genial Equity Research

USIMINAS

2Q24 Review: Breach of trust

LatAm Metals & Mining

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Company

USIM5 BZ Equity
Neutral

Price: R$ 6.33 (26-Jul-2024)
Target Price 12M: R$ 7.50

Main takeaways:

(i) Flat shipments q/q; **(ii)** Realized price impacted by discounts; **(iii)** MUSA: Realized price in mining division surpassing Genial Est. **(iv)** Shipments also improving slightly, in mining; **(v)** Help from MUSA to make up net revenue, which continues to be pressured by the Steel business division; **(vi)** Steel COGS/t: Exchange rate and slabs affecting costs; **(vii)** Mining COGS/t: Advance surprisingly negative; **(viii)** EBITDA reflects the difficult challenge to overcome; **(ix)** Reversal of net income into loss; **(x)** Exchange rate variation affecting the company's result; **(xi)** HRC output remains at a good level; **(xii)** In this sense, as Usiminas is the company that is most exposed to flat steel in our coverage, we remain very reticent about the name; **(xiii)** We believe that the market's negative reaction to the result, with a **-23% drop in the shares** during a single trading session, was due to **breach of trust** in what the consensus expected and **what management was able to signal in terms of efficiency going forward.** Therefore, we emphasize that we do not believe it is a good buying opportunity yet; **(ix)** The company should continue to suffer from a **high USD/BRL exchange rate**, buying more expensive inputs (slabs and third-party coke), and should not find room to pass on prices. Therefore, trading at an **EV/EBITDA 25E** of **3x** and going through a challenging macroeconomic context, we reiterate our **Neutral rating** and **reduce our 12M Target Price** to **R$7.50** (vs. R$8.70 previously), reflecting an **upside** of **+18.48%**.

Usiminas released its **2Q24 results on July 26**. The results came in only **marginally below what we expected,** mainly in the EBITDA line, which marked R$247mn (-8.6% vs. Genial Est.). On the other hand, cash flow generation in 2Q24 improved, reaching an FCF of R$381mn (vs. a burn of -R$108mn in 1Q24). Even so, the effect of the **USD/BRL exchange rate**, which rose sharply during 2Q24, had serious impacts on the company, such as an increase in the variation of USD debt converted into BRL. This increase altered leverage to **0.8x Net Debt/EBITDA** (vs. 0.2x in 1Q24).

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

(Thousand Tonnes - kt)	Reported	Genial Est.					
Summary (Shipments	**2Q24**	**2Q24E**	**% R/E**	**1Q24**	**% q/q**	**2Q23**	**% y/y**
Steel	1.042	1.040	**0,2%**	1.037	**0,5%**	971	**7,3%**
Iron Ore	2.015	1.963	**2,6%**	1.962	**2,7%**	2.398	**-16,0%**

Source: Usiminas, Genial Investimentos

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

(R$ millions)	Reported	Genial Est.					
Income Statement	**2Q24**	**2Q24E**	**% R/E**	**1Q24**	**% q/q**	**2Q23**	**% y/y**
Net Revenue	6.350	6.281	**1,1%**	6.223	**2,0%**	6.887	**-7,8%**
Adjusted EBITDA	247	271	**-8,6%**	416	**-40,6%**	366	**-32,5%**
Net Income	(100)	23	**-**	60	**-265,4%**	287	**-134,7%**

Source: Usiminas, Genial Investimentos

Strong negative market reaction! During the trading session on the day the results were released, Usiminas shares **fell an impressive -23%**. In addition to the increase in leverage, management's signaling of the reduction in **COGS/t for 3Q24**, which is the indicator widely awaited by the market, **was once again disappointing**. The consensus expected a sequential reduction since 2Q24 (since the cost actually fell in 1Q24). However, in fact, already in the 1Q24 disclosure, the cost guidance for 2Q24 was passed as flat, which at the time had already disenchanted a portion of investors who were more bullish, with shares falling -13% on April 23. After ~3M, now in the 2Q24 release, COGS/t came in with a slight increase, of +1.2% q/q (vs. the stability that had been signaled). In addition, **management was**, in our opinion, **reluctant to make a clear argument as to whether or not investors could expect a cooling of costs in 3Q24**.

Management thinks in the long run, but commodity investors always look the short. Phrases such as: “Our project is long-term. Our vision is not for a month or a quarter. We seek to build an industry strength with a strong focus in order to supply steel competitively to our clients”, uttered in the closing speech by Mr. Marcelo Chara, CEO of Usiminas, during the conference call with analysts, show that the market consensus expected cost reduction results in the short term and that the company seems to be struggling to meet this demand, and sets the tone for the long run, even after the end of the Blast Furnace 3 (BF3) refurbishment. This frustration was the main reason for the sharp drop in shares. We've been trying to warn about the consensus' over-optimism since the beginning of the year. With several analysts from other sell-side firms going on to recommend buying the stock over the first few months of the year, we have remained skeptical since the end of the BF3 reform in November last year. **We were right once again...**

Valuation and rating. The appreciation of the **USD/BRL exchange rate** had a significant impact on Usiminas' results in 2Q24, increasing operating costs due to the acquisition of USD-denominated inputs, such as iron ore and slabs, and negatively affecting the company's liabilities, also in USD, such as debt variation and other financial obligations. This factor contributed to net foreign exchange losses of -R$292mn, leading to a total loss of -R$100mn in 1Q24 bottom line, contrasting with net income of +R$60mn in 1Q24 and R$287mn in 2Q23.

In addition, Usiminas was unable to capture the cost efficiency expected by consensus after the refurbishment of Blast Furnace 3 (BF3). It is possible to state that we have always been on the more conservative side with regard to efficiency gains by lowering COGS/t, evidence of which can be found in the various reports we have published on Usiminas since the beginning of the year, such as the one attached (4Q23 Preview). At the start of the year, Usiminas shares were on an upward trend, with investors pricing in an improvement in EBITDA as a result of the COGS/t cooling. In fact, in 1Q24 COGS/t cooled, but management's signal for 2Q24 was cost stabilization, even with the efficiency gains of FY3. The **(i)** higher cost of third-party slabs (which rose ~20% in 1Q24 and went through P&L in 2Q24), as well as **(ii)** a higher value-added mix (and therefore more costly to produce), in addition to **(iii)** the impact of the USD/BRL exchange rate, transformed the previous expectation of cost reduction into a real increase of +1.2% q/q in COGS/t.

Why is Usiminas unable to lower costs even with the refurbishment of BF3? Although the refurbishment was completed in November 2023, the company still faces significant challenges in reducing costs throughout 2024, especially due to the dependence on third-party slabs, whose high prices continue to impact results, as we explained above. The expectation that the efficiency gains from the AF3 reform would be reflected in 2Q24 did not materialize, and **Usiminas shares fell -23%** on the day the results were released, reflecting investors' disbelief.

The macroeconomic scenario continues to present challenges, with high production of Chinese flat steel being exported to Brazil, reducing the market share of local mills, and especially Usiminas, which is heavily exposed to this segment. The new import quotas for steel in Brazil, implemented since June by the Ministry of Trade (MDIC), may improve the situation somewhat, but are not enough to quickly reverse the unfavorable picture in 2H24. Chinese exports continue to be the escape valve for weakened domestic demand in China, negatively affecting the operations of Brazilian steelmakers.

Finally, the company reported a loss in 2Q24, reflecting the combination of adverse factors, including currency devaluation, the inability to capture cost efficiencies and the challenging macroeconomic scenario. In this sense, as Usiminas is the company with the most exposure to flat steel in our coverage, we remain very wary of the name. On the other hand, it is possible that, as the fall was very strong (we expected a negative reaction, but not of this intensity), the shares may see relative relief in the coming days. However, we understand that there has been a drop in confidence in what the consensus expected and what management was able to signal in terms of efficiency going forward. We therefore stress that we do not believe this is a good buying opportunity.

The company should **(i)** continue to suffer from a high USD/BRL exchange rate, **(ii)** buy more expensive inputs, and **(iii)** find no margin to pass on prices. Therefore, trading at an **EV/EBITDA 25E** of **3x** and going through a challenging macroeconomic context, we reiterate our **NEUTRAL rating** and reduce our **12M Target Price** to **R$7.50** (vs. R$8.70 previously), reflecting an **upside** of **+18.48%**.

2Q24 Review: In detail!

Steel: shipments flat q/q, with reversed dynamics. In the domestic market (DM), due to cuts in the SELIC rate during 1H24 and the MP (Brazilian legislation) for popular cars, implemented in May 2023 by reducing taxes, demand for light vehicles increased and the company reported volumes of 974Kt (+4.4% vs. Genial Est.), up +6.0% q/q and +7.9% y/y. In the foreign market (FM), due to the end of the Néstor Kirchner project, we saw shipments of 68Kt (-43.9% vs. Genial Est.), showing a much larger drop than expected, with a reduction of -44.9% t/t and -2.4% y/y. Total sales (DM + FM) reached 1,042Kt (+0.2% vs. Genial Est.), expanding sequentially in a subtle way to +0.5% q/q, with a more significant rise of +7.9% y/y.

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

(R$ millions)	2Q24 Reported	2Q24E Genial Est.	% R/E	1Q24 Reported	% q/q	2Q23 Reported	% y/y
Net Revenue	**6.350**	**6.281**	**1,1%**	**6.223**	**2,0%**	**6.887**	**-7,8%**
Steel	5.728	5.792	-1,1%	5.784	-1,0%	5.976	-4,2%
Mining	777	702	10,8%	649	19,7%	905	-14,1%
Eliminations	(156)	(213)	-26,6%	(211)	-25,9%	6	-

Source: Usiminas, Genial Investimentos

Steel: realized price impacted by discounts. As we mentioned in the preview report (2Q24 Preview: The days of struggle continue), due to the -12% discount granted to the automotive segment for 70% of the base, Usiminas reported a realized price for the domestic market (DM) of R$5,441/t (-2.1% vs. Genial Est.), contracting -3.0% q/q and -10.4% y/y. In total contrast to our estimate, there was a change in the mix of products sold, which resulted in an increase of +23.5% t/t in the realized price on the foreign market (FM), reaching R$6,294/t (+26.1% vs. Genial Est.), despite the contraction of -11.0% y/y. On a consolidated basis (MD +FM), Usiminas reported a realized price in the Steel unit of R$5,497/t (-1.3% vs. Genial Est.), down -1.0% q/q and -10.7% y/y.

MUSA: Realized price and shipments surpassing Genial Est. We had commented on the expectation of higher prices due to the improved mix and a more subtle impact of the forward provisioning system. However, the realized price for the mining segment surprised us with a more significant increase, reaching R$386/t (+7.9% vs. Genial Est.), accelerating +16.5% q/q and +2.2% y/y. Iron ore shipments were recorded at 2,015Kt (+2.6% vs. Genial Est.), up +2.7% q/q, despite a drop of -16.0% y/y. Despite entering periods with less rainfall, the company did not make opportunistic sales of low-grade iron ore in 2Q24, as seen in the previous quarter, and so we saw a marginal increase in shipment volumes.

MUSA's help in net revenue. The company's consolidated net revenue rose +2.0% q/q to R$6.4bn (-1.1% vs. Genial Est.), shrinking -7.8% y/y. The unit that contributed to this growth was mining. MUSA exceeded our estimates for sales and realized price, which were already increasing in our model, and reported a top line of R$777mn (+10.8% vs. Genial Est.), accelerating +19.7% q/q, despite a drop of -14.1% y/y. The highlight was the quality of the mix of ore sold. Steelmaking, on the other hand, suffered the impact of discounts granted to the automotive segment and recorded net revenue of R$5.7bn (-1.1% vs. Genial Est.), down -1.0% q/q and -4.2% y/y.

Steel COGS/t: exchange rate and slab costs lead to an increase, compared to expectations of stability. Usiminas reported COGS/t for the Steel division at R$5,330/t (+1.7% vs. Genial Est.), slightly above our expectation, growing +1.2% q/q, with a contraction of -5.8% y/y. The reason for the quarterly variation was due to the higher cost of raw materials, especially **(i)** the higher cost of acquiring slabs from third parties (which rose ~20% in 1Q24 and was processed through P&L in 2Q24) and **(ii)** the upward movement in the USD/BRL exchange rate. These factors outweighed the efficiency gains from Blast Furnace 3 (AF3). As a result, the unit's nominal COGS stood at R$5.6bn (-1.1% vs. Genial Est.), up +1.7% q/q and down -1.7% y/y.

Mining COGS/t: Progress surprisingly negative. For the mining business unit (MUSA), the COGS/t reported was R$300/t (+11% vs. Genial Est.), up +9.9% q/q and +5.0% y/y. We expected a drop on a sequential basis; however, the company made more sales with spot freight, and we therefore see an increase in costs.

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

(R$ millions)	2Q24 Reported	2Q24E Genial Est.	% R/E	1Q24 Reported	% q/q	2Q23 Reported	% y/y
COGS	**(6.022)**	**(5.970)**	**0,9%**	**(5.824)**	**3,4%**	**(6.305)**	**-4,5%**
Steel	(5.554)	(5.618)	-1,1%	(5.464)	1,7%	(5.651)	-1,7%
Mining	(605)	(530)	14,1%	(535)	13,0%	(685)	-11,7%
Eliminations	137	178	-23,0%	175	-21,8%	31	-

Source: Usiminas, Genial Investimentos

EBITDA reflects a difficult challenge to overcome. As we expected cost dynamics to be cooler than the figures released, the company ended up reporting lower consolidated adjusted EBITDA than we had projected, coming in at R$247mn (-8.7% vs. Genial Est.), down -40.6% q/q and -32.3% y/y. For MUSA, EBITDA stood at R$156mn (-4.4% vs. Genial Est.), up +88.9% q/q and +6.2% y/y, due to the better level of shipments with a composite mix with fewer low-grade products, helping price realization. As for the steel industry, still suffering from the challenging macroeconomic scenario for steel, it reported EBITDA of R$70mn (-53.5% vs. Genial Est.), down sharply by -79.0% q/q and -61.9% y/y, due to weak cost efficiency dynamics, even with BF3 ramping up after the reform.

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

(R$ millions)	2Q24 Reported	2Q24E Genial Est.	% R/E	1Q24 Reported	% q/q	2Q23 Reported	% y/y
Adjusted EBITDA	**247**	**271**	**-8,7%**	**416**	**-40,6%**	**365**	**-32,3%**
Steel	70	151	-53,5%	334	-79,0%	184	-61,9%
Mining	156	163	-4,4%	83	88,9%	147	6,2%
Eliminations	21	-43	-148,7%	0	-	34	-38,4%

Source: Usiminas, Genial Investimentos

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

(R$ millions)	2Q24 Reported	2Q24E Genial Est.	% R/E	1Q24 Reported	% q/q	2Q23 Reported	% y/y
Net Revenue	**6.350**	**6.281**	**1,1%**	**6.223**	**2,0%**	**6.887**	**-7,8%**
COGS	(6.021)	(5.970)	0,9%	(5.824)	3,4%	(6.305)	-4,5%
Adjusted EBITDA	**247**	**271**	**-8,6%**	**416**	**-40,6%**	**366**	**-32,5%**
EBITDA Margin (%)	3,9%	4,3%	-0,41p.p	6,7%	-2,79p.p	5,3%	-1,42p.p
EBIT	**(28)**	**14**	**-301,0%**	**131**	**-121,0%**	**287**	**-109,6%**
EBIT Margin (%)	-0,4%	0,2%	-0,65p.p	2,1%	-2,54p.p	4,2%	-4,61p.p
D&A	(302)	(257)	17,6%	(303)	-0,2%	(262)	15,2%
Financial Result	(197)	(48)	305,4%	(156)	26,3%	205	-195,7%
Net Income	**(100)**	**23**	**-526,1%**	**60**	**-265,4%**	**287**	**-134,7%**
Net Margin (%)	-1,6%	0,4%	-1,94p.p	1,0%	-2,54p.p	4,2%	-5,74p.p

Source: Usiminas, Genial Investimentos

Our Take on Usiminas

What happened to Usiminas? Many in the market had hoped that after the completion of the Blast Furnace 3 (BF3) refurbishment in November 2023, the company would show a more solid operational performance. However, Usiminas still faces significant challenges in reducing costs, especially due to its dependence on third-party slabs, whose high prices continue to affect the earnings results in 2Q24.

On the day the results were released (Friday, July 26), the company's shares fell -23%, reflecting investors' disbelief about efficiency gains after the BF3 reform. Until then, our expectation had been that after the conclusion of the BF3 ramp-up, scheduled for 3Q24, we would see a slightly more significant reduction in COGS/t, as well as an increase in volume due to the seasonality typical of third quarters. It's worth mentioning here that our expectation, even of a reduction, would never match the optimism that the consensus has created around this aspect.

Conversely, **management was**, in our opinion, **reluctant to make a clear argument as to whether or not investors could expect a cooling of costs in 3Q24**. This puts us in doubt about what is to come in next quarter's COGS/t and the true level of efficiency that AF3 can generate after the ramp-up in the face of several other cost variables going against the cooling vector.

Exchange rate variations affecting the company's results. Usiminas suffered greatly from the appreciation of the USD/BRL exchange rate, since it buys USD-denominated inputs for its operations, such as its own iron ore and third-party plate. In addition, the company ended up leveraging itself more by maintaining debts in American currency, reaching R$998mn in gross debt (+222% vs. 1Q24) and reaching **Net Debt/EBITDA of 0.8x** (vs. 0.2x in 1Q24).

HRC output remains at a good level. As we commented in our weekly report (Straight out of the Blast Furnace: Week 4, July 2024), we saw a drop in rebar production, which occurred especially in eastern China, particularly in Jiangsu province, where some mills stopped operations or switched from rebar production to flat steel products in an attempt to obtain better returns, as we had already anticipated in last week's report. Therefore, the mills producing HRC (reference for flat steel) continue to show satisfactory output levels, driven by downstream demand linked to the export of durable goods. The utilization rate stood at 83.5% (-1.14p.p w/w), showing a weekly slowdown, but still well above the 2023 level (+5.12p.p y/y).

This export bias has been hampering the operations of Brazilian steel mills. With the implementation of new import quotas for steel imported into Brazil, made possible since June by the Brazilian Ministry of Trade (MDIC), we should expect slightly better days for companies. However, we still don't feel that the 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 steel or shipments of crude steel, which finds a market in Brazil still with a complex and potentially ineffective tariff protection system, through the complementary quota system.

Breach of trust. In this sense, as Usiminas is the company with the most exposure to flat steel in our coverage, we remain very wary of the name. On the other hand, it is possible that, as the fall was very strong (we expected a negative reaction, but not of this intensity), the shares may see relative relief in the coming days. However, we understand that there has been a drop in confidence in what the consensus expected and what management was able to signal in terms of efficiency going forward. We therefore stress that we do not believe this is a good buying opportunity.

The company should **(i)** continue to suffer from a high USD/BRL exchange rate, **(ii)** buy more expensive inputs, and **(iii)** find no margin to pass on prices. Therefore, trading at an **EV/EBITDA 25E** of **3x** and going through a challenging macroeconomic context, we reiterate our **NEUTRAL rating** and reduce our **12M Target Price** to **R$7.50** (vs. R$8.70 previously), reflecting an **upside** of **+18.48%**.

Appendix: Usiminas

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

Income Statement	2024E	2025E	2026E	2027E	2028E
Net Revenue	**26.690**	**26.956**	**27.619**	**27.985**	**27.707**
(-) COGS	(24.033)	(23.371)	(23.699)	(24.035)	(23.603)
Gross Profit	**2.657**	**3.585**	**3.921**	**3.949**	**4.104**
(-) Expenses	(1.105)	(1.301)	(1.445)	(1.365)	(1.324)
Adjusted EBITDA	**2.590**	**3.377**	**3.626**	**3.834**	**3.769**
(-) D&A	(1.038)	(1.093)	(1.150)	(1.250)	(990)
EBIT	**1.552**	**2.284**	**2.476**	**2.585**	**2.779**
(+/-) Financial Result	545	391	469	746	837
(-) Taxes	(319)	(402)	(441)	(497)	(538)
Net income	**1.885**	**2.380**	**2.611**	**2.941**	**3.185**
Profitability					
Net margin (%)	7,06%	8,83%	9,45%	10,51%	11,50%

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

Cash Flow (FCFF)	2024E	2025E	2026E	2027E	2028E
Net Revenue	**26.690**	**26.956**	**27.619**	**27.985**	**27.707**
(-) COGS	(24.033)	(23.371)	(23.699)	(24.035)	(23.603)
Adjusted EBITDA	**2.590**	**3.377**	**3.626**	**3.834**	**3.769**
EBIT	**1.552**	**2.284**	**2.476**	**2.585**	**2.779**
(-) Taxes	(319)	(402)	(441)	(497)	(538)
(+) D&A	1.038	1.093	1.150	1.250	990
(+/-) Δ WK	978	20	(188)	(18)	158
(-) Capex	(1.813)	(1.559)	(2.573)	(2.058)	(1.955)
FCFF	**1.436**	**1.435**	**425**	**1.261**	**1.434**

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	Definition	Coverage
Buy	Expected return above +10% in relation to the Company's sector average	**49%**
Neutral	Expected return between +10% and -10% relative to the Company's industry average	**41%**
Sell	Expected return below -10% in relation to the Company's sector average	**5%**
under Review	Under review	**5%**

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