genial Equity Research

USIMINAS

2Q24 Preview: The days of struggle continue

LatAm Metals & Mining

Main takeaways:

(i) Consolidated **steel volume up slightly**, driven by the automotive segment; **(ii)** The end of phase 3 of the Néstor Kirchner project (gas pipeline in Argentina) should cause the price in the foreign market to fall down, due to a worsening mix; **(iii)** For the domestic market, the **realized price** is projected to compose in a **mild decline**, due to the **12% discount** for 70% of the clients base in the **automotive segment**, which **will be partially offset by the improved mix**; **(iv)** For mining, MUSA's mix will probably be less loaded with low grade, which will lead to better prices on a sequential basis; **(v)** We expect net revenue to be practically flat q/q; **(vi)** COGS/t with a slight increase of +1.7% q/q in our estimates; **(vii)** EBITDA to shrink by mid double digits on a quarterly and annual basis; **(viii)** Net income projected to be anemic, contracting sequentially and annually; **(ix)** We expect an **improvement in efficiency only in 3Q24**, with a reduction in COGS/t due to the **falling cost of slabs expected for the next quarter**, in line with the increase in volume due to the typical seasonality of the 3Qs, helping to **dilute fixed costs**; **(xi) HRC production**, benchmark for flat steel, **hits a record in China** and supports the thesis aimed at exporting goods. In this sense, **China should continue to export embedded and crude steel to other global markets**. As Usiminas is the company with the greatest exposure to the flat steel market, we prefer to remain cautious on the name; **(xii)** Trading an **EV/EBITDA 25E** of **3x** and going through a challenging macroeconomic context, we reiterate our **NEUTRAL rating**, with a **12M Target Price** of **R$8.70** and an **upside** of **+1.99%**.

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Company

USIM5 BZ Equity
Neutral

Price: R$ 8.53 (19-Jul-2024)
Target Price 12M: R$ 8.70

Usiminas will report its **2Q24 results on July 26**, before the market opens. We expect **weak consolidated figures** once again.

Table 1. Shipments Summary (2Q24 Genial Est.)

(Thousand Tonnes - kt)	Genial Est.	Reported			
Summary (Shipments)	**2Q24E**	**1Q24**	**% q/q**	**2Q23**	**% y/y**
Steel	1.040	1.028	**1,2%**	971	**7,1%**
Iron Ore	1.963	1.962	**0,1%**	2.398	**-18,1%**

Source: Usiminas, Genial Investimentos

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

(R$ millions)	Genial Est.	Reported			
Income Statement	**2Q24E**	**1Q24**	**% q/q**	**2Q23**	**% y/y**
Net Revenue	6.281	6.223	**0,9%**	6.887	**-8,8%**
Adjusted EBITDA	271	416	**-34,9%**	366	**-26,1%**
Net Income	23	60	**-61,2%**	287	**-91,9%**

Source: Usiminas, Genial Investimentos

Despite weak figures expected for consolidated 2Q24, we believe a **slight sequential improvement in the mining segment is likely**, with a partial recovery in prices. On the other hand, this segment is not representative enough to generate a significant change in the consolidated result, since **we don't expect significant improvements in the steel segment** (which is much more representative). On a consolidated basis, we believe in a **reduction in EBITDA and net income**, both y/y and q/q.

Valuation and rating. We believe that costs efficiency gains with the refurbishment of Blast Furnace 3 (BF3) will not be reflected in 2Q24. As BF3 goes through ramp-up (which should last until 3Q24), the cost should cool down. However, this improvement in efficiency will be inhibited by **(i)** a higher quality sales mix, which is therefore more costly to produce, and **(ii)** the processing of more expensive slabs through the P&L. Even though slabs consumption has already been regularized by the return to operation of BF3, the company still has slabs inventory purchased at a more representative value than current market standards.

For these reasons, **we expect COGS/t to rise by +1.7% q/q and still be far from the parameters set by the consensus on cost reduction**. It's important to remember that we have always taken a more conservative approach to the optimism surrounding Usiminas' name. At the beginning of the year, when the shares were accumulating a +15% rise by mid-April, just before the 1Q24 results, several other sell side firms were raising their ratings to "Buy". On the other hand, **we remain skeptical about anemic demand in a market tightened by competition with Chinese steel**. In addition to these factors, in our view, there was a certain **exaggerated tone in the assumptions that the consensus was using regarding efficiency gains at COGS/t** (resulting from the reform in BF3).

When, in its 1Q24 earnings release on April 23rd, Usiminas signaled a lateralization in COGS/t for 2Q24, as opposed to the drastic cost reduction that the consensus was projecting, investors became frustrated and created considerable selling pressure on the shares, causing them to fall by ~13% in a single trading session. Since then, **the share price has converged towards our Target Price** (which has remained static since the beginning of the year). We tried to warn the market about this back in February, when we wrote in the 4Q23 preview that the shares would probably give back some of the gains they had been making until then. This can be confirmed in the attached publication (Usiminas Preview 4Q23). Once again, **we anticipate movement ahead of consensus**.

It's also worth noting that we still won't see the effects of the new steel import quotas in 2Q24, implemented by the Ministry of Trade (MDIC) since they started in June, which would only represent 1/3 of the result of quarter, and even so the figures for the parity premium for flat steel in the domestic market didn't indicate a consistent improvement in the gap vs. imports (which remains at ~18%). The Chinese export bias still seems to be bothering the mills, creating difficulties for the Brazilian steel industry. After falling in April, without showing a consistent recovery, **Usiminas' shares seem to us to be fairly priced at the current market valuation**. Trading at an **EV/EBITDA 25E** of **3x** and **going through a challenging macroeconomic context**, we reiterate our **NEUTRAL rating**, with a **12M Target Price** of **R$8.70** and an **upside** of **just +1.99%**.

2Q24 Preview: In detail!

DM follows gradual increase in volume, but with a price discount. We are projecting shipments to the domestic market (DM) at 933kt Genial Est. (+1.6% q/q; +3.4% y/y). According to our analysis, the domestic market should show a gradual improvement in demand from the automotive segment, which accounts for ~1/3 of the company's sales. We highlight two reasons for the increase in demand for light vehicles: **(i)** the cuts in the SELIC rate observed during 1H24; **(ii**) the MP (Brazilian legislation) to make cars cheaper, which came into force in May 2023 and made it possible to reduce taxes (IPI, PIS and COFINS). On the other hand, we expect the 12% discount granted to the automotive segment for ~70% of the client's base to have the opposite effect, even with an improved mix. We therefore estimate the price at R$5,559/t Genial Est. (-0.9% q/q; -8.5% y/y).

As for heavy-duty vehicles, demand in 2023 remained significantly low due to the implementation of the Euro 6 standard, after the market anticipated a higher volume of purchases of Euro 5 vehicles. As automakers' Euro 5 inventory are currently running low, companies that choose to renew their fleets in 2024 will have no choice but to purchase new Euro 6 vehicles, even at a higher cost. ANFAVEA data therefore suggests a double-digit recovery in heavy-duty sales in 2024.

The end of the Néstor Kirchner project should bring down the price of FM. It's important to remember that there were still remnants of deliveries in 1Q24 linked to the third phase of the Néstor Kirchner project (gas pipeline in Argentina).Conversely, with 2Q24 no longer having this destination with a higher value-added mix for the oil & gas sector, we should see a slight reduction in shipments to foreign market (FM) and, above all, a drop in the realized price, given a worsening mix. We are therefore estimating shipments to FM at 121kt Genial Est. (-1.8% q/q; +74% y/y) and a realized price of R$4,989/t Genial Est. (-2.1% q/q; -29.4% y/y).

Total shipments up slightly, driven by the automotive segment. We are estimating a marginal sequential increase for total shipments (DM+FM), reaching 1,040kt Genial Est. (+1.2% q/q; +7.1% y/y). The improvement, even if slight, will probably be due to the performance of the automotive segment, in the face of a gradual recovery in this sector, which accounts for ~1/3 of Usiminas' total sales portfolio.

Consolidated realized prices will probably be impacted in DM and the mix in FM will worsen. The data still shows a high penetration of Chinese flat steel, increasing competition with domestic mills, even if the automotive segment is expanding its demand vs. 2023 (it is worth remembering that 2023 was very weak base). According to the Aço Brasil (IABr), a penetration rate of 16% of apparent consumption was recorded in June. In the Jan-Jun period, the rate was 18.5%. Among the measures announced by the Brazilian Ministry of Trade (MDIC) in an attempt to alleviate this problem are tariff increases via the complementary quota system, which came into force in June. However, more concrete effects on the realized price are expected from 3Q24 onwards, and even then, they should be mild, so we are not expecting a large cool down in penetration vs. current levels. Therefore, for 2Q24, we estimate a consolidated realized price (DM+FM) of R$5,568/t Genial Est. (-1.0% q/q; -9.5% y/y).

Table 3. Net Revenue Usiminas (2Q24 Genial Est.)

(R$ millions)	2Q24E Genial Est.	1Q24 Reported	% q/q	2Q23 Reported	% y/y
Net Revenue	**6.281**	**6.223**	**0,9%**	**4.787**	**31,2%**
Steel	5.792	5.784	0,1%	5.976	-3,1%
Mining	702	649	8,0%	905	-22,5%
Eliminations	(213)	(211)	0,9%	(2.093)	-89,8%

Source: Usiminas, Genial Investimentos

MUSA: Looking back at last quarter to understand what will happen in 2Q24. To put it in context, last quarter was challenging for the mining division (MUSA), especially in terms of price realization. In 1Q24 we saw a greater composition of low grade in the mix, as well as price marking in the forward provisioned system, negatively impacted by the sharp drop in the 62% Fe reference curve, which reached ~US$97/t at the start of 2Q24 (first days of April). In addition, MUSA's eastern treatment unit was shut down due to the exhaustion of the mining front that fed the division. However, the retention of volume due to the shutdown didn't have such an impact on shipments, which would naturally be weaker due to the typical seasonality of Q1s, since the company managed to ship more low-grade volume to China, due to a demand that doesn't usually recur in the first months of the year.

MUSA: Improved mix in 2Q24 will lead to an increase in price realization. In this 2Q24, we shouldn't see any representative changes in shipments, since the company improved its mix and thus sold less low-grade iron ore, a fact that occurred in excess in 1Q24, as explained in the section above. Therefore, even if there is naturally a sequential improvement in production in 2Q24, due to entering a period with less rainfall vs. 1Qs, the quality improvement in the mix reducing demand will still offset the gain we would potentially see in shipments due to the change in seasonality. On the other hand, the **(i)** improvement in the mix will lead to an increase in the realized price, which should also include **(ii)** a lower impact from the forward provisioning system. We believe that these two factors will be more than enough to compensate for the average 62% Fe curve having slowed down compared to 1Q24. We therefore estimate volumes at 1,963kt Genial Est. (+0.1% q/q; -18.1% y/y) and a realized price of US$69/t Genial Est. (+2.6% q/q; -10.2% y/y). Given the appreciation of the USD/BRL exchange rate, we expect prices in BRL to stand at R$357/t Genial Est. (+8.0% q/q; -5.3% y/y).

Consolidated net revenue basically flat q/q. We are projecting consolidated net revenue of R$6.3bn Genial Est. (+0.9% q/q; +31.2% y/y), practically flat vs. 1Q24. Although our projection for the mining division shows sequential growth to R$702mn Genial Est. (+8.0% q/q; -22.5% y/y), MUSA's representativeness is quite small within the consolidated result. As for the Steel division, due to the price drop through the discount for the client's portfolio in the automotive segment being partially offset by the improvement in the sales mix, we expect revenues of R$5.8bn Genial Est. (+0.1% q/q; -3.1% y/y), indicating sequential stability as well.

Steel COGS/t projected with a slight increase. Our analysis suggests that there will be a slight rise in COGS/t for the steel division. This is because, in addition to the **(i)** higher quality mix, and therefore more expensive to produce, there is also the effect of **(ii)** slabs acquired at higher prices going through the P&L. We are therefore estimating a COGS/t of R$5,416/t (+1.7% q/q; -5.3% y/y). As for the mining division (MUSA), we expect a drop in COGS/t to R$270/t Genial Est. (-1.0% q/q; -5.5% y/y), driven by lower freight costs vs. 1Q24. As for the consolidated nominal cost, we are expecting something close to -R$6bn Genial Est. (+2.5% q/q; -5.8% y/y).

Table 4. COGS Usiminas (2Q24 Genial Est.)

(R$ millions)	2Q24E Genial Est.	1Q24 Reported	% q/q	2Q23 Reported	% y/y
COGS	**(5.970)**	**(5.824)**	**2,5%**	**(6.336)**	**-5,8%**
Steel	(5.618)	(5.464)	2,8%	(5.651)	-0,6%
Mining	(530)	(535)	-1,0%	(685)	-22,6%
Eliminations	178	175	1,5%	-	-

Source: Usiminas, Genial Investimentos

EBITDA shrinking considerably on a quarterly and annual basis. Due to an improved quarter for mining, with a drop in COGS/t and better realized price, we are projecting an EBITDA for MUSA ~2x higher sequentially, standing at R$163mn Genial Est. (+97.7% q/q; +11.1% y/y). However, in continued difficulty, the steel division is calculated in our model with retraction, reaching EBITDA of R$151mn Genial Est. (-54.9% q/q; -18.0% y/y). Due to a significant decline in the most relevant segment, we estimate that consolidated EBITDA should reach R$271mn Genial Est. (-34.9% q/q; -25.8% y/y).

Table 5. EBITDA Usiminas (2Q24 Genial Est.)

(R$ millions)	2Q24E Genial Est.	1Q24 Reported	% q/q	2Q23 Reported	% y/y
Adjusted EBITDA	**271**	**416**	**-34,9%**	**365**	**-25,8%**
Steel	151	334	-54,9%	184	-18,0%
Mining	163	83	97,7%	147	11,1%
Eliminations	-43	0	-	34	-226,6%

Source: Usiminas, Genial Investimentos

We project an anemic and shrinking net income. Our model points to a net income of R$23mn Genial Est. (-61.2% q/q; -91.9% y/y), quite anemic, reflecting the difficulties faced not only by Usiminas, but also by domestic mills exposed to flat steel. Costs remain high, although there are expectations of improvement in the coming quarters from 3Q24 onwards.

Table 6. Income Statement Usiminas (2Q24 Genial Est.)

(R$ millions)	2Q24E Genial Est.	1Q24 Reported	% q/q	2Q23 Reported	% y/y
Net Revenue	**6.281**	**6.223**	**0,9%**	**6.887**	**-8,8%**
COGS	(5.970)	(5.824)	2,5%	(6.305)	-5,3%
Adjusted EBITDA	**271**	**416**	**-34,9%**	**366**	**-26,1%**
EBITDA Margin (%)	4,3%	6,7%	-2,38p.p	5,3%	-1,01p.p
EBIT	**14**	**131**	**-89,5%**	**287**	**-95,2%**
EBIT Margin (%)	0,2%	2,1%	-1,89p.p	4,2%	-3,95p.p
D&A	(257)	(303)	-15,1%	(262)	-2,0%
Financial Result	(48)	(311)	-84,4%	411	-111,8%
Net Income	**23**	**60**	**-61,2%**	**287**	**-91,9%**
Net Margin (%)	0,4%	1,0%	-0,6p.p	4,2%	-3,8p.p

Source: Usiminas, Genial Investimentos

Our Take on Usiminas

The days of struggle continue. Usiminas is not dealing with easy days, quite the contrary. In our view, unlike the significant improvement expected the consensus, the company has not been able to post solid results, and we even expect that EBITDA and net income will come across as contracted in 2Q24. A significant portion of the market believed that with the end of the refurbishment of Blast Furnace 3 (BF3) between 4Q23 and 1Q24, the company would start to record stronger operating figures. However, cost improvement continues to be a major challenge, mainly due to the dependence on third-party slabs, with costs still high going into the P&L in 2Q24.

Even though slabs consumption has already been re-established at a normal pace for the company's current reality, following the BF3 reform, we believe that the consensus was too optimistic about the company's shares at the start of the year. Conversely, we always pointed out that the market situation was still very fragile for flat steel. Even so, the consensus insisted on the idea that **(i)** the increase in demand projected for the automotive segment in 2024 and **(ii)** the belief in a lasting or more significant improvement in costs would be the triggers for Usiminas to drastically improve its operating performance. We have always been wary of this thinking. We recognize that in 1Q24 there was indeed a cooling of COGS/t, but the outlook, signaled by Usiminas itself, was that in 2Q24 this cost would not continue to fall. This frustrated, in last quarter's release, the expectations of those who were more bullish on the name. Since then, the shares have converged on our Target Price, which at the time was much lower than most of sell-side firms. So, we were proved right, ahead of the consensus.

But what can we expect going forward? The company has made investments in coking plants, to reduce the need to buy from third parties, also reducing costs and the risk of fluctuating slab prices, as well as improving efficiency by refurbishing Blast Furnace 3 (BF3). While the investments in the coking plants have not yet come to an end, the refurbishment of BF3 was completed at the end of last year. However, we have not yet been able to visualize the gains from these investments in what we consider to be a representative improvement in EBITDA. It is possible that, after the end of the BF3 ramp-up, expected for 3Q24, we may see some more significant level of COGS/t cooling down, along with the volume improvement due to the typical seasonality of the 3Qs. Even so, we maintain the view that a representative portion of the market expects a cost reduction at a much more intense level than our estimates, and this will probably not happen. We will await further information on the cost outlook for 3Q24 in the 2Q24 release.

HRC production hits record in China and supports the export-oriented thesis. Although rebar output is anemic, figures for hot-rolled coil (HRC), continue to accelerate strongly. The mills monitored for flat steel in China reached their highest weekly output for 3Y, closing the week of July 6-12 at 3.26Mt (+1.59% w/w). The hot rolling capacity utilization rate increased for the third week in a row, to an average of 84.7% (+1.33p.p w/w). As we quoted in our weekly report (Metals & Mining: Streight out of the Blast Furnace - Week 3, July 2024), mills that have production flexibility are shifting their output from long to flat steel. As we see it, this is mainly due to the export bias of China's manufacturing facilities. We highly recommend reading our weekly reports for more details.

This export bias is hampering the operations of Brazilian steel mills. With the implementation of new import quotas, made possible since June by the Brazilian Ministry of Trade (MDIC), we should expect slightly better days ahead. However, we still don't feel that this bad situation will be reversed quickly in 2H24. In addition to Brazil, we have seen Mexico, Chile and the USA implement increases in their tariffs on steel imports, a product that China ends up disposing of part of its production. However, we don't believe that the mills in China will change their strategy, since exports continue to be the escape valve for weaker domestic demand, whether through embedded or shipments of crude steel. In this sense, **as Usiminas is the company with the most exposure to flat steel in our coverage**, we remain very reticent about the name, and **we believe that the current market valuation is fair**, with basically no room for appreciation of the shares in the short term, in a fundamentalist way. Trading at an **EV/EBITDA 25E** of **3x** and going through a challenging macroeconomic context, we reiterate our **NEUTRAL rating**, with a **12M Target Price** of **R$8.70** and an **upside** of **+1.99%**.

Appendix: Usiminas

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

Income Statement	2024E	2025E	2026E	2027E	2028E
Net Revenue	**25.929**	**27.103**	**28.490**	**29.773**	**30.247**
(-) COGS	(23.533)	(23.454)	(24.396)	(25.446)	(25.682)
Gross Profit	**2.396**	**3.649**	**4.095**	**4.327**	**4.565**
(-) Expenses	(1.211)	(1.298)	(1.475)	(1.429)	(1.419)
Adjusted EBITDA	**2.250**	**3.445**	**3.774**	**4.154**	**4.142**
(-) D&A	(1.082)	(1.094)	(1.154)	(1.256)	(997)
EBIT	**1.185**	**2.352**	**2.620**	**2.898**	**3.146**
(+/-) Financial Result	(48)	37	48	160	186
(-) Taxes	(139)	(354)	(395)	(451)	(491)
Net income	**1.241**	**2.096**	**2.335**	**2.669**	**2.903**
Profitability					
Net margin (%)	4,79%	7,73%	8,20%	8,97%	9,60%

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

Cash Flow (FCFF)	2024E	2025E	2026E	2027E	2028E
Net Revenue	**25.929**	**27.103**	**28.490**	**29.773**	**30.247**
(-) COGS	(23.533)	(23.454)	(24.396)	(25.446)	(25.682)
Adjusted EBITDA	**2.250**	**3.445**	**3.774**	**4.154**	**4.142**
EBIT	**1.185**	**2.352**	**2.620**	**2.898**	**3.146**
(-) Taxes	(139)	(354)	(395)	(451)	(491)
(+) D&A	1.082	1.094	1.154	1.256	997
(+/-) Δ WK	1.047	(124)	(428)	(287)	(81)
(-) Capex	(1.845)	(1.586)	(2.618)	(2.094)	(1.989)
FCFF	**1.330**	**1.380**	**334**	**1.322**	**1.581**

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	Definition	Coverage
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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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