genial Equity Research

GERDAU

3Q23 Preview: Oxidized steel

LatAm Metals & Mining

Main takeaways:

(i) Volume is struggling to grow in all business units, especially in Brazil BD; **(ii)** Price is being negatively affected by the macro factor, in relation to the Chinese situation; **(iii)** Net revenue is projected to be down by -9.0% q/q and -21.4% y/y; **(iv)** Adjusted EBITDA of R$3.1bn Genial Est., and net income clocking in at R$1.6bn Genial Est, both in a double digit retraction; **(v)** Rating is reiterated at **Neutral**, with a **12M Target Price cut** to **R$26.00** (vs. R$32.00 previously), which leaves an **upside** of **+13.79%** for the shares.

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Company

GGBR4 BZ Equity
Neutral

Price: R$ 22.85 (03-Nov-2023)
Target Price 12M: R$ 26.00

Gerdau will release its 3Q23 results on November 6th, after the market closes. We expect **weaker numbers** sequentially and a **double-digit drop year-on-year on EBITDA.**

The **main reasons** for the shrinking numbers in 3Q23, in our view, are: **(i)** Macroeconomic scenario getting worse. We believe that even with the recent drop in interest rates in Brazil, there is a delay until the effect of the SELIC cuts reaches domestic demand for steel. In addition, we see **(ii)** greater penetration of Chinese steel within apparent consumption in Brazil. We agree that Gerdau, being more exposed to long steel, suffers less than its peers, but competition with the imported product is instigating a price war in the domestic market. Finally, we highlight the **(iii)** slowdown in the pace of vehicle inventory rebuilding by automakers in the US, indicating a drop in volume for Special Steel division, which previously followed the United Auto Workers (UAW) strike.

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

(Thousand Tonnes - kt)	Genial Est.				
Summary (Shipments)	**3Q23E**	**2Q23**	**% q/q**	**3Q22**	**% y/y**
Brazil BD	1.225	1.344	**-8,9%**	1.330	**-7,9%**
North America BD	962	975	**-1,3%**	988	**-2,7%**
South America BD	304	311	**-2,4%**	297	**2,2%**
Special Steel BD	354	379	**-6,6%**	403	**-12,1%**

Soure: Gerdau, Genial Investimentos

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

(R$ millions)	Genial Est.				
Income Statement	**3Q23E**	**2Q23**	**% q/q**	**3Q22**	**% y/y**
Net Revenue	16.614	18.265	**-9,0%**	21.149	**-21,4%**
Adjusted EBITDA	3.158	3.792	**-16,7%**	5.369	**-41,2%**
Net Income	1.633	2.143	**-23,8%**	3.022	**-46,0%**

Soure: Gerdau, Genial Investimentos

Valuation and rating. Our perception for Brazil BD is of a very adverse scenario, as the Brazilian steel market is facing challenges due to the continuous wave of exports from China. This remaining volume of steel produced in China that is not being fully consumed, and is soon being exported by Chinese producers, is increasing the concentration of imported steel within apparent consumption in Brazil, reaching a penetration rate of 23.2% according to the latest available data from September, a very elastic increase of +11.8p.p y/y. This dynamic results in pressure for price discounts in the local market.

As we went into in more detail in our last report, which is attached (Gerdau: No longer just a rebar company), until we see clearer signs of the possibility of an increase in tariff barriers by the Brazilian authorities, following Aço Brasil's request (increase to 25% vs. ~12% currently), we will continue to have a Neutral bias towards the steel sector. We still see competition with imported product causing further damage to price realization ahead.

As for North America BD, although we have a slightly more constructive outlook for the business unit, it is also beginning to feel the effects of the economic slowdown, due to the FED's contractionary monetary policy cycle. To top it off, Gerdau is also going through a period of rising CAPEX, and as we are seeing the effects of a bearish steel cycle on the EBITDA line, which continues to contract itself, we believe in a downward trend in cash flow generation in the short term, potentially affecting dividends.

By updating our assumptions in our model to consider a **(i)** higher CAPEX for 2024 and 2025; **(ii)** price realization in Brazil with a still poor dynamics for 2024; and **(iii)** lower volumes for Special Steel due to the United Auto Workers (UAW) strike and a slowdown in the automakers' inventory rebuilding. All that came together, and we ended up **cutting** the **12M Target Price** to **R$26.00** (vs. R$32.00 previously), providing an upside of **+13.79%**. Trading at an **EV/EBITDA 24E** of **3.4x**, we reiterate our **Neutral rating**.

Straight to the point...

Macro scenario should deteriorate both volume and price. In the expectation of falling volumes in all geographic operations, and with Brazil BD downtrading to 1,225Kt (-8.9% q/q; -7.9% y/y), we expect revenues of R$6.6bn Genial Est. (-9.1% q/q; -22.5% y/y) in Brazilian operations, which should bring prices basically flat to R$5,400/t (-0.2% q/q; -15.8% y/y). As for North America, the drop in volumes should have a smaller impact, but with realized prices suffering more, reaching R$6,500/t (-6.9% q/q; -18.0% y/y).

We see the macro environment hampering the formation of Gerdau's top line, of which we project the consolidated net revenue to reach R$16.6bn Genial Est. (-9,0% q/q; -21.4% y/y). Even so, we stand by our position that the negative effects will be felt to a lesser extent at Gerdau compared to its Brazilian peers. This is due to the fact that the product mix is mostly linked to long steels, which are experiencing less intense price contraction dynamics than flat steels.

EBITDA down, with margins falling in all units. Looking at the cost outlook, we expect Brazil BD to be the exception with a negative bias, since for all the other business units we are projecting sequentially softer costs, while for the Brazilian operations our estimates indicate something very close to what it was last quarter.

So, with lower revenues and a flat COGS/t, we expect margins to fall at Brazil BD to 10.4% (-3.3p.p q/q). As the Brazilian business unit has ~40% weight, we arrive at a consolidated EBITDA of R$3.1bn Genial Est. (-16.7% q/q; -41.2% y/y) in our model, showing a double-digit nominal decline and with a margin falling to 19.0% (-1.75p.p q/q). As a result, our expectation is for a cooler net income of R$1.7bn Genial Est. (-22.3% q/q; -43.3% y/y).

In detail!

Realized prices should be negatively affected by the macro scenario. In the main operating units, we expect prices to fall, with Brazil BD expected to fall marginally to R$5,400/t (-0.2% q/q; -15.8% y/y), reflecting the strong export situation from China. Although the situation is challenging, as we have mentioned in recent reports, Gerdau has slightly greater protection against Brazilian peers, given a more resilient product mix, and greater exposure to long steel, which is suffering less impact from imports than flat steel. This explains why the drop is projected to be only marginal.

Looking at North America BD, we believe that the downward dynamic in price realization is stronger, reaching R$6,500/t (-6.9% q/q; -18.0% y/y), after the company granted discounts of -US$50/t during the quarter. In addition, Special Steel and South America BDs should both see further price drops, of -4.0% q/q and -5.0% q/q, respectively.

Despite the fall in prices, volume may also be affected. Brazil's BD domestic market should suffer slightly in terms of volume, reaching 1,035kt Genial Est, (-2.8% q/q; -14.1% y/y), while the foreign market could shrink more, to 190kt Genial Est. (-32.0% qqt; +50.6 y/y). Reaching a consolidated 1.2Mt in the region, down -8.9% q/q and -7.9% y/y.

North America BD should be more resilient, especially after a more relevant price discount that helps maintain volumes q/q, at 962Kt Genial Est. (vs. 975kt in 2Q23). Through our latest conversations with the company, we feel that demand had a downward trajectory in 3Q23 in both regions, but mainly in Brazil BD, reflecting directly on expected volume and price levels we motioned.

For the other business units, we also expect a reduction in sales volume, with South America BD being negatively impacted by the disruption in exports from Brazil, and Special Steel by the automotive scenario slowing down again in the US, and with ANFAVEA revising its projection to +1% y/y growth (vs. 2% y/y previously) in light vehicle production in Brazil.

Revenue down across all business units. In line with the tight price dynamics and falling volumes, we expect a contraction in consolidated net revenue to R$16.6bn Genial Est. (-9.0% q/q; -21.4% y/y), driven by a decline in all business units, but mainly in Brazil BD of -9.1% q/q and in North America BD of -8.1% q/q.

Table 3. Net Revenue Gerdau (3Q23 Genial Est.)

(R$ millions)	3Q23E Genial Est.	2Q23 Reported	% q/q	3Q22 Reported	% y/y
Net Revenue	**16.614**	**18.265**	**-9,0%**	**21.149**	**-21,4%**
Brazil BD	6.579	7.236	-9,1%	8.484	-22,5%
North America BD	6.251	6.806	-8,1%	7.832	-20,2%
South America BD	1.492	1.609	-7,3%	1.972	-24,4%
Special Steel BD	2.765	3.086	-10,4%	3.477	-20,5%
Eliminations	(474)	(471)	0,6%	(616)	-23,1%

Soure: Gerdau, Genial Investimentos

Costs in different dynamics between the operations' geographies. In order to help the overall result a little, we expect costs at North America BD to ease a bit, reaching R$5,100/t Genial Est. (-3.8% q/q; -8.7% y/y), along with South America BD and Special Steel, which also are pointed to reduce sequentially, by -8.7% q/q and -10.8% q/q, respectively. Conversely, Brazil BD is still unlikely to make much progress, with costs rising marginally q/q to R$4,600/t Genial Est. (+2.2% q/q; -9.3% y/y).

What we saw happen in the first half of the year was a gradual increase in the supply of scrap in the US, which until last year had been under pressure. This pressure, which had previously existed, coupled with a still-strong demand dynamic, led to a rise in the metal spread during this period. However, as the level of scrap reserves has recovered over the last few months, there is almost no room for the metal spread to remain at such high levels. As a result, we were seeing clients holding back on ordering, in the expectation that steel producers would cut prices. We had anticipated this trend since our reports last quarter, and this is exactly what happened for 3Q23.

Gerdau cut prices by ~US$50/t, and some US peers even cut prices more intensely than that. Along these lines, looking at costs, the positive counterpoint is our expectation that the higher supply of scrap is one of the justifications for lower costs for North America BD. We'll talk about the outlook for 4Q23 and 2024 in the "Our Take" section at the end of the report.

EBITDA projected in contraction, with margins decreasing. We consolidate our expectation of an Adjusted EBITDA clocking in at R$3.1bn Genial Est., representing a drop of -16.7% q/q and -41.2% y/y, equivalent to a margin of 19.0% (-1.75p.p q/q; -6.38p.p y/y).

The main business units should bring in weaker figures, with Brazil projected at R$687mn Genial Est. (-30.8% q/q; -56.0% y/y) and North America at R$1.4bn Genial Est. (-17.5% q/q; -43.2% y/y), also showing compression in their margins, to 10.4% and 23.4% respectively. Despite the difficulties that the other BDs (South America and Special Steels) are likely to experience, we expect the reduce in costs tendency to offset the top line's loss for them.

Table 4. EBITDA Gerdau (3Q23 Genial Est.)

(R$ millions)	3Q23E Genial Est.	2Q23 Reported	% q/q	3Q22 Reported	% y/y
Adjusted EBITDA	**3.158**	**3.792**	**-16,7%**	**5.369**	**-41,2%**
Brazil BD	687	992	-30,8%	1.563	-56,0%
North America BD	1.465	1.777	-17,5%	2.579	-43,2%
South America BD	421	481	-12,5%	573	-26,6%
Special Steel BD	634	603	5,2%	631	0,5%
Eliminations	(49)	(60)	-18,1%	23	-

Soure: Gerdau, Genial Investimentos

Weaker net income. With a financial result of -R$94mn expected, we arrived at a net profit of R$1.6bn Genial Est. at our model, representing a drop of -23.8% q/q and -46.0% y/y, and a net margin of 9.8% (-1.9p.p q/q; -4.46p.p y/y).

Table 5. Income Statement Gerdau (3Q23 Genial Est.)

(R$ millions)	3Q23E Genial Est.	2Q23 Reported	% q/q	3Q22 Reported	% y/y
Net Revenue	**16.614**	**18.265**	**-9,0%**	**21.149**	**-21,4%**
COGS	(14.013)	(14.987)	-6,5%	(16.411)	-14,6%
Adjusted EBITDA	**3.158**	**3.792**	**-16,7%**	**5.369**	**-41,2%**
EBITDA Margin (%)	19,0%	20,8%	-1,75p.p	25,4%	-6,38p.p
EBIT	**2.293**	**2.885**	**-20,5%**	**4.463**	**-48,6%**
EBIT Margin (%)	13,8%	15,8%	-2p.p	21,1%	-7,3p.p
D&A	(733)	(752)	-2,6%	(738)	-0,7%
Financial Result	(94)	(423)	-77,8%	(530)	-82,3%
Net Income	**1.633**	**2.143**	**-23,8%**	**3.022**	**-46,0%**
Net Margin (%)	9,8%	11,7%	-1,9p.p	14,3%	-4,46p.p

Soure: Gerdau, Genial Investimentos

Our Take on Gerdau

Brazil remains the main challenge. Looking ahead, we believe that Brazil BD should continue to feel the impacts of the flood of Chinese steel into apparent consumption, whose imports have been revised by the Aço Brasil Institute to 2Mt in 2023 (vs. 1.2Mt in 2022). This figure would be equivalent to almost 50% of the entire volume of imported steel consumption. The ease way of accessing the Brazilian market, given the low import tariff compared to other countries, creates a scenario in which the local steel market is constantly under pressure, with difficulties in maintaining the sales volume and price previously practiced. In an attempt not to lose any more market share, we believe that the successive price discounts for flat steel will continue, which will end up hampering the results of domestic steelmakers.

Chinese exports probably will remain at high levels for a while. We believe that low margins and a still contracting industrial PMI should continue to create the conditions for the situation to remain challenging. Iron ore and coke prices are putting pressure on steelmaking margins in China, leading the local metal spread to narrow further, after a gradual improvement that we have witnessed since July. According to our data, the metal spread in China fell back below US$10/t, putting an end to this movement and closing September at US$9.6/t for hot-rolled coil, a notable drop from the US$51/t we were seeing at the end of August.

The industrial PMI for October fell back to 49.5, returning to the contraction zone after reaching 50.2 in September. Therefore, demand for domestic steel for capital goods still looks shaky. Considering China's large installed steel capacity of over 1.2Bt, with our projection of 920Mt 23E for total production, we believe that 4Q23 will still see weak price dynamics for flat steel in Brazil and with the beginning of 2024 following in the same vein. In other words, China will continue to export surplus steel to global markets, mainly affecting countries with lower protectionist barriers, which is the case with Brazil. For long steel, we are seeing a premium of +10.8% vs. imported steel, and for flat steel the premium is +17.8%.

The situation for long steel continues to be better than for flat steel. Our price monitoring indicates that Brazilian domestic rebar has seen a drop in premium of ~1.5p.p, due to a rise of +R$50/t in the domestic price, to ~R$3,750/t. For the first time in a few months, the premium would have been reduced by an increase in the domestic price, and not by a drop in relation to the cheaper imported steel braking barriers at Brazilian's borders. We believe that some steelmakers are in the process of negotiating the suspension of discounts since September and the beginning of the process of repricing long steel for the last few months of the year. Some players who have faced greater difficulties with volume may have been too forceful when it came to negotiating price increases, which may have made it quite difficult the pass-through to be fully accepted by clients, since demand still seems to be very weak at the top end. With the SELIC rate still being cut (once again by -50bps recently), demand could lift in 2024.

North America is slowing down, but still has better prospects than Brazil. On the other hand, even though it is beginning to show signs of an economic slowdown, we believe that the situation for North America BD still has a slightly more constructive view of the sector's sustainability in the local context. After several estimates pointing to a recession in the American economy in recent quarters, we have had strong data that has shown resilience, but which has also highlighted the need for the FED to raise interest rates.

In fact, already showing signs that monetary tightening is having an effect, the FED held back on the pace of increases at the last meeting, leaving the prime rate stable at 5.25%-5.50%. However, we believe that the situation for Brazil will remain more challenging than in the US, looking ahead to 4Q23 and 2024. With increased exports of scrap iron to other markets in August and the steady easing of the summer season doldrums, coupled with tight supply, have led to a growing optimistic outlook for steel in the US, especially in 2024. After the price cut to try to level the metal spread, we believe it is likely that clients will return to placing orders in the steel producers' supply book.

CAPEX as the center of investor discussion. On top of all this, Gerdau has been presenting expansion projects, with an increase in CAPEX until 2026, which ends up reducing cash flow generation in the short and medium term. We emphasize that the vast majority of investors we talk to are looking at short-term dynamics when they invest in companies linked to commodities.

So, whether for capacity addition projects, maintenance of current mills or cost efficiency, we believe that Gerdau using a significant portion of its operating cash flow generation to maintain its competitive advantages can be seen as a short-term negative, precisely because it is doing so at a lower point in the steel cycle, without the EBITDA strength to sustain an increase in CAPEX.

Oxidized steel. We believe that this dynamic has been removing the buyers' flow from the stock, explaining the -20% drop in the share prices since the week preceding the release of the results for the previous quarter, when, at the time, we downgraded the company to Neutral, anticipating the market's reaction ahead of consensus.

Exactly one year ago, for the 3Q22 review, we published a report entitled "Macro scenario does not oxidize Gerdau steel", alluding to the fact that since this time last year, the company's Brazilian peers had already begun to report weaker results, given the increase in interest rates in Brazil, cooling demand. But at that time, Gerdau was still ahead of the competition and showed numbers pointing to growth. Nowadays, we still prefer Gerdau to other steel peers in our coverage, but as the macro scenario has only worsened since then, the tendency is for Gerdau to start suffering from the sector's situation as well. Last quarter's results have already confirmed this, and we expect 3Q23 to only reinforce this trend.

As we explained at the beginning of this report, we revised our assumptions to better reflect our **(i)** upward bias for CAPEX, **(ii)** continuation of the price deterioration process for flat steel in Brazil (~1/3 of Gerdau's portfolio) and **(iii)** worsening volumes in the Special Steel division. **The new assumptions led to a Target Price cut**. Trading at a **24E EV/EBITDA** of **3.4x**, we reiterate our **NEUTRAL rating**, with a new **12M Target Price** of **R$26.00** (vs. R$32.00 previously), providing an **upside** of **+13.79%** to the shares.

Appendix: Gerdau

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

Income Statement	2023E	2024E	2025E	2026E	2027E	2028E
Net Revenue	**69.336**	**67.848**	**68.664**	**68.621**	**70.399**	**73.112**
(-) COGS	(57.644)	(56.415)	(57.233)	(57.927)	(58.700)	(59.766)
Gross Profit	**11.692**	**11.434**	**11.431**	**10.693**	**11.699**	**13.345**
(-) Expenses	(2.027)	(1.951)	(2.029)	(2.089)	(2.163)	(2.249)
Adjusted EBITDA	**14.046**	**13.910**	**14.200**	**13.720**	**14.968**	**16.833**
(-) D&A	(2.200)	(3.206)	(3.562)	(3.880)	(4.165)	(4.420)
EBIT	**11.359**	**10.161**	**10.088**	**9.291**	**10.240**	**11.828**
(+/-) Financial Result	(1.044)	(1.075)	(1.005)	(1.030)	(957)	(1.189)
(-) Taxes	(2.340)	(2.338)	(2.337)	(2.126)	(2.389)	(2.737)
Net income	**7.975**	**6.748**	**6.746**	**6.136**	**6.895**	**7.902**
Profitability						
Net margin (%)	11,50%	9,95%	9,83%	8,94%	9,79%	10,81%

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

Cash Flow (FCFF)	2023E	2024E	2025E	2026E	2027E	2028E
Net Revenue	**69.336**	**67.848**	**68.664**	**68.621**	**70.399**	**73.112**
(-) COGS	(57.644)	(56.415)	(57.233)	(57.927)	(58.700)	(59.766)
Adjusted EBITDA	**14.046**	**13.910**	**14.200**	**13.720**	**14.968**	**16.833**
EBIT	**11.359**	**10.161**	**10.088**	**9.291**	**10.240**	**11.828**
(-) Taxes	(2.340)	(2.338)	(2.330)	(2.134)	(2.366)	(2.727)
(+) D&A	2.200	3.206	3.562	3.880	4.165	4.420
(+/-) Δ WK	1.880	(194)	(29)	(421)	(296)	(444)
(-) Capex	(5.822)	(5.888)	(5.952)	(6.018)	(6.085)	(6.152)
FCFF	**7.278**	**4.946**	**5.340**	**4.598**	**5.658**	**6.925**

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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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