genial Equity Research

GERDAU

4Q23 Preview: Squeezed on both sides

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Company

GGBR4 BZ Equity
Neutral

Price: R$ 21.21 (16-Feb-2024)
Target Price 12M: R$ 24.50

Main takeaways:

(i) Realized prices should bring it up a still difficult situation in 4Q23; **(ii)** Volumes could show even more significant reductions in Brazil and North America; **(iii)** We project South America BD to be marked-to-market due to the situation in Argentina; **(iv)** Special Steel BD: Weaker US figures partially offset by improving dynamics in Brazil; **(v)** Projected revenue declines across all operating divisions; **(vi)** Costs rising q/q; **(vii)** EBITDA in double-digit decline and margins in compression; **(viii)** Net income weakened; **(ix)** Reinstatement of steel import tariff in Brazil will raise average rate to 14% (vs. 12% in force previously), however the measure should not be confused with the request to increase the import tariff to 25%, still being pleaded by Aço Brasil; **(x)** South America: asset divestment as a consequence of low profitability; **(xi)** Although many predicted a strong post-Covid-zero return in 2023, a more skeptical stance was maintained by us and proved to be correct. Now, although a consensus revision has downgraded China's 2024/25 growth forecasts, a slightly less negative outlook is being adopted by us; **(xii)** Readjustments in Brazil: we maintain our bias that long steel is in a better spot than flat steel and may get the chance to be at a price pass-through sooner; **(xiii)** USA: Higher interest rates for longer will reduce steel consumption; **(xiv)** Gerdau will be squeezed on both sides (Brazil and USA). Trading at an **EV/EBITDA 24E** of **4.1x**, we reiterate our **NEUTRAL** rating. The **changes we made** to the assumptions in our model resulted in a **reduction** of the **12M Target Price** to **R$24.50** (vs. R$26.00 previously), guaranteeing an **upside of 15.51%**.

Table 1. Shipments Summary (4Q23 Genial Est.)

(Thousand Tonnes - kt)	Genial Est.				
Summary (Shipments)	**4Q23**	**3Q23**	**% q/q**	**4Q22**	**% y/y**
Brazil BD	1.175	1.260	**-6,8%**	1.150	**2,1%**
North America BD	870	943	**-7,7%**	887	**-1,9%**
South America BD	259	290	**-10,4%**	290	**-10,6%**
Special Steel BD	324	345	**-6,1%**	401	**-19,3%**

Source: Gerdau, Genial Investimentos

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

(R$ millions)	Genial Est.				
Income Statement	**4Q23E**	**3Q23**	**% q/q**	**4Q22**	**% y/y**
Net Revenue	15.536	17.063	**-9,0%**	17.964	**-13,5%**
Adjusted EBITDA	2.012	3.349	**-39,9%**	3.630	**-44,6%**
Net Income	920	1.592	**-42,2%**	1.219	**-24,6%**

Source: Gerdau, Genial Investimentos

Gerdau will release its **4Q23 results on February 20th**, after the market closes. We expect **weaker data** with a **double-digit decrease** in revenue **q/q** and substantial double-digit downshifts for EBITDA and Net Income. The **main reasons** for shrinking numbers in 4Q23, in our view, are:

In Brazil: (i) automotive sector showing the first signs of recovery (valid for Special Steel BD), but industrial segment still with low demand (valid for Brazil BD); **(ii)** civil construction segment slowing down, number of work sites may start to feel the effect of the reduction in real estate launches in 2024, especially for the high- and middle-income segment. Still on the subject of construction, thinking about the quarter, the 4Qs generally show seasonality in relation to demand, considering that the rainfall reduces the construction progress, reducing steel sales in this segment.
Nevertheless, we see the **(iii)** penetration rate acceleration of Chinese steel in Brazilian apparent consumption. Although we recognize that Gerdau, with its greater exposure to long steel, is relatively less impacted than its peers, competition with imported products is resulting in a generalized price war in the domestic market, as already reported in several previous reports.

In North America: (i) weaker seasonality, combined with **(ii)** high interest rates, following the FED's hikes, should hamper steel demand. We believe that the slowdown in the economy will lead to lower consumption of durable goods, as well as a slowdown in the expansion of infrastructure projects, both of which are strong consumers of steel. We believe that 3Q23 already showed signs of this slowdown, with a drop in volume and a cut in price t/t. Our expectation is that 4Q23 will show the continuation of this movement, consolidating a tighter market in the short term for Gerdau in the USA. It is worth mentioning that the industrial PMI closed December at 47.9 (-1.5pt m/m), the lowest level since August, showing a clear sign of reduced demand.

In South America: (i) the strong currency devaluation promoted by the economic team under current president Javier Milei administration, of more than 50% in the official ARS/USD exchange rate, in an attempt to get closer to the Blue-Chip Swap rate (unofficial market exchange rate). We believe that this should have a considerable effect in reducing results, due to mark-to-market approach that Gerdau will have to make in 4Q23. **(ii)** Assets with weaker profitability, including those in Colombia, the Dominican Republic and Panama. Gerdau also announced the sale of its stake in the JVs it operated in these locations, with effect taking place at 1Q24.

For Special Steel: the United Auto Workers (UAW) strike is likely to amplify the effects of the seasonality already observed last quarter, when we saw the automakers' impetus to rebuild inventories withdraw. Therefore, we are considering a stronger reduction in sales within the Special Steel division aimed at the US automotive market as an additional effect of the strike.

Valuation and rating. Regarding Brazil BD, we see a complicated situation, the domestic market continues to compete with the penetration of imported steel, especially Chinese. As industrial activity and the real estate market are not at high levels in China, surplus steel is exported by producers, increasing the penetration rate of these products in global markets, including Brazil. According to Aço Brasil (IABr), penetration stood at 25.2% in December. As a result, Brazilian steelmakers are forced to discount the price of domestic steel in order to compete with the Chinese product.

North America, on the other hand, is suffering from high interest rates and a short-term economic slowdown in the consumption of durable goods that require steel. A couple weeks later, the FED kept interest rates between 5.25% and 5.50%, noting that the market consensus is for a soft landing. We expect to see a slowdown in consumption in the short term, especially considering that the official industrial PMI, measured by the ISM, marked levels below 50pts during the 12M of 2023. We believe that the US economy is being driven more by services than by the consumption of goods.

Our opinion is that the slowdown should not throw the country into a technical recession, given that the services PMI is consistently coming in within the expansion zone. The latest reading, now in January, was 53pts (+3.1pts m/m), with a strong expansion compared to December. However, services are not a driver for steel consumption. The industry seems to be feeling the effects of higher interest rates, which will culminate in a reduction in steel volumes and difficulties in maintaining high metal spread levels.

In line with this logic, we have become a little more pessimistic about the company's performance for 2024 and have updated our assumptions in relation to: **(i)** volume and metal spread in North America BD, already noting the readjustment that Gerdau made for 1Q24 (a great move made by the company in the face of difficulty). In addition, we changed the assumptions in the model to reflect the **(ii)** majorated gap in parity premium conditions, especially in flat steel, with a more marginal drop in volume vs. our previous assumptions. We also reassessed conditions in relation to the automotive market, with **(iii)** lower shipments from the Special Steel division on the American automakers' side for 2024, but with partial optimism (still embryonic) for the market in Brazil. These different dynamics culminated in a **12M Target Price cut** to **R$24.50** (vs. R$26.00 previously), providing an **upside** of **+15.51%**. Trading at an **EV/EBITDA 24E** of **4.1x**, we reiterate our **NEUTRAL** rating.

Price adjustments. Even in an adverse sector environment in Brazil, the price of long steel benchmarks saw a reduction in premium to ~2% in January (vs. 10% in November), with this level now stabilizing at the beginning of February. We note that the premium has reduced due to the stability of the domestic price in the face of the rise in the Turkish rebar benchmark, which currently stands at US$617/t vs. US$570/t in November. On the other hand, our market analysis suggests that Gerdau may be considering a 5-7% price adjustment by the end of 1Q24, indicating that there is room for improvement. Contradicting the sentiment that the steelmakers gave us when asked about price increases, most replied that they would try to make moves in flat steel (and not in long steel).

However, we don't see any room today, given that flat steel references are cutting prices. Chinese HRC even increased in price towards the end of last year. However, we saw the benchmark fall back from US$598/t in the first week of January to US$553/t at the start of February, indicating a drop of -7.5% in ~30 days, with the parity gap rising back to ~18% at the close of last month vs. 12% at the start of January. In other words, the situation continues to be weaker for flat and attempts to readjust this type of steel should be innocuous. On the other hand, we see better chances for longs.

Looking now at the movements in the US, we know that Gerdau announced two price increases, divided by product group: **(i)** the first announcement, on December 23, targeted rebar (+US$50/t) and merchant bars (+US$65/t). **(ii)** The second announcement, made on January 5, targeted beams (+US$50/t). In addition, to encourage volume, Gerdau announced the adjustments in advance, to indicate that clients who bought before December 22 would get a cheaper price range.

Although the policy makes total sense in our opinion, it didn't change the orderbook, which remains at ~60 days. In other words, considering this factor, the effect of the policy of bringing forward purchases before the price adjustment should be observed with more emphasis in 1Q24. Therefore, the fundamentals point to a slight improvement in volume in 1Q24. In 2Q24, we expect a slightly expansionary dynamic in the realized price of North America BD.

Even so, we are more skeptical about the metal spread. As we'll go into **more detail in the "Our Take" section** (page 9), we don't believe there's much room for Gerdau to make continuous price increases in the US. These announced adjustments seem to be linked to the cost of scrap, which came under more pressure in 4Q23, with a price correction to level out the spread. However, in the face of slowing demand, we see a tighter demand market for Gerdau in 2024, which will increase the difficulty of passing on prices to maintain the metal spread at this level, which is already well above the historical average. Our assessment is that the spread will tend to narrow between 2H24 and 1H25, with a gradual movement towards the historical average. We still expect it to be above average, but not at the level we see today.

Straight to the point...

Macro scenario reducing both volume and revenue in all units. We expect declining volume on a quarterly basis for all the company's operating divisions, especially for South America BD, from which we estimate shipments of 259Kt Genial Est. (-10.4% q/q; -10.6% y/y), resulting in net revenue of R$1.2bn Genial Est. (-22.3% q/q; -22% y/y). In the Brazilian operation, we project net revenue of R$6.0bn Genial Est. (-8.9% q/q; -12.1% y/y), with volume at 1.1Kt Genial Est. (-6.8% q/q; +2.1% y/y). For North America BD, our model points to net revenue of R$5.9bn Genial Est. (-6.5% q/q; -8.6% y/y), with sales clocking in at 870Kt Genial Est. (-7.7% q/q; -1.9% y/y).

Although we have always maintained the opinion that Gerdau seems less affected by the strong penetration of Chinese steel within apparent consumption, due to its greater exposure to long steel, even so, as the company went through a process of diversifying its product mix, it also ended up somehow having a percentage of its portfolio exposed to competitiveness with imported steel.

Sharp decline in EBITDA. We project the company's consolidated EBITDA at ~R$2.0bn Genial Est. (-39.9% q/q), a return noticeable in all of Gerdau's BDs, mainly due to the low revenue expected for the quarter and COGS/t rising mid-single digit q/q. Therefore, with lower revenue and higher COGS/t, we calculate margins regressing. For Brazil BD, the company's most relevant unit, we expect EBITDA to shrink to R$448mn Genial Est. (-48.4% q/q), thus reflecting a decline in margin to 7.41% (-5.7p.p q/q). Consequently, the consolidated bottom line should decrease, by our calculations, to R$920mn Genial Est. in 4Q23 (-42.2% q/q; -24.6% y/y).

4Q23 Preview: In detail!

Realized prices should still show a difficult situation. At the Brazil operating unit, we believe that the price will fall to R$5,147 Genial Est. (-2.3% q/q; -13.9% y/y), due to the delicate situation faced by the steel market. One of the main factors behind this scenario is the slowdown in the Chinese economy. Instead of Chinese mills adjusting the utilization rate of their blast furnaces to the reality of domestic demand, they continued to produce close to ~90% during almost the entire year, with some level of government incentives, at low margins (also pressured by the cost of metallurgical coal). The raw volume not consumed in China, mainly flat steel, was exported to other global economies, including Brazil.

As a result, Chinese steel arrived in Brazil at a very low-price level. In addition to the still anemic domestic demand, local steel mills found themselves in serious difficulties in 2023. This is because the domestic *players* are unable to compete with the price of the imported product and have therefore lost their bargaining power in renegotiating with the industry over the course of last year. Therefore, due to weak demand for consumer durables, the industry has switched to the cheaper steel offered by China, increasing the import penetration within apparent consumption to ~25% in December (the highest level in history data points).

As for North America BD, we expect the realized price in USD to be basically flat q/q, reaching US$1,374/t Genial Est. However, when we perform the USD/BRL conversion, we actually see estimates indicating an increase of +1.3% q/q to R$6,803/t Genial Est., due to the slight appreciation at the average exchange rate for 4Q23.

Volumes could fall even more significantly in Brazil and North America. For Brazil BD, in terms of volumes, the figures should show a quarter with tight conditions. The reason for this is the unfavorable macro scenario and weaker seasonality, through the lower sequence of appetite for steel consumption caused by the slowdown normally seen between 3Qs and 4Qs.

We project shipments of 939kt Genial Est. (-9.6% q/q; -2.4% y/y) in the domestic market (DM), while for the foreign market (FM), we expect sales to rise to 235kt Genial Est. (+6.6% q/q; +25.3% y/y). We believe that, in the opposite trend, Gerdau should make use of a greater redirection of sales to other markets in Latin America, as a result of the domestic market not being able to absorb volume. Therefore, by consolidating the two markets (DM + FM), we obtain a projection for Brazil BD of 1.1Kt Genial Est. (-6.8% q/q; +2.1% y/y).

North America BD should also be hit with a sequential drop in shipments, as it suffers from seasonality (weaker period than 3Q23) and high interest rates by US standards. We therefore estimate a sales volume of 870kt Genial Est. (-7.7% q/q; -1.9% y/y).

We project South America BD to be marked to market due to the situation in Argentina. South America BD is expected to suffer a considerable hit in volume, caused once again by the turbulent macroeconomic scenario, especially in Argentina. In addition to a reduction in demand, the Argentine operation will have to endure a strong mark-to-market effect.

We explain that the forced currency devaluation of ~50% that took place in 4Q23, in an attempt to bring the value closer together to the Blue-Chip Swap, reducing the spread practiced between the market and the official exchange rate, will have a significant impact on the mismatch between the pricing seen previously and the conversion of the figures into the AR$/BRL rate. As a result, we are likely to see a quarter with a sharp sequential reduction. In an attempt to reproduce this effect within our model for 4Q23, we estimate a realized price for South America BD clocking in at R$4,694/t Genial Est. (-13.2% q/q; -12.8% y/y).

Special Steel Unit: weaker US demand partially offset by Brazil improving dynamics. As for the Special Steels unit, we believe in opposite trends between the US and Brazil. The business division, which has operations in both countries, is essentially linked to the automotive segment. For the USA, we point out: **(i)** the American macro scenario is slowing down due to the effect of higher interest rate (FED rate of 5.25-5.50%). In addition to this factor, we see the **(ii)** weakened seasonality of the 4Qs, added to the **(iii)** strike by the United Auto Workers (UAW) as potential agents of a weakened result, especially in volume. Although the AUW strike came to an end in November, 4Q23 was more impacted than 3Q23.

However, in Brazil the 4Q23 trend should be improving. In the opposite direction to the US, Brazil's Central Bank made early moves in terms of contractionary policy. The SELIC rate went from 2% to 13.75% in a year and a half and remained at this level for 12 months. The monetary tightening cycle was severe (and necessary), elevating Brazil to the status of the country with the highest real interest rate in the world at that time. In August 2023, after almost 3 years of hawkish speeches on fighting inflation, COPOM redirected the cycle towards monetary easing, cutting the SELIC by -0.50p.p. From then on, there were 4 additional and consecutive cuts of equal magnitude, bringing the SELIC to 11.25% at the end of January.

Just as the FED started raising interest rates in December 2022 and we are only seeing the effect of the slowdown in the real US economy now, Brazil, which is going in the opposite direction and has already been cutting the SELIC rate since August 2023, also has a delay in feeling the good influence on the real economy. This delay is essentially linked to the greater appetite for the consumption of durable goods. In other words, the successive interest rate cuts, which have been underway for six months, have only recently begun to have an impact on the increase in demand for goods with a longer consumption cycle, such as cars and trucks, for example.

Added to this effect, we also see the reduction in taxes on light vehicles (IPI, PIS and COFINS), which took place on May 25th, 2023. The cut in the tax rate as a price-reducing effect on cars by 1.5% to 10.8% by the Brazilian authorities led to a progressive increase in demand for light vehicles, exceeding expectations. Even though the effect is medium, we saw progress in the figures released by ANFAVEA in December. On the heavy-duty side, the imposition of the Euro 6 standard kept demand at low standards in 2023. With inventory of Euro 5 vehicles dwindling in factories, companies renewing their fleets in 2024 will be forced to buy Euro 6 models, even if they are more expensive. In this case, the SELIC rate cuts will be essential to reactivate demand for trucks and buses.

To summarize, the message we want to convey is that the USA and Brazil are currently moving in opposite directions in terms of the automotive market. The US is slowing down, and Brazil is starting to consume again, mainly due to the positions related to the phase of the interest rate cycle and its respective delays within the real economy. We therefore project a shipment volume for the Special Steel division of 324kt Genial Est. (-6.1% q/q; -19.3% y/y), with a realized price of R$8,014/t (-0.1% q/q; -1.7% y/y). Despite the stabilization of the price in the sequential movement, we still believe that on the volume side, the slowdown in the US added to the UAW workers' strike will have more weight than the gradual improvement in the Brazilian market.

Projected revenue falls in all operating divisions. In line with the cooling down prices (in some cases) and sales volumes (in all cases), we see net revenue shrinking in all segments of the company, without exception. Consolidated revenue in our projections declines to R$15.5bn Genial Est. (-9.0% q/q; -26.5% y/y). South America BD, proportionally, shows the worst performance in the *top line*, reaching R$1.2bn (-22.3% q/q; -38.2% y/y), due to the mark-to-market effect of the assets in Argentina, but Brazil BD is the one that has the most weight to nominally pull consolidated revenue down, marking R$6bn Genia Est. (-8.9% q/q; -28.7% y/y).

Table 3. Net Revenue Gerdau (4Q23 Genial Est.)

(R$ millions)	4Q23E Genial Est.	3Q23 Reported	% q/q	4Q22 Reported	% y/y
Net Revenue	**15.536**	**17.063**	**-9,0%**	**17.964**	**-13,5%**
Brazil BD	6.046	6.635	-8,9%	6.877	-12,1%
North America BD	5.918	6.332	-6,5%	6.472	-8,6%
South America BD	1.217	1.566	-22,3%	1.561	-22,0%
Special Steel BD	2.598	2.771	-6,3%	3.274	-20,7%
Eliminations	(243)	(242)	0,6%	(219)	11,0%

Source: Gerdau, Genial Investimentos

Costs rising q/q. We believe that the cost per ton should worsen up in all of Gerdau's operating divisions. Even with our expectation of an improvement in the coke cost in 4Q23 in relation to the *delay* for the *spot* curve, the price of metallurgical coal has risen sharply and will probably cause COGS/t to be higher on a quarterly basis, especially at Brazil BD, which is more exposed to blast furnace production. We expect the cost for the unit to reach R$4,997/t (+5.2% q/q; -8.4% y/y).

For North America DB we are projecting a COGS/t of R$5,675/t (+6.6% q/q; -1.4% y/y). While on the one hand the price of metallurgical coal has risen, impacting our projections for Brazil BD, on the other hand the price of ferrous scrap has also risen over the quarter, which should put pressure on margins at North America BD, considering that it is more exposed to electric arc furnaces. According to our monitoring, the scrap market price in the USA reached US$505/t in the East (+12% q/q) and US$477/t in the Midwest (+7% q/q).

As for the special steel unit, we see a slightly more significant increase, reaching a COGS/t equivalent to R$7,517/t Genial Est. (+10.6% q/q; +5.7% y/y), with **(i)** greater idleness, **(ii)** higher scrap costs and **(iii)** less capacity to dilute fixed costs, due to the lower sales volume coming from the USA operations, as a result of the strike by the UAW union.

EBITDA in double-digit decline and margins in compression. We expect a consolidated Adjusted EBITDA of R$2.0bn Genial Est. (-39.9% q/q; -44.6% y/y), with a double-digit drop, implying a margin of 13.0% (-6.68p.p q/q; -7.26p.p y/y), in a strong compression. All the business units should bring in weaker figures, with Brazil BD at an EBITDA of R$448mn Genial Est. (-48.4% q/q; -40.8% y/y) and North America BD clocking in at R$1.1bn Genial Est. (-28.1% t/t; -38.7% y/y), also showing compression in their margins, to 7.4% and 18.9% respectively. The Special Steel division should also post a result well below potential, with R$282mn Genial Est. (-40.6% q/q; -46.3% y/y).

This is due to the following factors: **(i)** an increase in the projected cost per ton in all divisions and **(ii)** a contraction in revenues, caused by **(iii)** greater penetration of Chinese steel and a potential reduction in the volume of shipments in Brazil, as well as **(iv)** high interest rates in the US and **(v)** the UAW strike. All of these catalysts for a fragile result were discussed at length throughout the report.

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

(R$ millions)	4Q23E Genial Est.	3Q23 Reported	% q/q	4Q22 Reported	% y/y
Adjusted EBITDA	**2.012**	**3.349**	**-39,9%**	**3.630**	**-44,6%**
Brazil BD	448	868	-48,4%	757	-40,8%
North America BD	1.118	1.555	-28,1%	1.824	-38,7%
South America BD	182	502	-63,7%	354	-48,5%
Special Steel BD	282	475	-40,6%	525	-46,3%
Eliminations	(19)	(51)	-62,9%	170	-

Source: Gerdau, Genial Investimentos

Weakened net income. The impact of the projection for a weakened EBITDA on net income couldn't be different: we also expect a reduction. Despite a better financial result (-R$216mn in 4Q23 Genial Est. vs. -R$478mn in 3Q23) we still see, coming out of our model for 4Q23, a bottom line of R$920mn Genial Est. (-42.2% q/q; -24.6% y/y).

Table 5. Income Statement Gerdau (4Q23 Genial Est.)

(R$ millions)	4Q23E Genial Est.	3Q23 Reported	% q/q	4Q22 Reported	% y/y
Net Revenue	**15.536**	**17.063**	**-9,0%**	**17.964**	**-13,5%**
COGS	(13.960)	(14.271)	-2,2%	(15.036)	-7,2%
Adjusted EBITDA	**2.012**	**3.349**	**-39,9%**	**3.630**	**-44,6%**
EBITDA Margin (%)	13,0%	19,6%	-6,68p.p	20,2%	-7,26p.p
EBIT	**1.317**	**2.384**	**-44,8%**	**2.485**	**-47,0%**
EBIT Margin (%)	8,5%	14,0%	-5,49p.p	13,8%	-5,35p.p
D&A	(771)	(789)	-2,3%	(770)	0,1%
Financial Result	(216)	(478)	54,9%	(497)	-56,6%
Net Income	**920**	**1.592**	**-42,2%**	**1.219**	**-24,6%**
Net Margin (%)	5,9%	9,3%	-3,41p.p	6,8%	-0,87p.p

Source: Gerdau, Genial Investimentos

Our Take on Gerdau

Our assessment is that Brazil BD will continue to face, over the coming months, the effects of the abundance of steel of Chinese origin within apparent consumption, whose imports have been adjusted by the Instituto Aço Brasil (IABr) to 4.5Mt in 2023. This reflects a penetration rate of 25.2% in December 2023 (vs. 17.8% in December 2022) and 18.6% during the year (vs. 13.6% in 2022). The high accessibility of the Brazilian market continues to establish a scenario in which local steel mills face pressure, due to the low import tariff compared to other countries, such as the USA and Mexico, for example. Therefore, in order not to lose market share, Brazilian steelmakers spent 2023 offering price discounts, especially on flat steel. Although we have recently started to see the Brazilian authorities broadening their dialog with the sector, the movement is still far short of what is needed, as described below.

Reinstatement of the steel import tariff. Brazil's Foreign Trade Chamber (CAMEX) recently approved, on February 8th, the full restoration of the import tax rate on steel products, in order to inhibit the effect of the previous measure reducing tariffs (made in 2022 unilaterally by Brazil). According to our preliminary calculations, this will raise the average rate to 14% (vs. 12% previously), bringing it into line with the Mercosur bloc's Common External Tariff (TEC) levels before Brazil's unilateral reduction. Our view is that the news is positive, but it should not be confused with the request to increase the import tariff to 25%, still being sought by Aço Brasil since the measure announced is merely a re-establishment of the rates previously in force.

China: what are we seeing that the consensus isn't? Our view of China always seems to run counter to the consensus. When most investors expected a strong recovery after the end of Covid-zero, we adopted a much more skeptical tone, and we got it right. Now, after several banks and brokerages have revised China's growth downwards for the next few years, we have taken a slightly less pessimistic view.

Here it's important to enhance, it's not that we're bullish on China, we just think that the stabilization of China's growth vs. the end of the high single digit expansion cycle in GDP seen in the decade before the pandemic has already been priced in. Additionally, our studies indicate a 2024 with a slightly better performance of the industrial PMI in 2024 vs. 2023 and with a less pressured domestic steel consumption in China, due to the reduction in interest rates and the three points below.

The **(i)** potential improvement in tax collection and budget activity, together with the additional ¥1 trillion (~US$240bn) in special CGBs and local government debts in 1Q24, according to our analysis, could lead to a ~15% y/y expansion in tax revenues from 2Q24 onwards. The government's **(ii)** easing of the fiscal deficit limit to 3.8% of GDP (vs. 3% previously) will also provide more room to encourage the economy through stimulus.

In addition, a **(iii)** new social housing program policy is being drawn up. This, in turn, differs from the old stimulus (2015-2017) in the use of funds, the prohibition on distributing money (only the housing voucher option applies) and the use of property (preventing the subsequent sale of housing on the secondary market). Our take is that the program will not result in an abrupt income shock but will gradually help to reduce the vacancy of commercial properties and point to the beginning of a sustained growth in the construction and building of properties, especially those for low to mid income families. With our forecast of stimulating an increase of +8.5% q/y in real estate sales between 2024 and 2025, we believe that the program will be able to neutralize the -9% decline that occurred in 2023.

It's worth mentioning that the new policy may stabilize the sector, but we don't expect demand to match the expansion seen in previous decades. Therefore, now bringing the macro content to the micro, we started incorporating into our supply/demand model in December last year an annual steel production in China between 2024 and 2028 in the range of 950-990Mt, which is +4.5% compared to the pre-December estimate, but still a reduction of -2.5% compared to the 2020 record of ~1.1Bt. For 2024, we believe that steel production in China will be 990Mt (vs. ~1Bt in 2023).

Even with an estimated 1% y/y reduction in production in 2024, we believe that domestic steel consumption will improve and, therefore, there will be a slight reduction in Chinese steel exports to other global markets during 2H24. We elaborated on these points in an extensive report, published in December last year, which is attached (Metals & Mining: A deep dive into the Chinese government's upcoming stimulus).

Brazil: we maintain our bias that long steel is in a better spot than flat steel. Our analysis suggests that steelmakers have more urgency to readjust the price of flat steel, as the margins of this group of products compressed much more during 2023 than the rebar. However, as the parity gap premium for rebar is being marketed at significantly tighter levels than for flat steel, we believe that the possibility of passing on prices with more adherence for clients ends up being more viable for long steel. This is not such a bad move for Gerdau at all.

South America: asset divestment as a consequence of low profitability. In addition to the impact on Argentina that we have quoted throughout the report, a reduction in the size of operations in some other regions will be underway in the coming months. On February 1st, Gerdau announced the total sale of its stake (equivalent to 50%) in the JV Gerdau Metaldom Corp. (and subsidiaries) to the INICIA group, for US$325mn. The closing of this operation is expected to take place in 1Q24. The company is also looking to complete the sale of JV Diaco S.A. (this time a 49% stake held by Gerdau) by the end of 1H24. The operations involved in both sales are: Colombia, Dominican Republic, Panama and Costa Rica. Although they did not represent a significant EBITDA when compared to the consolidated figure, it still makes it clear that Gerdau is following the trend of withdrawing from part of South America, remaining only in Peru, Argentina, and Uruguay. The low profitability of these assets and the macro conditions of the different countries were the factors that motivated the sell-off.

USA: Higher interest rates for longer will reduce steel consumption. Currently, the steel market seems more restricted for Gerdau's North American division, considering that the industrial and infrastructure segments are reducing activities due to the high interest rates for US standards, maintained between 5.25% and 5.50% by the FED at the last FOMC meeting. Therefore, a slowdown in results is looming for 2024. As we commented at the beginning of this report, during the whole year the manufacturing PMI, measured by the ISM, remained below 50pt, flashing a gradual weakened demand for steel. Despite this, the services PMI has shown consistent expansion, with the most recent reading in January at 53pts, an increase of +3.1pts m/m, indicating that a technical recession is unlikely. However, the steel sector may face challenges due to rising interest rates, leading to a possible continued reduction in volumes during 2024 and problems maintaining high metal spread levels. This thesis about the gradual reduction of spreads has already been disseminated by us since the middle of last year, in our reports on Gerdau.

The FED has reinforced the idea that it will only make cuts when the reading of data impacting inflation shows that the rate will move smoothly towards the 2% target. However, the consensus opened the year forecasting interest rate cuts as early as 1H24. Some FED officials have said that the approach of cutting interest rates so quickly may be exaggerated. This optimism, while easing financial conditions, runs counter to the FED's objectives of fighting inflation.

In the alternative, if the consensus proves correct and the FED starts cutting interest rates, the long-term curve will narrow even further. However, **(i)** beneficial inflation data, **(ii)** a loosening dynamic of the labor market conditions and **(iii)** lower economic activity in the services sector must all materialize for the overly optimistic interest rate cut scenario to continue. Which doesn't seem to be happening. Recently, the PPI and CPI indicators were released, and both showed that the terms for cutting interest rates are still just not getting there yet.

Our forecast, since the end of last year, has been that cuts will only start to happen from June onwards. There was a marked probability of a cut in March by some economists, but that probability has already fallen short after the FOMC meeting at the end of January. So, the scenario once again seems to be converging on our take. And in this case, high interest rates for longer are not good news for Gerdau...

Squeezed on both sides. Our assumptions about Gerdau's performance in 2024 were updated according to three main factors: **(i)** volume and metal spread at North America BD, given the company's carryover to 1Q24 but with lower chances of further price increases throughout the year, **(ii)** the adverse parity premium conditions in domestic steel, particularly in flat steel, leading to a greater volume decline than previously anticipated at Brazil BD, and **(iii)** reduced volumes in the Special Steel division, due to greater pessimism regarding the performance of American automakers in 2024, but partially offset by potential growth in the Brazilian market (for both heavy and light vehicles).

With a **24E EV/EBITDA** of **4.1x**, we see Gerdau trading in line with its historical average, after the stock's voracious fall over the last 6M (~20%). We like the company's investment thesis, but we know that most investors who follow commodities have a short-term mentality. Our take is that all the assumption adjustments we made in our model to reflect a worse situation in both main divisions (Brazil BD and North America BD) are already incorporated into the share price today. Therefore, the **22% drop in EBITDA** projected by us **for 2024** (R$10.4bn 24E vs. R$13.5bn 23E) **seems to have already been priced in by the market**.

This means that the shares from now on shouldn't fall much more than they already have. However, we also **don't see any stronger bullish catalysts in the short term**, with the 4Q23 results potentially giving signs of what much of 2024 will be like: Gerdau will be squeezed on both sides (Brazil and the US). The changes we made to the assumptions resulted in a reduction in the **12M Target Price** to **R$24.50** (vs. R$26.00 previously), guaranteeing an **upside of 15.51%**.

Appendix: Gerdau

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

Income Statement	2023E	2024E	2025E	2026E	2027E	2028E
Net Revenue	**69.737**	**67.168**	**69.253**	**71.206**	**72.980**	**75.726**
(-) COGS	(58.461)	(59.561)	(59.437)	(60.785)	(62.004)	(62.934)
Gross Profit	**11.276**	**7.607**	**9.816**	**10.421**	**10.976**	**12.792**
(-) Expenses	(2.053)	(1.824)	(1.891)	(1.922)	(1.946)	(1.996)
Adjusted EBITDA	**13.482**	**10.462**	**12.264**	**13.317**	**13.927**	**15.935**
(-) D&A	(2.257)	(3.253)	(3.603)	(3.915)	(4.195)	(4.446)
EBIT	**10.881**	**6.459**	**8.613**	**9.208**	**9.754**	**11.547**
(+/-) Financial Result	(1.420)	(1.258)	(1.364)	(1.358)	(1.317)	(1.552)
(-) Taxes	(1.842)	(925)	(1.113)	(1.233)	(1.292)	(1.540)
Net income	**7.618**	**4.275**	**6.136**	**6.617**	**7.144**	**8.456**
Profitability						
Net margin (%)	10,92%	6,36%	8,86%	9,29%	9,79%	11,17%

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

Cash Flow (FCFF)	2023E	2024E	2025E	2026E	2027E	2028E
Net Revenue	**69.737**	**67.168**	**69.253**	**71.206**	**72.980**	**75.726**
(-) COGS	(58.461)	(59.561)	(59.437)	(60.785)	(62.004)	(62.934)
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EBIT	**10.881**	**6.459**	**8.613**	**9.208**	**9.754**	**11.547**
(-) Taxes	(1.842)	(925)	(1.113)	(1.233)	(1.292)	(1.540)
(+) D&A	2.257	3.253	3.603	3.915	4.195	4.446
(+/-) Δ WK	1.478	262	(294)	(408)	(413)	(290)
(-) Capex	(5.820)	(5.886)	(5.950)	(6.016)	(6.082)	(6.149)
FCFF	**6.953**	**3.162**	**4.859**	**5.466**	**6.161**	**8.014**

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