do not indicate a performance that justifies such a bearish sentiment. Following this line of reasoning, we maintain our **BUY rating**, with a **12M Target Price** for **VALE3-B3** of **R$82.50** and **US$16.75** for the **NYSE ADRs**, leaving an **upside** of **+26.34%** for the shares.

Production and Sales retrospective

In our preview of the financial results, published after the release of Vale's production and sales report on October 18th, which is attached (Vale Preview 3Q23; Built on iron, not copper), we pointed to a trend of sequential acceleration, from Net Revenue to Net Income, and an improvement y/y in Revenue and EBITDA, considering that the year-on-year base of profit was difficult to overcome, given a non-recurring effect that occurred in 3Q22. We were assertive in this trend, although EBITDA came in lower than our projections due to C1/t not cooling down enough.

Strong i.o. production despite a marginal drop y/y, with partial reversal of the inventory created in 1H23 strengthening volume. As already mentioned in the previous report, Vale posted an increase in sales of iron ore fines, despite a marginal drop in iron ore production y/y due to lower ROM availability (86.2Mt vs. 89.7Mt in 3Q22). We then saw a partial reversal of the inventory built up in 1H23, which more than offset the slightly lower production year-on-year, further reducing the gap between production and sales typical of the 3Qs. As a result, sales were reported at 69.7Mt (+3.9% vs. Genial Est.), up +6.6% y/y, a positive point for the quarter.

Pellets production is still growing slowly, with the guidance for copper being revised. With the commissioning of the Torto dam helping with the ramp-up of the Brucutu mine (MG), we have already seen a slight impact on pellet production (+0.7% q/q; +11.1% y/y), and with a substantial improvement in the product mix. However, we still don't see this effect of production gains being reflected in pellet shipments, which even slowed down to 8.6Mt (-2.2% q/q; +1.1% y/y). We believe that there is a delay between the extraction of iron ore in Brucutu (MG) and its arrival at the Tubarão plant (ES) for the pelletizing process. Therefore, we expect an increase in pellet sales only in 4Q23.

In addition, copper had difficulty ramping up production, mainly due to the need for maintenance at mines mostly in Canada, leading to a revision in guidance (315-325kt vs. 335-375kt previously). This cut, together with an expectation of worsening freight costs due to the increase in bunker fuel, led us to gently revise down our 12M Target Price in the preview report. Therefore, since then, our model has indicated R$82.50 (vs. R$83 previously) for VALE3-B3 and US$16.75 (vs. US$17.00 previously) for NYSE ADRs.

Provisioned prices helped fine iron ore, while pellet premiums shrink. Although the 62% Fe iron ore curve had a small gain of +2.7% q/q to US$114/t, as we mentioned in our preview report and at the beginning of this one, the provisioning system for the end of the quarter helped Vale's price realization to reach US$105/t (+6.7% q/q; +13.5% y/y). Meanwhile, pellet premiums fell again, reaching +US$30/t, with a reduction of -US$2/t q/q, a weaker performance than our estimate at the time. In addition, nickel suffered from the downtrend in the curve, drawing down its realized price by -7.6% q/q and -8.7% y/y.

3Q23 Review

Growing net revenue, no surprises there. As we already have basically all the variables to calculate the revenue in advance, there were no surprises or any divergences between our estimate and what was reported. That being said, the company posted net revenue of US$10.6bn (9.8% q/q; +7.0% y/y), with the base metals' unit losing share in the face of a disappointing performance.

Even so, the ferrous division reported good numbers and they were enough to offset the weak dynamics of base metals and boost the company's revenue sequentially and year-on-year. We then saw growth driven by **(i)** the entry of the seasonally more favorable period, **(ii)** better price conditions for iron ore fines and **(iii)** the partial reversal of accumulated stockpiles.

C1/t is slowly moving towards normalization, with rising freight costs hampering progress in the consolidated figures. Considering that it is common in Q3 for production to ramp up, given the lower rainfall volumes, we would normally expect a greater dilution of fixed costs compared to Q2. In addition to this factor, we saw the beginning of the more intense destocking process (which was atypical in Q3), a greater potential to further accelerate this impact on sales and then deliver an even more powerful fixed cost dilution. However, C1/t clocked in at US$25.6/t (+7.1% vs. Genial Est.), still above our expectations, showing a dilution capacity below what we expected.

Even though C1 costs fell by -3.4% q/q, we would point out that the figure was not only above our expectations but also above the company's historical practice, reflecting **(i)** the weight of the new ways of operating in the mines, **(ii)** the impact of geological inflation and **(iii)** the appreciation of the USD/BRL exchange rate as a reflection within some components.

Along with C1 falling less sharply than we were expecting, the degree of improvement that was sequentially achieved was basically offset by freight costs rising to US$18.9/t (+2.7% q/q; +0.5% y/y), as a consequence of stronger bunker fuel prices and greater exposure to spot rates (exactly as we anticipated in our preview report and one of the reasons for our Target Price cut).

New guidance for C1 (excluding third-party purchases) to be achieved. Revised since last quarter to US$21.5-22.5/t (vs. US$20-21/t previously), albeit above our expectations, our model indicates that with the figure reported in 3Q23 of US$21.9/t, Vale will achieve sufficient dilution of fixed costs so that, with the sequential improvement in 4Q23 in sales, it will further reduce C1/t to ~US$22/t in the weighted full year, therefore remaining within the guidance.

EBITDA misses estimates. Vale reported a Proforma EBITDA of US$4.4bn in 3Q23 (-13.0% vs. Genial Est.), lower than expected, even in the face of an increase of +7.8% q/q and +11.2% y/y. The biggest divergence to justify the difference between our projections and what was actually achieved is in the C1/t cost. As we highlighted above, the indicator came in higher than we expected, and this directly affected the ability to deliver a slightly more intense expansion in EBITDA. Although below expectations, we don't characterize the operational result as bad news, since it shows both sequential and double-digit growth y/y.

Strong net profit is the main positive highlight. After expenses related to the Brumadinho (MG) accident on a smaller scale than estimated (R$305mn vs. R$505mn Genial Est.), net income was reported at US$2.8bn (+7.5% vs. Genial Est.), consolidating a strong sequential boost of +98.5% q/q, with a drop of -36.8% y/y.

It is important to remember that the annual comparison basis is not fair, since in 3Q22 there was a non-recurring effect on the financial result line that impacted net income. This non-recurring effect came from a capital reduction in a subsidiary abroad, which took place in August 2022. This capital reduction generated a gain of ~US$1.5bn due to the reclassification of the exchange variation accumulated in equity. Disregarding the non-recurring effect of the gain on the exchange rate variation, net income would have been US$2.9bn, which would indicate that the performance obtained by the company of US$2.8bn in 3Q23 would have been stable y/y, and would not have implied a drop, as the naked eye data might suggest.

Table 3. Income Statement Vale (3Q23 vs. Genial Est.)

(US$ millions)	3Q23 Reported	3Q23E Genial Est.	% R/E	2Q23 Reported	% q/q	3Q22 Reported	% y/y
Net Revenue	**10.632**	**10.732**	**-0,9%**	**9.638**	**10,3%**	**9.958**	**6,8%**
COGS	(6.309)	(5.917)	6,6%	(5.791)	8,9%	(6.301)	0,1%
Proforma EBITDA	**4.482**	**5.153**	**-13,0%**	**4.157**	**7,8%**	**4.031**	**11,2%**
EBITDA Margin (%)	42,2%	48,0%	-5,86p.p	43,1%	-0,97p.p	40,5%	1,68p.p
Adjusted EBIT	**3.397**	**3.466**	**-2,0%**	**3.107**	**9,3%**	**2.920**	**16,3%**
EBIT Margin (%)	32,0%	32,3%	-0,34p.p	32,2%	-0,29p.p	29,3%	2,63p.p
D&A	(780)	(805)	-3,1%	(779)	0,1%	(775)	0,6%
Financial Result	(385)	(445)	-13,5%	(157)	145,2%	2.347	-116,4%
Net Income	**2.836**	**2.638**	**7,5%**	**1.428**	**98,5%**	**4.484**	**-36,8%**
Net Margin (%)	26,7%	24,6%	2,09p.p	14,8%	11,85p.p	45,0%	-18,35p.p

Source: Genial Investimentos, Vale

Our Take on Vale

We expect that the guidance given for **(i)** iron ore production at 310-320Mt, **(ii)** pellet production at 36-40Mt, **(iii)** nickel and copper production, with the latter revised downwards to 315-325kt, and **(iv)** C1 cost, revised upwards to US$20-21/t, should be achieved in the year.

Despite iron ore production falling y/y, some dynamics with ROM brought a very positive effect in 2Q23, which doesn't necessarily mean a weak number in this year; reaching its guidance with ease, by our estimate of producing 82Mt in 4Q23 (-4.8% q/q; +1.5% y/y), consolidating 313Mt. Meanwhile, pellets should have a strong ramp-up after the release of the Brucutu operation, which after accelerating production in 3Q23 should lead to higher shipments in 4Q23, as we explained earlier.

Some difficulties in the copper mines led to unanticipated maintenance, causing a revision in the short-term guidance, but which does not yet impact the ramp-up capacity in the long term. In addition, as the base metals unit has a low EBITDA composition (~10%), **we don't believe that the guidance revision is reason enough to justify investors not taking advantage of the more favorable momentum** that Vale is entering from now on. We remain bullish about the investment thesis.

Last but not least, the C1 cost without third-party purchases showed a significant improvement, even if it is still a little higher than we expected, but it is a more accurate reflection than the accounting C1 cost with third-party purchases. Especially given the rise in ore prices in the period, we understand that any advance in the indicator was compromised by the higher volume of ore purchased from other players. Nevertheless, 4Q23 promises to bring a further improvement, with the increase in sales forcing C1/t to an even lower standards, given the greater capacity for diluting fixed costs, in the quarter that is typically most favorable for this.

Cash cow. On top of a recovering result, which we believe will go some way to take it off investor uncertainty, Vale also announced a **dividend of R$2.33** (~US$0.47) **per share**), of which R$1.56 as dividends and R$0.76 via Equity Interest (JCP), together representing ~US$2bn, equivalent to 3.6% of Vale's current market cap. The announcement was **in line with our estimates for 3Q23**, and we see the distribution as a positive sign of generation for shareholders. Speaking of next steps, our **FCF Yield projection is 11% 23E**, which would support a **dividend of US$1.9bn for 4Q23E**, very close to the R$2.33 per share announced now in 3Q23. We see Vale with **EPS of R$10.45 in 2023** and **R$9.30 in 2024**, with a **payout of between 65-70%**, without considering the extraordinary dividends that may knock on shareholders' doors next year.

To stress this point out, we then believe in the possibility of distributing extraordinary dividends in 2024, with the US$2.4bn that Vale should keep in cash flow after selling the minority stake in the base metals unit. Should this happen through dividends, we see our **Dividend Yield going to 14.7% 24E**. Further reinforcing its role as a cash cow, with a focus on returns for its shareholders, we also received the news of a new share buyback plan, after completing the previous one, acquiring up to 150 million shares on free float, valid for up to 18 months.

In fact, it's hard to say at the moment whether this new share buyback program might involve the use of the US$2.4bn. What we do know is that the chances are high that Vale will not leave the resource idle in cash, nor use it for very significant CAPEX, **so we believe that the destination of the resource will be to generate value for the shareholder,** either through dividends or share buybacks.

Therefore, we see Vale trading at an **EV/EBITDA 24E** of **4.3x** (vs. a historical average of 4.8x), which reinforces our **BUY rating**, with a **12M Target Price** of **R$82.50** for **VALE-B3**, and **US$16.75** for **NYSE ADRs**, demonstrating an **upside of +26.34%** for the shares.

Appendix: Vale

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

Income Statement	2023E	2024E	2025E	2026E	2027E	2028E
Net Revenue	**40.950**	**39.200**	**40.940**	**42.627**	**43.338**	**43.944**
(-) COGS	(22.554)	(23.976)	(25.203)	(26.536)	(27.776)	(28.996)
Gross Profit	**18.396**	**15.225**	**15.737**	**16.091**	**15.562**	**14.948**
(-) Expenses	(3.727)	(4.151)	(3.078)	(3.206)	(2.764)	(2.696)
Adjusted EBITDA	**16.728**	**14.233**	**16.109**	**16.308**	**16.346**	**15.929**
(-) D&A	(3.153)	(3.326)	(3.471)	(3.615)	(3.753)	(3.886)
EBIT	**13.575**	**10.907**	**12.637**	**12.693**	**12.593**	**12.043**
(+/-) Financial Result	(1.854)	(1.659)	(1.633)	(1.559)	(1.697)	(1.509)
(-) Taxes	(2.556)	(1.094)	(1.284)	(1.320)	(1.291)	(1.248)
Net income	**9.165**	**8.154**	**9.721**	**9.815**	**9.605**	**9.286**
Profitability						
Net margin (%)	22,38%	20,80%	23,74%	23,02%	22,16%	21,13%

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

Cash Flow (FCFF)	2023E	2024E	2025E	2026E	2027E	2028E
Net Revenue	**40.950**	**39.200**	**40.940**	**42.627**	**43.338**	**43.944**
(-) COGS	(22.554)	(23.976)	(25.203)	(26.536)	(27.776)	(28.996)
Adjusted EBITDA	**16.728**	**14.233**	**16.109**	**16.308**	**16.346**	**15.929**
Adjusted EBIT	**13.575**	**10.907**	**12.637**	**12.693**	**12.593**	**12.043**
(-) Taxes	(2.556)	(1.094)	(1.284)	(1.320)	(1.291)	(1.248)
(+) D&A	3.153	3.326	3.471	3.615	3.753	3.886
(+/-) Δ WK	(1.810)	(427)	773	(194)	2	(61)
(-) Capex	(5.928)	(6.137)	(6.288)	(6.341)	(6.364)	(6.384)
FCFF	**6.435**	**6.575**	**9.310**	**8.453**	**8.693**	**8.236**

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	Definition	Coverage
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under Review	Under review	**5%**

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