USIMINAS

3Q23 Review: Chinese steel, the big villain

LatAm Metals & Mining

Main takeaways:

(i) Steel volume above guidance, but with no expectations of increases in 4Q23; **(ii)** Prices with new discounts, following the more challenging environment; **(iii)** MUSA with prices below the reference curve, we believe in a greater penetration of low grade ore bringing down the price; **(iv)** Revenue in retraction by all business divisions; **(v)** Slabs continue to dictate the pace of costs; **(vi)** Mining with higher costs; **(vii)** EBITDA negative at -R$20mn (vs. -R$47mn Genial Est.), reflecting the weak dynamics in the steel industry; **(viii)** Reversal of net profit into a loss, reaching -R$166mn in 3Q23 (vs. -R$200mn Genial Est.); **(ix)** Today the import tax was re-established at a rate of ~12% (it was even lower until September). However, Mexico works with something close to 25%, and in the US this percentage is even higher. Aço Brasil's plea to the Brazilian authorities is for 25%, but we believe this is unlikely to be accepted fully. Until the impasse is resolved, we maintain our neutral bias on the sector; **(x)** New **pressures for discounts make us more bearish**, which leads us to **cut our 12M Target Price** to **R$7.00** (vs. R$7.50 previously), reiterating our **NEUTRAL rating**, with an **upside** of **+12.36%**.

Analysts

Igor Guedes
+55 (11) 3206-8286
igor.guedes@genial.com.vc

Lucas Bonventi
+55 (11) 3206-8244
lucas.bonventi@genial.com.vc

Renan Rossi
+55 (11) 3206-1457
renan.rossi@genial.com.vc

Company

USIM5 BZ Equity
Neutral

Price: R$ 6.23 (27-oct-2023)
Target Price 12M: R$ 7.00

Usiminas released its 3Q23 results today, October 27th. The consolidated figures showed a further downturn, reporting a **negative EBITDA and consequently a loss on the bottom line**, given the sectoral difficulties spreading through the steel industry in Brazil. Even so, the **steel volume came in above expectations**, exceeding Usiminas' own quarterly guidance, and ended up helping the company a little, although the **only part to bring in positive figures was MUSA** (the mining business unit). Among the highlights, Usiminas disclosure that the **refurbishment of Blast-furnace 3** (BF3) **is due to be completed in the next few days**, during 4Q23. Expectations are that along with the ramp-up, we may see some cost improvements, due to the resumption of the furnace's full capacity and greater capacity to dilute fixed costs, which may be key to helping the company get through this challenging time in the steel market.

Table 1. Shipments Summary (3Q23 vs. Genial Est.)

(Thousand Tons - Kt)	Reported	Genial Est.					
Summary (Shipments)	**3Q23**	**3Q23E**	**% R/E**	**2Q23**	**% q/q**	**3Q22**	**% y/y**
Steel	1.021	966	**5,6%**	972	**5,1%**	1.047	**-2,5%**
Iron Ore	2.391	2.298	**4,1%**	2.398	**-0,3%**	2.242	**6,7%**

Soure: Usiminas, Genial Investimentos

Table 2. Income Statement Summary (3Q23 vs. Genial Est.)

(R$ Millions)	Reported	Genial Est.					
Income Statement	**3Q23**	**3Q23E**	**% R/E**	**2Q23**	**% q/q**	**3Q22**	**% y/y**
Net Revenue	6.714	6.413	**4,7%**	6.887	**-2,5%**	8.434	**-20,4%**
Adjust. EBITDA	(20)	(47)	**-58,0%**	366	**-105,5%**	836	**-102,4%**
Net Income	(166)	(200)	**-16,8%**	287	-	609	-

Soure: Usiminas, Genial Investimentos

Valuation and rating. Even though volume surprise positively, we still prefer to be cautious with our recommendation, since the pressure for new discounts remains strong, in the context of the price war between steel imported from China and Brazilian steelmakers, which could lead to a downward trajectory in estimates going forward. We continue to **review realized price assumptions** for the coming quarters with a **bearish tone**, which has led us to **cut our 12M Target Price** to **R$7.00** (vs. R$7.50 previously), reiterating our **NEUTRAL rating**, with an **upside** of **+12.36%**.

Straight to the point...

Price scenario remains very negative, but volume surprises positively. Steel sales volume was reported at 1,021kt (+5.6% vs. Genial Est.), coming in not only above our projections, but also above the guidance of 900-1,000kt. Even so, the indicator was maintained for the next quarter, demonstrating an expectation that the overrun should not occur again this year. Even so, we consider the maintenance of the guidance to be somewhat in line with expectations, given that Q3 is typically the best quarter of the year in terms of demand, which then starts to slow down in Q4 and only picks up again in Q2 of the following year. So, volume is not the factor that concerns us most at the moment.

On the other hand, discounts continue to set a negative tone for price realization, both in the Domestic Market (DM) and in the Foreign Market (FM). The pressure to reduce prices is the variable that continues to worry us, since Usiminas is very exposed to flat steel and has a significant percentage of its customer portfolio in the automotive market. As competition is fierce in relation to the flood of imported Chinese steel, price revisions with successive discounts don't seem to be over yet, with the recent drop in premiums being caused much more by the retraction in the national price than by imports becoming more expensive. As a result, Usiminas reported a consolidated realized price of R$5,600/t (-8.4% q/q; -20.8% y/y), slightly below our expectations. We currently see a premium of +17.8% on flat steel, which should continue to squeeze Usiminas' profitability, and consequently, we expect further price reductions ahead.

Refurbishment in BF3 still affected, but the resumption could help in 4Q23. The refurbishment of Blast-furnace 3 in Ipatinga (MG), which was due to start in April and last ~110 days, was extended to the beginning of November, accounting for more than 180 days. Despite this, we already have a more certain expectation of the resumption in the coming days, according to management, which ends up removing some of the current uncertainty by focusing on the efficiency gains that the reform should generate in the coming quarters.

Mining with positive figures to help the consolidated business. On the other hand, the diversification with mining ended up bringing the only positive effect on the result, with the entry into the best time of the year for production. It posted revenues of R$793mn (-10.7% vs. Genial Est.), and EBITDA of R$129mn (-9.4% vs. Genial Est.). In fact, MUSA ended up posting lower revenue than we expected, but considering the anemic performance of the steel division, which delivered an EBITDA of -R$251mn (vs. -R$131mn Genial Est.), we see the mining division as a point that helped mitigate the negativity of consolidated EBITDA, which clocked in at -R$20mn (vs. -R$47mn Genial Est.), less than half the loss we expected.

In detail!

Table 3. Net Revenue Usiminas (3Q23 vs. Genial Est.)

(R$ millions)	3Q23 Reported	3Q23E Genial Est.	% R/E	2Q23 Reported	% q/q	3Q22 Reported	% y/y
Net Revenue	**6.714**	**6.413**	**4,7%**	**6.887**	**-2,5%**	**8.434**	**-20,4%**
Steel	5.754	5.585	3,0%	5.976	-3,7%	7.451	-22,8%
Mining	793	888	-10,7%	905	-12,3%	833	-4,8%
Steel Transformation	2.009	2.003	0,3%	2.100	-4,3%	2.629	-23,6%
Eliminations	(1.841)	(2.064)	-10,8%	(2.093)	-12,1%	(2.479)	-25,7%

Soure: Usiminas, Genial Investimentos

Steel volume above guidance, but no expectations of increases in 4Q23. Despite delivering a volume of 1,021kt (+5.6% vs. Genial Est.), up +5.1% q/q and down -2.5% y/y, Usiminas kept its guidance intact for 4Q23, at 900-1000kt. Both domestic and foreign markets were responsible for the increase, with DM at 931kt (+6.8% vs. Genial Est.) and FM at 90kt (-5.0% vs. Genial Est.), with emphasis on the redirection of exports to Asia, which was not previously included in sales.

Prices with new discounts, following the more challenging environment. In 3Q23, the unfavorable dynamics for the domestic steel industry continued, due to the maintenance of exports from China, which capture markets with lower tax barriers such as Brazil. As a result, Usiminas' realized prices continued to fall, with the Domestic Market (DM) reported at R$5,600/t (-6.9% q/q; -20.1% y/y), in line with our estimate.

In the same direction, with new contracts created at an unfavorable time for prices, the Foreign Market (FM) reached a realized price of R$6,400/t, down -23.6% q/q. Therefore, on a consolidated basis (DM + FM), we saw the company report a realized price of R$5,600/t (-8.4% q/q; -20.8% y/y), slightly below our expectations.

MUSA with prices below the reference curve. After another strong quarter for iron ore sales, which reached 2.4Mt (+4.1% vs. Genial Est.), we expected MUSA's realized price to benefit from **(i)** a higher average for 62% Fe ore during the period (US$114/t vs. +2.7% q/q), and **(ii)** provisioned prices at the end of the quarter at ~US$118/t, which usually represent a relevant part of sales pricing.

Even with these two points playing in favor of all mining companies in 3Q23, we still saw MUSA with a drop in realized price to US$77/t, which represents -6.1% q/q. We believe that a higher percentage of low-grade iron ore may have interfered with the company's price realization and may not have allowed Usiminas to ride the positive wave of price increases seen in other mining companies under our coverage.

Revenue shrinking across all business divisions. Revenues reached a consolidated R$6.7bn (+4.7% vs. Genial Est.), although above our expectations, due to a higher-than-expected volume in the steel division, we still saw a -2.5% q/q and -20.4% y/y drop. No business unit showed growth on either a sequential or annual basis.

Slabs continue to dictate the costs' pace. The initial plan for the refurbishment of Blast-furnace 3 (AF3) was to be finish by October, but that ended up being extended to the first days of November. As the deadline was pushed forward, we saw 3Q23 still carrying the effects of the refurbishment significantly on COGS.

As the reform continued to loom over the quarter, the relevance of the consumption vs. acquisition of slabs continued to dictate the costs' pace in 3Q23. The average cost of acquiring slab inventory was more relevant than the input costs of iron ore and especially metallurgical coal for coke, which, by the way, are moving in the opposite direction to the price of slab. Even though the increase in inputs didn't put pressure on costs, we saw a COGS/t of R$5,700/t, a marginal drop of -1.6% q/q. We expect further increases from here on, considering that 4Q23 will be a mix between de-stocking slabs going through the P&L and reusing coke + iron ore after refurbishment.

Slab prices may even have rebounded in 4Q23 as iron ore prices accelerated. As the company had already stockpiled a large part of its required consumption, additional pressures in terms of working capital should not be felt in any significant way, and at this point, we are ruling them out.

Higher mining costs. We see an increase of +5.8% q/q in mining costs, reaching a COGS of US$23.6/t in 3Q23. This increase was due to **(i)** higher costs for operating services, mainly internal transportation for feeding and moving the mining company's tailings, **(ii)** higher equipment maintenance costs and **(iii)** greater use of ROM from third-party areas to feed the production plants.

Negative EBITDA, reflecting sector's weak dynamics. Despite the steel industry accounting for a large part of revenues (~88% in 3Q23), the best Adjusted EBITDA was seen in mining, with R$129mn (+21.4% q/q; +13.6% y/y), albeit below our expectations. Precisely following the trend, we announced in our preview report, with a more favorable dynamic for mining companies than for steelmakers in 3Q23.

Experiencing difficulties with competitiveness in the domestic steel market, especially vs. steel imported from China, we access that the dynamic of volume over price continues for Usiminas. As a result, we saw the company trying to compensate for the discounts with an increase in sales, even reported above guidance. But there's no miracle to be done, as the discounts end up grinding down the company's margins, the increase in volume doesn't bring enough fixed cost dilution to compensate, resulting in a very weak figure.

Steelmaking had a negative EBITDA of -R$251mn (vs. -R$131m Genial Est.), almost 2x more negative than we were projecting. Consolidated EBITDA came in at -R$20mn (vs. -R$47mn Genial Est.), slightly better than projections due to the steel transformation segment doing better than expected. Even so, as the segment's representativeness is low in the consolidated accounts, we still classify the total result as anemic.

Table 4. EBITDA Usiminas (3Q23 vs. Genial Est.)

(R$ millions)	3Q23 Reported	3Q23E Genial Est.	% R/E	2Q23 Reported	% q/q	3Q22 Reported	% y/y
Adjusted EBITDA	**(20)**	**(47)**	**-58,0%**	**366**	**-**	**836**	**-**
Steel	(251)	(131)	91,0%	184	-	401	-
Mining	129	142	-9,4%	147	-12,2%	157	-17,8%
Steel Transformation	28	(80)	-	2	1505,5%	148	-81,1%
Eliminations	74	21	248,1%	34	117,0%	130	-43,0%

Soure: Usiminas, Genial Investimentos

Reversal of net income into loss. Despite the positive financial result, the bottom line still came in with a loss of -R$166mn in 3Q23 (vs. -R$200mn Genial Est.) reversing the profit of R$287mn in 2Q23. Like EBITDA, which was negative, the reversal of net income into a loss was due to the still poor dynamics for the steel industry, in the face of a very challenging sector environment considering the price war with Chinese steel.

Table 5. Income Statement Usiminas (3Q23 vs. Genial Est.)

(R$ millions)	3Q23 Reported	3Q23E Genial Est.	% R/E	2Q23 Reported	% q/q	3Q22 Reported	% y/y
Net Revenue	**6.714**	**6.413**	**4,7%**	**6.887**	**-2,5%**	**8.434**	**-20,4%**
COGS	(6.538)	(6.237)	4,8%	(6.305)	3,7%	(7.430)	-12,0%
Adjusted EBITDA	**(20)**	**(47)**	**-58,0%**	**366**	**-**	**836**	**-**
EBITDA Margin (%)	-0,3%	-0,7%	0,44p.p	5,3%	-5,62p.p	9,9%	-10,2p.p
EBIT	**(244)**	**(284)**	**-14,1%**	**287**	**-**	**577**	**-**
EBIT Margin (%)	-3,6%	-4,4%	0,79p.p	4,2%	-7,81p.p	6,8%	-10,48p.p
D&A	(261)	(237)	10,4%	(262)	-0,5%	(225)	16,0%
Financial Result	(98)	60	-	205	-	171	-
Net Income	**(166)**	**(200)**	**-16,8%**	**287**	**-**	**609**	**-**
Net Margin (%)	-2,5%	-3,1%	0,64p.p	4,2%	-6,64p.p	7,2%	-9,69p.p

Soure: Usiminas, Genial Investimentos

Our Take on Usiminas

In general terms, Usiminas posted a weak result in 3Q23. Despite this, steelmaking volumes came in higher than our estimates, as did the steel transformation figures, with mining also giving a small helping hand by reporting a positive EBITDA, in the face of steelmaking EBITDA that was not only contracting, but also negative. As the mining unit (MUSA) is the second largest force by business division, the situation could have been even worse without the mining company's contribution.

Chinese steel, the big villain. The refurbishment of Blast-furnace 3 (BF3), the company's highest-capacity asset (~1Mtpa), continued to have negative repercussions, placing greater weight on slabs, which are being destocked and passed through the P&L, consequently affecting EBITDA. However, the big villain continues to be Chinese crude steel, which has been competing strongly on price with the domestic steel industry, given the low protectionist barriers in Brazil compared to other countries, such as Mexico (which has a similar economy to Brazil) and the USA.

Today the tax has been re-established at a rate of ~12% (it was even lower until September). However, Mexico works with something close to 25%, and in the USA this percentage is even higher. So Aço Brasil's request to the Brazilian authorities, which was made last month, aims to raise the import tariff to 25%. While this issue is being discussed, and steelmakers' margins in China have fallen back, indicating that exports will not let up in the short term, we prefer to remain neutral on all the companies we cover linked to the steel industry in Brazil.

We expect that the price war between imported and domestic steel will continue to hurt price realization for Usiminas, and even if volume recovers, as we saw it do this quarter, this doesn't seem to be enough to cause an EBITDA gain, on the contrary. The company from the EBITDA line showed a loss in 3Q23, ending the bottom line with a reversal from a net income of R$287mn last quarter to a loss of -R$166mn in 3Q23.

Cash flow generation surprises positively. Despite the negative EBITDA in 3Q23, as BF3 continues to be refurbished, slab inventories are being sold, which resulted in a large reduction in the working capital (WC) needs in 3Q23, reaching a release of R$1.5bn. That represented the main driver for the cash flow generation of ~R$800mn (+12% vs. Genial Est.). We consider this figure to be important, and it shows that the company has prepared itself as best it can for the BF3 shutdown.

The shutdown has been going on since April and was initially expected to last ~110 days. We've seen it postponed on two occasions, and the company has confirmed that it will last until the beginning of November, accounting for ~200 days. Even so, the expectation for the future is positive, given the resumption of full capacity, and with an improvement in costs due to the lower use of coke in the production process, as the equipment would hit a better burning coefficient. These are important steps that will help profitability, especially in the face of a difficult scenario for the steel sector.

As the reform is coming to an end, we don't see the need, at first, for a larger purchase of slab inventory, which would once again put pressure on the company's working capital, as happened from 2H22 to 1Q23. In other words, last quarter we had already witnessed an interesting WC release, due to the reduction in the pace of stockpiling and the start of slab destocking, doing the opposite movement and freeing up working capital instead of putting pressure on it. We believe that this will be repeated in 4Q23, but on a smaller scale, as the refurbishment is due to be completed in November.

With BF3 being reconnected, the company will once again consume more coke and iron ore, therefore being at the mercy of commodity prices, and this slab dynamics affecting both working capital and COGS will be greatly minimized. Faced with a scenario still deteriorating due to the **large amount of steel exports from China**, which hit markets with lower import taxes harder, as is the case in Brazil, **new pressures for discounts make us more bearish about Usiminas**, which leads us to **further cut the 12M Target Price** to **R$7.00** (vs. R$7.50 previously), reiterating our **NEUTRAL rating**, with an **upside** of **+12.36%**.

Appendix: Usiminas

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

Income Statement	2023E	2024E	2025E	2026E	2027E	2028E
Net Revenue	**26.895**	**26.956**	**28.084**	**29.413**	**30.249**	**30.422**
(-) COGS	(24.992)	(24.271)	(24.791)	(25.381)	(25.704)	(25.884)
Gross Profit	**1.903**	**2.685**	**3.293**	**4.032**	**4.545**	**4.538**
(-) Expenses	(1.769)	(1.668)	(1.700)	(1.769)	(1.774)	(1.772)
Adjusted EBITDA	**1.202**	**2.069**	**2.698**	**3.399**	**3.919**	**3.913**
(-) D&A	(993)	(1.051)	(1.105)	(1.136)	(1.148)	(1.147)
EBIT	**353**	**1.017**	**1.593**	**2.263**	**2.771**	**2.766**
(+/-) Financial Result	1.059	(103)	(50)		148	430
(-) Taxes	(300)	(295)	(458)	(645)	(814)	(885)
Net income	**721**	**846**	**1.312**	**1.849**	**2.332**	**2.537**
Profitability						
Net margin (%)	2,68%	3,14%	4,67%	6,29%	7,71%	8,34%

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

Cash Flow (FCFF)	2023E	2024E	2025E	2026E	2027E	2028E
Net Revenue	**26.895**	**26.956**	**28.084**	**29.413**	**30.249**	**30.422**
(-) COGS	(24.992)	(24.271)	(24.791)	(25.381)	(25.704)	(25.884)
Adjusted EBITDA	**1.202**	**2.069**	**2.698**	**3.399**	**3.919**	**3.913**
EBIT	**353**	**1.017**	**1.593**	**2.263**	**2.771**	**2.766**
(-) Taxes	(300)	(295)	(458)	(645)	(815)	(884)
(+) D&A	993	1.051	1.105	1.136	1.148	1.147
(+/-) Δ WK	1.250	(240)	(180)	(356)	(63)	(61)
(-) Capex	(3.171)	(1.813)	(1.559)	(1.341)	(1.153)	(1.084)
FCFF	**(874)**	**(279)**	**501**	**1.057**	**1.888**	**1.884**

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	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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