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GERDAU

1Q24 Review: Keeping up with US economic data has become key.

LatAm Metals & Mining

Main takeaways:

(i) Prices suffer from the macroeconomic context, although they are up q/q, Brazil BD with realized price growing +4.0% q/q; **(ii)** Shipments still impacted but growing sequentially. North America BD managed to achieve a rise of 8.1% q/q; **(iii)** Revenue grew considerably on a sequential basis, since the one-off effect from Argentina did not impact the quarter (+10.2% q/q); **(iv)** Higher COGS/t in Brazil BD, but encouraging bias in the long term with **a -R$1.5bn cost cutting package until 2025**; **(v)** EBITDA growing significantly, in line with Genial Est. **(vi)** Net income expanding strongly q/q due to JV operations one-off; **(vii)** Recapping our rating upgrade; **(viii)** Macro scenario still complicated for steelmakers; **(ix) Dividends** of **R$0.28/share** (-7% vs. Genial Est.). We expect a **24E Dividend Yield** of **~4.5%**; **(xii)** Although the benefits of the cost measures may take some time to materialize, we firmly believe in the **company's ability to execute**. Therefore, we have adjusted our recommendation to **BUY rating** since the earnings preview, with a **12M Target-Price** of **R$23.40**, representing an **upside** of **+25.60%**.

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Company

GGBR4 BZ Equity
Buy

Price: R$ 18.63 (29-Apr-2024)
Target Price 12M: R$ 23.40

Gerdau released its **1Q24 results yesterday**, May 2nd, after the market closed. The figures reported **were very close to those anticipated** in our results preview Consolidated revenue was R$16.3bn (-0.7% vs. Genial Est.), up +10.2% q/q and with a better-than-expected cost at Brazil BD (-2% vs. Genial Est.), despite being on the rise (+2% y/y). At North America BD, sales exceeded our expectations (+4.4% vs. Genial Est.), and costs were also marginally lower than expected. With good execution in the face of a challenging macro scenario, adjusted EBITDA was R$2.8bn (+4.2% vs. Genial Est.), consolidating a rise of +38% q/q and a fall of -35% y/y.

Table 1. Shipments Summary (1Q24 vs. Genial Est.)

(Thousand Tonnes - kt)	Reported	Genial Est.					
Summary (Shipments)	**1Q24**	**1Q24E**	**% R/E**	**4Q23**	**% q/q**	**1Q23**	**% y/y**
Brazil BD	1.300	1.322	**-1,7%**	1.268	**2,5%**	1.256	**3,5%**
North America BD	957	916	**4,4%**	885	**8,1%**	1.104	**-13,3%**
South America BD	227	222	**2,3%**	243	**-6,7%**	281	**-19,3%**
Special Steel BD	339	348	**-2,4%**	339	**0,1%**	355	**-4,6%**

Source: Gerdau, Genial Investimentos

Table 2. Income Statement Summary (1Q24 vs. Genial Est.)

(R$ millions)	Reported	Genial Est.					
Income Statement	**1Q24**	**1Q24E**	**% R/E**	**4Q23**	**% q/q**	**1Q23**	**% y/y**
Net Revenue	16.210	16.614	**-0,7%**	14.716	**10,2%**	18.873	**-14,1%**
Adjusted EBITDA	2.813	3.158	**4,2%**	2.039	**38,0%**	4.328	**-35,0%**
Net Income	2.053	1.633	**61,7%**	588	**249,2%**	2.964	**-30,7%**

Source: Gerdau, Genial Investimentos

At Brazil BD, after very apathetic figures in 4Q23 with a very difficult market due to the influx of Chinese steel, the company showed sequential recovery now in 1Q24, with a +4% q/q improvement in realized price (+1.9% vs. Genial Est.), which was carried by a higher value-added mix. In addition, we saw an assertive strategy to re-establish market share by boosting volume, which grew by +2.5% q/q and +3.5% y/y, although slightly lower than we expected (-1.7% vs. Genial Est.).

For North America BD, we highlight the greater degree of efficiency in COGS/t, falling -4.9% q/q (-2.9% vs. Genial Est.). On the other hand, the realized price showed sequential stability, compared to our expectation of a marginal increase. Even with a slightly lower price than we expected (-0.6% vs. Genial Est.), the company compensated in sales volume (+4.4% vs. Genial Est.), which grew by +8.1% q/q due to the exit from the seasonally weaker period. Resilience in the order book (~55 days) was ensured by non-residential construction and manufacturing activity, although sales ended up collapsing by -13.3% y/y, due to higher interest rates in the US compared to the same period last year.

Net income clocked in higher than expected at R$2bn (+249.2% q/q; -30.7% y/y), due to the processing of +R$808mn as a result of operations with subsidiaries, due to the profit on sale (+R$400mn) of the JVs' stake in the Dominican Republic and Colombia, in a purchase agreement by the company INICIA, in the amount of US$325mn (~R$1.6bn), in addition to a portion of the JVs' stake that was allocated to Shareholders' Equity and had an exchange rate effect (+R$407mn).

Valuation and rating. In the Brazilian steel market, current trading prices for hot-rolled coil (HRC) are showing a significant premium of +21.6% vs. imported steel, well above the usual average of ~12%. In contrast, rebar prices are more stable, with a premium of +4.5% vs. imported steel, indicating a possible effectiveness in price adjustments in the long steel segment.

Gerdau, despite having diversified its product portfolio towards a greater penetration of flat steel, is still mostly linked to long steel. According to market (and unofficial) information, we believe that, together with other steelmakers, the company initially proposed a price increase of +8% for long steel for the civil construction segment at the beginning of 2024. However, negotiations will probably result in a smaller increase, of around +4%, which should be finalized in 2Q24.

We highlight that coincidentally, already in 1Q24, the realized price of Brazil BD rose to R$4,950/t (+4.0% q/q; -10.2% y/y), above our expectation (+1.9% vs. Genial Est.) and making up exactly the same expected degree of increase for 2Q24, according to our market reading. As Gerdau does not exercise price commentary on its operations in Brazil, it is difficult to know whether there was already an impact of this pass-through in this quarter or whether it was just the **(i)** improved mix in the domestic market and **(ii)** less redirection of semi-finished products to the foreign market. We will follow the market data over the next few days to find out more precisely whether the transfers were anticipated in the negotiations between Gerdau and the construction sector. For the time being, we continue with **our base scenario that in 2Q24 Gerdau's price would rise again in Brazil BD**.

As for **North America BD**, although US interest rates remain high, with the FED rate kept in the range of 5.25% and 5.5% at the FOMC meeting that took place this Wednesday, there is still a notable increase of +80% y/y in industrial construction spending, driven by sectors such as semiconductors, food and beverages, chemicals and renewable energy. This robust investment trend, stimulated by reshoring initiatives and legislative incentives, has kept Gerdau's order backlog at ~60 days in recent quarters, with a slight drop to ~55 days in 1Q24.

However, it is unquestionable that rising interest rates have negatively impacted demand for durable goods, leading to a reduction in steel consumption in the US. The manufacturing PMI once again hovered around the 50pt mark, with February and March slightly above the expansion zone threshold. However, with the release just two days ago of the April data, clocking in at 49.2pts (-1.1pt m/m), we can see an indication of contraction compared to the more robust services sector PMI, which has been successively expanding with readings always close to ~52pts in recent months. It's worth emphasizing once again what we've said in other reports: "services are not a driver for steel consumption".

So, a significant portion of persistent US inflation is coming from the services sector and not from the demand for goods, and consequently, **steel consumption is lower than the 2021 and 2022 bases**. At this week's FOMC, the FED admitted that during the first few months of 2024 there was an interruption in the disinflation process, which had been underway since the end of last year, recognizing that the balance between achieving a low unemployment rate in the payroll and inflation at the 2% target has become more challenging.

We also saw in Wednesday's decision the FED choosing to slow down the reduction of its balance sheet in an attempt to avoid market disruptions and maintain demand for reserves. This seems to us to reflect the lessons learned in 2019, when a sharp drop in liquidity led to reinjections through repurchase agreements. In 2022, post-pandemic, the FED stopped quantitative easing (QE) before raising interest rates. However, we don't think that in 2024 the situation will be inversely proportional in the monetary easing cycle. Currently, despite the ongoing quantitative tightening (QT), we believe that rate cuts will begin in 4Q24.

In other words, in the 2021/22 cycle, the FED completely stopped quantitative easing (QE) before raising interest rates. In contrast, we believe that during this 2023/24 cycle, although there are signs that quantitative tightening (QT) will be reduced, it will probably coexist with the start of the interest rate cut. Therefore, our analysis suggests that the current approach balances **cautious reductions in the FED rate**, which **we expect only in December**, with continued tightening to manage still unanchored inflation expectations. However, it's important to mention that a portion of the market still believes in an interest rate cut in July (smaller portion) or September (consensus today).

Trading at an **EV/EBITDA 24E** of **4.2x** (vs. historical average of 5x), considering the cost cuts the company intends to make this year, we believe that the **company's austerity plan has not been priced in by the market**. We emphasize that the short term is still challenging, with 2024 being a year of tight margins and loss of traction in EBITDA. We are looking to 2025 margin gains, not the short term of 2024.

After we upgraded its rating in the preview report, Gerdau became the first steel company under our coverage to leave Neutral rating territory after ~7 months with all players within this bias, due to a macro decision we made at the time, which is now being reversed by a specific micro plan for the company. **We know that this call may take a while to work**, but we are convinced of the **company's ability to execute**. We therefore reiterate our **BUY rating**, with a **12M Target Price** of **R$23.40**, providing an upside of **+25.60%**.

Why has the US macro data become so important for Gerdau's call?

Commodity companies are extremely cyclical, and especially metals & mining companies have their cycles highly correlated with the macro environment. Additionally, we see the share of North America BD quarter after quarter gaining more relevance within Gerdau's consolidated EBITDA.

In 1Q24, North America's share of consolidated EBITDA rose to 54.3% (+0.8p.p vs. 4Q23). The second largest share is Brazil BD, which accounted for only 20.6% (-3.5p.p vs. 4Q23). This means that Gerdau is increasingly having more exposition to US economic scenario, and therefore the FED decision on interest rate is taking a upscaled movement to serve as trigger for share price appreciation. On the other hand, Brazil's macro prospects are losing relevance for the company. Today, **operations in the US already represent more than 2x the size of the Brazil BD**. Therefore, Brazil is no longer the main focus of our conversations regarding Gerdau's investment thesis and the US is taking this sweet spot.

When we spoke to investors after the publication of our preview report, **in which we raised Gerdau's recommendation to a BUY rating**, we noticed a great deal of concern in the market about the expectation of an interest rate cut in the USA. This means that the market is looking more closely at what happens in the US, and, at some point, this could represent a trigger for appetite in long positions on the stock. In other words, getting the timing right for the US interest rate cut seems decisive for us to witness an appreciation of Gerdau's shares.

We commented at the time that our call was now based on the cost reduction program (more on this in the "Our Take" section) and not on the macro. However, we also talked in the last report about the macro-outlook that influences steel consumption, both in the US and in Brazil. We strongly recommend reading this report to better understand that **we are bearish on the macro bias**, but even so, **we believe in the company's ability to execute on cutting costs** to improve margins. The report is attached (Gerdau 1Q24 Preview: Not to depend on the stroke of a pen).

Why did we raise the company's rating, and the shares fall on the same day?

We had the opportunity to talk to some investors after the report was published, but even so the stock didn't react, suffering a loss of ~2% on the day, with the Ibov sinking by a similar amount in the trading session, after only 12 companies in the index were among the risers. According to the FED directors, employment data is the key to the start of the interest rate cut cycle. On the day we published Gerdau's report, among other indicators, the release of the employment cost index by the US Department of Labor (DOL) dominated the trading session.

The market's reaction to the figure was terrible, as the index rose +1.2% in 1Q24 vs. 4Q23, with the result coming in above consensus (+0.9%). With rising wage pressure, the labor market remains very tight, and inflation is not letting down.

In this vein, investors priced in a very strong fear on Tuesday, before the FOMC, that not only could the interest rate cut cycle be pushed further ahead, but also that there would be an increase in interest rates rather than a reduction, since the labor market data could suggest the end of the inflation cooling process. Knowing that today Gerdau's operations in the US are sustaining the performance of the company as a whole, with operations in Brazil still anemic (mainly due to disputes with Chinese steel), investors, in our perception, didn't pay much attention to cost cutting, since the effect would only come in 2025 and they are very short term oriented.

Even so, they used the time of the meeting section we had to talk about: **(i)** the challenging macro environment, **(ii)** the postponed expectation of a US interest rate cut or potential rate increase, **(iii)** metal spreads, which may come down from the current level, since they are historically higher than normal, **(iv)** price pass-through in the US, which had apparently been ineffective in 1Q24. Among other negative contexts that we've covered in passages of the report. Therefore, they focused on the short-term dynamics for 2024, and avoid cost-cutting topic, living it aside.

Was the market spooked? During the press conference that followed Wednesday's FED statement, Chairman Jerome Powell indicated a dovish direction by ruling out the immediate likelihood of interest rate hikes, which is the great fear, and ended up keeping market expectations alive for the start of rate cuts as early as September (although we believe it will be in December). Powell also noted the challenges of making accurate economic forecasts, stressing his commitment to a data-dependent approach, assessing economic conditions at each meeting to guide future rate decisions.

GGBR4 1Q24 Review: In detail!

Brazil BD: Prices advance t/t, due to improved mix. For the Brazilian operations, we saw a realized price of R$4,950/t (+1.9% vs. Genial Est.), up +4.0% q/q, and coming in above our estimates, despite the -10.2% y/y drop. This increase is due to the improvement in the mix, focusing more on the domestic market and, consequently, exerting greater added value on finished products, in line with what we said in the results preview. However, the value remains weak due to the ongoing competition in the domestic market with Chinese products.

Brazil BD: Price realized above our expectations may raise suspicions of pass-throughs. As we mentioned in the preview report, we had access to market and unofficial information that Gerdau and other steelmakers tried to pass on prices for long steel to construction companies and developers, but there were only discussions for the February and March efforts in smaller proportions than initially requested. According to the information we have gathered, the proposed adjustment would have been +8% vs. the feasible +4%. By coincidence, price realization at Brazil BD ended up rising in 1Q24 exactly +4% q/q. However, we still believe that the real effect of the price increase will only be seen in 2Q24, since we still attribute this sequential acceleration in 1Q24 to the improved mix.

Brazil BD: Market share resumption helps volume gain q/q. Gerdau has the advantage of still being more exposed to long steel than its peers, but it also suffers from the rigid macroeconomics of flat steel, since it has increased the degree of diversification of its mix in recent years. Therefore, as the company planned to expand ON Brazil's market share, we see shipment volumes at 1,300Kt (-1.7% vs. Genial Est.), growing +2.5% q/q and +3.5% y/y, even exceeding the annual base due to good sales execution.

Brazil BD: Focus on added value, q/q drop in sales in foreign markets. As we said in our preview report, the focus in 1Q24 was on creating a better product mix. As the products shipped to the foreign market (FM) are generally semi-finished, consolidating a lower added value, Gerdau allocated more sales to the domestic market (DM), where the products go through rolling, cutting and bending until they are ready and consolidate a higher value. DM stood at 1,044Kt (-1.3% vs. Genial Est.), an increase of +8.3% q/q and a drop of -4.0% y/y. FM was reported at 255Kt (-3.4% vs. Genial Est.), down -14.4% q/q and up +34.2% y/y.

North America BD: Price stability disappoints. With stability of +0.1% q/q and a fall of -5.0% y/y, the unit reported a realized price of R$6,704/t (-0.6% vs. Genial Est.). We had expected a slightly higher sequential increase due to the two price increases made, **(i)** for rebar (+US$50/t) and merchant bars (+US$65/t) and **(ii)** for beams (+US$50/t). However, we had stated in our earnings call that after talks with Gerdau in recent days, the price increases in 1Q24 did not seem to have been effective, which would have led the company, together with the downturn in scrap prices, to promote discounts during 2Q24.

North America BD: Sales with more appetite than expected. Following the trend we predicted, but of greater intensity, North America BD managed to achieve an increase in sales on a sequential basis, reaching +8.1% q/q despite the slowdown of -13.3% y/y. The exit from the weaker seasonal period helped the sequential movement, with shipments marking 957Kt (+4.4% vs. Genial Est.). However, the US interest rate is higher today compared to the same period last year, resulting in less consumption of durable goods and tighter steel demand y/y.

South America BD: Sequential comparison is invalid, year-on-year the price falls. As for South America BD, the realized price was R$5,247/t (-2.5% vs. Genial Est.). Although we believe this to be invalid, as an example, if we compare it to last quarter's price, still considering the one-off effects of 4Q23, we see an advance of +291% q/q. However, if we compare the reported price to the realized price of the operation, excluding the effects of hyperinflation and exchange rate variations, we see a decline of -19.6% q/q and -8.8% y/y.

South America BD: Argentina slowing demand and JV sales. We see the high interest rate in Argentina generating a tighter demand environment, which helped make up the -6.7% t/t and -19.3% y/y reduction in the division's volume, which was reported at 227Kt (+2.3% vs. Genial Est.). We should see an increase in Argentina's weight within the unit (currently at ~30% according to our estimates), as the JV operations in Colombia and the Dominican Republic will leave the portfolio in 2Q24. Yesterday we followed the Argentine Central Bank's decision to cut the LELIC benchmark interest rate to 50% (vs. 60% previously), indicating that a possible slowdown in the economy is underway.

Special Steels: Brazil and the US are heading in different directions, as we anticipated. We assess a marginal price increase, reaching +1.0 % q/q, with a fall of -7.3% y/y, to be reported at R$7,693/t (+0.1% vs. Genial Est.). The reason for the stability is related to demand still not having much capacity to absorb prices, even with the end of the United Auto Workers (UAW) strike, which should help the recovery. FED didn't change interest rates, negatively influencing demand in the US. In Brazil, on the other hand, with the recent cuts in the SELIC rate, we can already see a more positive stance. However, the pressure from Chinese steel is still causing local steelmakers to offer discounts to automakers. The sales volume presented was 339Kt (-2.4% vs. Genial Est.), stable in the sequential comparison at +0.1% q/q, with a drop of -4.6% y/y.

Consolidated revenue grows +10% q/q. The company reported consolidated revenue of R$16.2bn (-0.7% vs. Genial Est.), up +10.2% q/q and down -14.1% y/y, mainly due to the increase in net revenue from South America BD, which was reported at R$1.2bn (+265% q/q; -26.3% y/y). Excluding the effect of hyperinflation in Argentina and currency devaluation, we also saw a marginal rise of +0.5% q/q (-0.3% vs. Genial Est.). Brazil's BD net revenue stood at R$6.4bn (+0.2% vs. Genial Est.), up +6.6% q/q, due to the improved mix and recovery of market share, but down -7.1% y/y, due to the challenge faced by steelmakers in competing with Chinese steel. As for North America, we saw a sequential increase of +8.3% q/q, mainly driven by the higher level of volume, despite a drop of -17.7% y/y, with a lower price and smaller market, reporting net revenue of R$6.4bn (+3.8% vs. Genial Est).

Table 3. Net Revenue Gerdau (1Q24 vs. Genial Est.)

(R$ millions)	1Q24 Reported	1Q24E Genial Est.	% q/q	4Q23 Reported	% q/q	1Q23 Reported	% y/y
Net Revenue	**16.210**	**16.317**	**-0,7%**	**14.716**	**10,2%**	**18.873**	**-14,1%**
Brazil BD	6.435	6.422	0,2%	6.034	6,6%	6.925	-7,1%
North America BD	6.416	6.182	3,8%	5.927	8,3%	7.793	-17,7%
South America BD	1.191	1.194	-0,3%	326	265,2%	1.617	-26,3%
Special Steel BD	2.608	2.672	-2,4%	2.580	1,1%	2.948	-11,5%
Eliminations	(440)	(153)	187,1%	(152)	190,1%	(411)	7,1%

Source: Gerdau, Genial Investimentos

COGS/t with better-than-expected dynamics. Brazil's COGS/t was presented at R$4,605/t (-2% vs. Genial Est.), up +2.0% q/q and down -4.1% y/y, the main reason for the sequential rise being pressure from the cost of metallurgical coal, although the effect was smaller than anticipated. North America's COGS/t fell -4.9% q/q and -0.2% y/y to R$5,284/t (-2.9% vs. Genial Est.), also lower than expected. The reason for the drop was the dilution of costs through increased volume and lower scrap costs. Consolidated nominal COGS was R$13.8bn (-3.5% vs. Genial Est.), an increase of +5.4% q/q, down -9.5% y/y.

EBITDA with strong sequential expansion. In line with our forecast, the company's consolidated EBITDA saw a significant decompression to R$2.8bn (+4.2% vs. Genial Est.), growing +38% q/q, driven by the start of the process of regaining market share in Brazil, with improved mix and lower costs in North America, as well as the absence of mark-to-market in ON South America.

However, it was hit hard on a year-on-year basis, slowing -35% y/y due to the weaker pricing environment and smaller addressable markets in Brazil, the US and Argentina. Brazil BD recorded EBITDA of R$595mn (+32.4% vs. Genial Est.), above our expectations, growing +16.3% q/q and down -44.1% y/y. North America BD reached R$1.6bn (+7.2% vs. Genial Est.), with an acceleration of +38.3% q/q and a drop of -33.3% y/y.

Table 4. EBITDA Gerdau (1Q24 vs. Genial Est.)

(R$ millions)	1Q24 Reported	1Q24E Genial Est.	% q/q	4Q23 Reported	% q/q	1Q23 Reported	% y/y
Adjusted EBITDA	**2.813**	**2.699**	**4,2%**	**2.039**	**38,0%**	**4.328**	**-35,0%**
Brazil BD	595	449	32,4%	512	16,3%	1.064	-44,1%
North America BD	1.570	1.465	7,2%	1.135	38,3%	2.355	-33,3%
South America BD	286	286	0,2%	135	111,4%	489	-41,5%
Special Steel BD	439	431	1,9%	340	29,3%	497	-11,7%
Eliminations	(77)	69	-211,6%	(83)	-7,5%	-77	0,0%

Source: Gerdau, Genial Investimentos

Sale of JVs has a one-off effect on the bottom line. In 1Q24, some factors arose from the sale of the Colombian and Dominican Republic assets in South America BD to the INICIA group, which also jointly operated the Diaco S.A. and Metaldom Corp JVs, of which Gerdau owned 49% and 50%, respectively. Among them, **(i)** a R$400mn premium on book value + **(ii)** an amount of R$408mn as a result of cumulative foreign currency translation adjustments. Both one-off effects amounted to +R$808mn, which went through the P&L, below the EBITDA line.

Net income well above expectations, but due to the sale of JVs. Gerdau reported a net income of R$2bn (+249% q/q; -30.7% y/y), excluding the non-recurring effect of the gains from the sale of the Joint-Ventures, the "adjusted" net income was in line with our expectation, at R$1.2bn (-2.0% vs. Genial Est.), which would still have been a growth of more than +100% q/q.

Table 5. Income Statement Gerdau (1Q24 vs. Genial Est.)

(R$ millions)	1Q24 Reported	1Q24E Genial Est.	% q/q	4Q23 Reported	% q/q	1Q23 Reported	% y/y
Net Revenue	**16.210**	**16.317**	**-0,7%**	**14.716**	**10,2%**	**18.873**	**-14,1%**
COGS	(13.791)	(14.288)	-3,5%	(13.083)	5,4%	(15.243)	-9,5%
Adjusted EBITDA	**2.813**	**2.699**	**4,2%**	**2.039**	**38,0%**	**4.328**	**-35,0%**
EBITDA Margin (%)	17,4%	16,5%	0,81p.p	13,9%	3,5p.p	22,9%	-5,58p.p
EBIT	**2.752**	**1.768**	**55,7%**	**891**	**208,7%**	**4.294**	**-35,9%**
EBIT Margin (%)	17,0%	10,8%	6,14p.p	6,1%	10,92p.p	22,8%	-5,77p.p
D&A	(726)	(801)	-9,3%	(791)	-8,2%	(715)	1,5%
Financial Result	(476)	(177)	168,3%	(155)	207,1%	(303)	57,1%
Net Income	**2.053**	**1.270**	**61,7%**	**588**	**249,2%**	**2.964**	**-30,7%**
Net Margin (%)	12,7%	7,8%	4,88p.p	4,0%	8,67p.p	15,7%	-3,04p.p

Source: Gerdau, Genial Investimentos

Our Take on Gerdau

Macro scenario involving China continues to squeeze the steel market. We have already mentioned the penetration of Chinese steel in Brazil several times in this and other reports, but this is the main key factor for Brazilian steel players at the moment. China continues to feed its blast furnaces, which today have a utilization rate of 85.53% (+3p.p m/m). The increase indicates that, quite possibly, we will continue to see the flow of crude steel to other economies, after the resumption of activities with the end of the Lunar New Year holiday.

On the other hand, we saw the Caixin PMI released a few days ago at 51.4pts, supposedly reflecting expanding industrial activity in China, which would raise hopes that domestic consumption may strengthen again. However, it's worth mentioning that Caixin's latest readings have come in above the official one measured by the NBS, and also the services PMI indications have always exceeded the manufacturing one over the last 12M.

This is in line with our thesis on the Chinese economy, which shows a migration of activity towards an increase in the consumption of services with a lower weight in industrial GDP. We elaborate on this in our sector report for the quarter, through a comprehensive study of the Chinese economy. We strongly recommend that you read it (Metals & Mining: Has China's economic model completely run out of steam?).

Company burns cash flow in 1Q24. With a similar event with Usiminas also in 1Q24, we recently reported in our coverage that EBITDA should not be seen as a good proxy for cash flow, since this statement is a fallacy and can mislead analysts and investors. Is common in Gerdau's balance sheet a greater pressure on working capital in Q1s, due to the exit from a seasonally less favorable period to an improvement in volumes, with receivables and inventories both stretching, while suppliers remain under more pressure, shortening the financial cycle and increasing the need for working capital. However, the need was well above our estimate, coming in at R$1bn (+62% vs. Genial Est.). In other components such as CAPEX, the company came in line with what we expected, reporting an expense of R$1bn (+1.5% vs. Genial Est.). Total cash flow burn (FCFE) was -R$610mn. If we exclude the JVs' proportional EBITDA, intangibles/leasing and other variations, FCFE would have been -R$38mn (vs. +R$90m Genial Est.).

Dividends slightly lower than expected. Gerdau's Board of Directors approved the payment of R$589mn in dividends to shareholders as of May 27, which would represent **R$0.28/share** (-7.0% vs. Genial Est.), forming a quarterly dividend yield of 1.5%. We expect a **24E dividend yield** of **~4.5%**, as we have already commented over the last few company reports, given that Gerdau has an aggressive CAPEX plan in the short term.

Recapping our rating upgrade. Despite the challenging scenario in the short term, we have opted to raise our recommendation to **BUY rating**. The decision is supported by Gerdau's effective management in the face of macroeconomic adversity, evidenced by a **robust cost-cutting plan**. This plan, which includes significant reductions in fixed expenses, has the potential to boost financial performance in the medium term.

When we updated assumptions in our model with this cost-cutting package, we saw a considerable difference in the company's result, with a **substantial margin improvement at Brazil BD**, where most of the cost cutting is expected to take place. Our model indicates, for Brazil BD, a 24E EBITDA of R$2.5bn (-25% vs. 2023), which would jump to a **25E EBITDA of R$6bn** (1.4x higher vs. 24E), with a **very strong margin expansion to ~22%** (+12p.p vs. 24E), a level close to that of Brazil BD was performing during the best years of operating profitability ever recorded by Gerdau (2021 and 2022).

Keeping up with US economic data has become key. Gerdau is the first steel company under our coverage to exit Neutral rating territory after ~7 months with all players within this bias, due to a macro decision we made at the time, which is now being reversed by a company-specific micro plan. **We are excited about the return of margins due to cost cutting for 2025**, especially at Brazil BD. But what seems to be **supporting the results in the short term are the US operations**, which although they have shown price dynamics that are below what we wanted in 1Q24, the company has compensated in sales.

We have felt an increase in investor interest in understanding the specific dynamics of the US steel market for Gerdau's call, since **Brazil BD is only losing ground in EBITDA (~20%**), and **North America BD already has more than 54% penetration on the consolidated result**. Although the benefits of these measures may take some time to materialize, we firmly believe in the company's ability to execute. We have therefore adjusted our recommendation to **BUY rating** in the preview report, with a **12M Target-Price** of **R$23.40**, representing an **upside** potential of **+25.60%**.

Appendix: Gerdau

Figure 1. Gerdau – Income Statement in R$ Millions (Genial Est. 2024-2028)

Income Statement	2024E	2025E	2026E	2027E	2028E
Net Revenue	**65.957**	**66.628**	**67.907**	**69.433**	**71.736**
(-) COGS	(56.697)	(55.257)	(54.833)	(55.976)	(56.782)
Gross Profit	**9.261**	**11.371**	**13.074**	**13.458**	**14.954**
(-) Expenses	(1.875)	(1.777)	(1.802)	(1.823)	(1.871)
Adjusted EBITDA	**10.615**	**14.122**	**15.989**	**16.449**	**18.253**
(-) D&A	(3.230)	(3.569)	(3.900)	(4.197)	(4.464)
EBIT	**7.714**	**10.258**	**11.947**	**12.323**	**13.795**
(+/-) Financial Result	(1.041)	(1.067)	(880)	(711)	(780)
(-) Taxes	(1.127)	(1.807)	(2.153)	(2.218)	(2.510)
Net income	**5.545**	**7.384**	**8.914**	**9.394**	**10.505**
Profitability					
Net margin (%)	8,41%	11,08%	13,13%	13,53%	14,64%

Figure 2. Gerdau– Cash Flow in R$ Millions (Genial Est. 2024-2028)

Cash Flow (FCFF)	2024E	2025E	2026E	2027E	2028E
Net Revenue	**65.957**	**66.628**	**67.907**	**69.433**	**71.736**
(-) COGS	(56.697)	(55.257)	(54.833)	(55.976)	(56.782)
Adjusted EBITDA	**10.615**	**14.122**	**15.989**	**16.449**	**18.253**
EBIT	**7.714**	**10.258**	**11.947**	**12.323**	**13.795**
(-) Taxes	(1.127)	(1.807)	(2.153)	(2.218)	(2.510)
(+) D&A	3.230	3.569	3.900	4.197	4.464
(+/-) Δ WK	(822)	220	(430)	(474)	(212)
(-) Capex	(5.998)	(6.063)	(6.130)	(6.198)	(6.267)
FCFF	**2.997**	**6.177**	**7.135**	**7.631**	**9.270**

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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%**
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under Review	Under review	**5%**

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