GERDAU

2Q24 Preview: It will get worse before it gets better

LatAm Metals & Mining

Main takeaways:

(i) Brazil BD: Slightly higher realized prices, R$5,023/t Genial Est. (+1.4% q/q); **(ii)** Shipments more focused on the domestic market; **(iii) North America BD:** Realized prices pressured by discounts: R$6,577 Genial Est. (-1.9% q/q); **(iv)** Demand waiting for lower prices; **(v) South America BD:** Peru performing well; **(vi) Special Steels:** Better volumes in Brazil and the U.S.; **(vii)** We project a slight increase in revenue q/q; **(viii) Brazil BD: COGS/t rising** due to metallurgical coal pressure and mills hibernations; **(ix) North America BD: COGS/t likely negatively impacted** by scrap delay; **(x)** Special Steels cost improvements: R$6,502/t Genial Est. (-15% q/q); **(xi) EBITDA decreasing** with short-term cost pressures; **(xii) Net income contraction:** R$1.1bn Genial Est. (-72% q/q; -46.1% y/y); **(xiii)** China's export bias likely to persist; **(xiv)** Mexico vs. U.S.: Special treatment for Brazilian steel (more on that on "Our Take" section); **(xv)** U.S.: Rate cut gaining visibility for September cut; **(xvi)** Brazil: Is there room for more price pass-through? We think so. Rebars are still trading with **negative premiums** vs. imported; **(xvii)** Our Take on costs: It will get worse before it gets better; **(xviii)** Trading at an **EV/EBITDA of 4.0x** (vs. a historical average of 5x), considering the cost cuts the company is already implementing this year to reap benefits in 2025, we believe the **market has not yet fully reflected Gerdau's austerity plan**. We emphasize that the **short term continues to be challenging** with reduced margins and a **slowdown in EBITDA in 2024**. Our focus is on the **expected margin increase for 2025**, not the immediate challenges. Thus, we reiterate our **BUY rating** with a **12M Target Price** of **R$23.40**, reflecting an **upside** of **+29.78%**.

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Company

GGBR4 BZ Equity
Buy

Price: R$ 18.03 (30-Jul-2024)
Target Price 12M: R$ 23.40

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

(Thousand Tonnes - kt)

Summary (Shipments)	2Q24E (Genial Est.)	1Q24	% q/q	2Q23	% y/y
Brazil BD	1.290	1.299	**-0,7%**	1.344	**-4,0%**
North America BD	966	957	**0,9%**	975	**-0,9%**
South America BD	253	227	**11,4%**	311	**-18,7%**
Special Steel BD	362	339	**6,6%**	379	**-4,7%**

Source: Gerdau, Genial Investimentos

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

(R$ millions)

Income Statement	2Q24E (Genial Est.)	1Q24	% q/q	2Q23	% y/y
Net Revenue	16.749	16.210	**3,3%**	18.265	**-8,3%**
Adjusted EBITDA	2.758	2.813	**-2,0%**	3.792	**-27,3%**
Net Income	1.156	1.245	**-7,2%**	2.143	**-46,1%**

Source: Gerdau, Genial Investimentos

Gerdau will release its **2Q24 results on July 31** after the market closes. We expect Gerdau to show a **less significant performance across most business divisions** following a surprisingly positive 1Q24. In **Brazil BD**, we believe there will be a cost increase as a temporary effect due to termination expenses embedded in the ongoing workforce reduction process in the asset footprint restructuring, which should intensify the margin contraction. For **North America BD**, we understand that Gerdau will also suffer from **slower demand** due to the U.S. economic slowdown given the high-interest rates and the reduced reshoring process with the Biden administration entering the election race (currently endorsing Kamala Harris' campaign).

Valuation and rating. With a weaker quarter, we expect a sequential and annual decline in consolidated EBITDA. We can anticipate the following dynamics for each unit:

Brazil BD:

Gerdau is trying to implement price adjustments in the range of +7-8% in various lines of its mix, mainly related to long steel. Since the 1Q24 preview report, attached link (Gerdau 1Q24 Preview), we had already indicated that, according to our market monitoring, the company was negotiating with its client's base to pass on prices for 2Q24.

On the other hand, we also mentioned that although the domestic premium for long steel vs. imported was at very low levels during the first 3M of the year, which facilitated price pass-throughs, the demand in Brazil for **civil construction is slowing down**, especially in the **high-end residential real estate market** due to high-interest rates. Even though the SELIC rate fell throughout the 1H24, the mortgage interest rate remained stable, hurting the appetite for new projects and the demand for steel in the construction phase of the projects. However, there is an expectation of an increase in the **low-income segment** due to the government program "Minha Casa Minha Vida" (MCMV). Even so, in line with what we had previously mentioned, we observed from S&P Platts data a **3-4% increase in rebar prices in July**. Therefore, although the price pass-through round was only effective for 3Q24, we believe that part of it already occurred in June, **contributing to 1/3 of the quarter** and that we will likely also witness an **improvement in the mix in 2Q24**, leading us to believe in a smooth growth of +1.4% q/q in realized prices, reaching R$5,023/t Genial Est.

However, we expect the shipment level to slightly decrease to 1,290Kt Genial Est. (-0.7% q/q), indicating a less heated demand and the **asset footprint management**, such as the shutdown of the **Barão de Cocais (MG)** unit and the suspension of production in **Maracanaú (CE)**, both part of Gerdau's cost-cutting plan mentioned in the previous report.

North America BD:

In the last two quarters, we observed a resilient order book (~60 days) due to significant construction activity, especially in semiconductor plants, as well as expansions in the food, beverage, and chemical sectors. This increase in construction activity is influenced by **reshoring**, reflecting legislative support and supply chain concerns. For 2Q24, we believe that the appetite for sales decreased**, potentially affecting the order book level**. As we move out of the more adverse seasonality from 4Q to 1Q, we should see demand gradually accelerating in 2Q24. However, the interest rate maintained by the FED in the range of 5.5%-5.25% since July last year has started to cause an **economic slowdown**, reducing downstream steel consumption. Additionally, the **U.S. election race has begun to hold back projects** from the current Biden administration, reducing the reshoring movement we were witnessing. This led players like Nucor to offer discounts to their customer base due to lower demand.

Gerdau, not being a price maker in the U.S., followed its peers and **reduced prices during 2Q24**, estimated at R$6,577/t Genial Est. (-1.9% q/q; -5.8% y/y), already considering the higher USD/BRL conversion effect. For volumes, we believe that while the company has indeed felt the effects of the slowing economy, the **diverse product mix** allowed Gerdau to maintain resilient demand in the **distribution segment**. Therefore, we expect stable volumes in 2Q24 at 966Kt Genial Est. (+0.9% q/q).

Special Steel:

The Special Steel division is the **only one with more positive prospects**. Our analysis suggests better figures in 2Q24 due to the continued recovery in demand **for light vehicles in Brazil** and an **improved appetite in the U.S.** driven by **(i)** expectations of Fed rate cuts (we expect in October vs. consensus in September) and **(ii)** a better credit cycle in Brazil. The rising credit supply conditions in Brazil also help with the **(iii)** partial recovery in demand for heavy vehicles due to better prospects reported by ANFAVEA. We expect volumes to rise to 362Kt Genial Est. (+6.6% q/q).

South America BD:

Brazilian exports are expected to be negatively affected, with Gerdau possibly focusing on higher value-added products in the domestic market due to low external prices. In South American operations, **Peru is projected to perform positively**, partially offsetting weaker performance in Argentina, resulting in a shipment increase to the region, reaching 253Kt Genial Est. (+11.4% q/q). However, realized prices in South America should remain stable at R$5,270/t Genial Est. (+0.4% q/q; +1.9% y/y).

It will get worse before it gets better.

As we mentioned since last quarter, as Gerdau's cost-cutting program is heavily focused on resizing the footprint in Brazil, leading to the hibernation of some plants to redirect volume to newer and more efficient facilities, there is a **significant workforce reduction**. Since employee terminations generate severance costs in the first months, the situation worsens before improving. Additionally, for North America, the cooling scrap cost may not fully reflect in 2Q24. This could result in an increase in production costs. Despite the challenging macroeconomic scenario, including pressure from Chinese steel exports and dependence on low-income projects in Brazilian housing sector, Gerdau maintains a **positive outlook for 2025** with expectations of **margin improvement.** We believe the company is committed to **reducing fixed costs** and avoiding reliance on government actions to protect against Chinese steel imports. The **BUY rating** was reiterated with a **12M Target Price** of **R$23.40**, reflecting an **upside** of **+29.78%**.

2Q24 Preview: In detail!

Brazil BD: Slightly higher realized prices. As we have already mentioned, Gerdau has been trying since the beginning of June to implement a +7-8% adjustments. According to the monitoring we received from S&P Platts, we observed a +3-4% increase for rebar. Therefore, we project a slight increase in realized prices in 2Q24 with an improved mix and residual partial increase in June (just 1/3 of the 2Q). We do not believe that the prices are absorbing the effects of the new import quotas implemented by MDIC focused on flat steel, reaching R$5,023/t Genial Est. (+1.4% q/q; -6.7% y/y).

Brazil BD: Shipments more focused on the domestic market. The company should experience a decline in exports. This is because Gerdau is carrying out **(i)** hibernations in old plants such as Barão de Cocais (MG), which shipped a significant volume of steel to the foreign market, and **(ii)** the realized price abroad is below expectations, leading to a focus on a higher value-added mix in the domestic market. With this in mind, we project a marginal increase in realized prices of +1.4% q/q and a decline of -6.7% y/y, reaching R$5,023/t Genial Est.

North America BD: Realized prices will be pressured by discounts. Regarding North America BD, at the end of last year and the beginning of this year, the company announced two price increases, the first for rebar (+US$50/t) and commercial bars (+US$65/t), and the second for beams (+US$50/t). These increases were not fully absorbed in the 1Q24 results, and everything suggested that we would see an increase in the realized price of the division. However, the company followed market movements and announced a discount (~US$5/t). Therefore, we estimate a realized price for North America BD at R$6,577 Genial Est. (-1.9% q/q; -5.8% y/y).

North America BD: Demand waiting for lower prices. Typically, the 2Qs presents better seasonality in the U.S. However, due to the observed decline in scrap prices, clients (distributors, representing 50% of the base) preferred to wait to place orders, convinced that with the drop in scrap prices, there would be room for price reductions. Therefore, we expect just a slight increase in shipments for North America BD at 966Kt Genial Est. (+0.9% q/q; -0.9% y/y).

Special Steel: Better volumes in Brazil and the U.S. We believe the company will grow shipments for the Special Steel in both Brazil and the USA. We highlight two reasons for the increased demand in the automotive segment in Brazil: **(i)** Observed cuts in the SELIC rate during the 1H24 and **(ii)** better credit cycle. Regarding the U.S., with the approach and perception of a FED rate cut (the market is betting on a cut in September), sector demand has also grown. Therefore, we estimate shipment volumes at 362Kt Genial Est. (+6.6% q/q; -4.7% y/y). As for the realized price of the division, we do not expect a q/q difference, reaching R$7,693/t Genial Est. (flat on a quarterly basis; -5.4% y/y).

We project a slight increase in net revenue q/q. With the observed compensation between North America BD and Brazil BD and more favorable scenarios in South America BD and Special Steel, we calculate consolidated net revenue of R$16.7bn Genial Est. (+3.3% q/q; -8.3% y/y). We estimate revenue for Brazil BD at R$6.5bn Genial Est. (+0.7% q/q; -10.4% y/y) mainly due to the better mix in the division, offsetting the slight projected decline in sales. Meanwhile, North America BD appears in our model with net revenue of R$6.4bn Genial Est. (-1.0% q/q; -6.7% y/y), primarily due to the order from distributor clients waiting for lower scrap prices to place cheaper orders. Finally, revenues from the South America BD and Special Steel divisions are estimated at R$1.3bn Genial Est. (+11.9% q/q; -17.1% y/y) and R$2.8bn Genial Est. (+6.6%; -9.9% y/y).

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

(R$ millions)	2Q24E Genial Est.	1Q24 Reported	% q/q	2Q23 Reported	% y/y
Net Revenue	**16.749**	**16.210**	**3,3%**	**18.265**	**-8,3%**
Brazil BD	6.481	6.435	0,7%	7.236	-10,4%
North America BD	6.351	6.416	-1,0%	6.806	-6,7%
South America BD	1.333	1.191	11,9%	1.609	-17,1%
Special Steel BD	2.781	2.608	6,6%	3.086	-9,9%
Eliminations	(198)	(440)	-55,1%	(471)	-58,0%

Source: Gerdau, Genial Investimentos

Brazil BD: COGS/t rising due to metallurgical coal pressure and hibernations. The company is proceeding with a cost structure overhaul, cutting fixed expenses, especially payroll. Management's previous expectation was for a reduction of ~R$400mn per quarter starting from 4Q24, resulting in a total cost-cutting package of -R$1.5bn in 2025, mainly in Brazil BD (we address this point further in the "Our Take" section). However, in 2Q24, we should not yet see cost easing. On the contrary, we expect **(i)** pressure on COGS/t from raw materials, particularly metallurgical coal, impacting the P&L and **(ii)** a one-off effect from the hibernations of the Barão de Cocais (MG) and Maracanaú (CE) plants. Both plants suspended production activities in May and have approximately 1K employees who either had their employment contracts terminated or were relocated to other units depending on the case. The severance cost of this workforce should negatively impact 2Q24. Therefore, we estimate COGS/t in Brazil BD at R$4,778/t Genial Est. (+3.7% q/q; -0.1% y/y).

North America BD: COGS/t likely negatively impacted by scrap delay. We observed an increase in the availability of ferrous scrap in the U.S., reducing the input cost in the spot market. However, as there is a delay in the destocking process, the company operated in 2Q24 with scrap still at higher prices, not reflecting the recent drop in raw material prices. Therefore, we forecast COGS/t at R$5,439/t Genial Est. (+2.9% q/q; +0.5% y/y).

Special Steel cost improvements. For South America BD and Special Steel, we expect COGS/t at R$4,246/t Genial Est. (+2.9% q/q; +2.8% y/y) and R$6,502/t Genial Est. (-1.5% q/q; -0.9% y/y), respectively. It is worth noting that Gerdau had already made efficiency improvement and cost reduction initiatives at the end of 2023 for the Special Steel division, so they should achieve more positive results in 2Q24.

EBITDA declining with short-term cost pressures. Our EBITDA expectation is R$2.8bn Genial Est. (-2.0% q/q; -27.3% y/y), declining due to the expected growth in COGS/t of the two main business units, resulting in a margin slowing to 16.5% (-0.89p.p. q/q; -4.29p.p. y/y). South America BD is the division expected to perform best this quarter due to increased demand and profitability in Peru, partially offsetting Argentina with lower volumes. Brazil BD shows EBITDA of R$515mn (-13.5% q/q; -48.1% y/y) and North America BD with EBITDA of R$1.4bn (-11.7% q/q; -22.0% y/y).

Table 4. EBITDA Gerdau (2Q24 Genial Est.)

(R$ millions)	2Q24E Genial Est.	1Q24 Reported	% q/q	2Q23 Reported	% y/y
Adjusted EBITDA	**2.758**	**2.813**	**-2,0%**	**3.792**	**-27,3%**
Brazil BD	515	595	-13,5%	992	-48,1%
North America BD	1.386	1.570	-11,7%	1.777	-22,0%
South America BD	379	286	32,5%	481	-21,1%
Special Steel BD	513	440	16,6%	603	-15,0%
Eliminations	(34)	(78)	-56,3%	-60	-43,6%

Source: Gerdau, Genial Investimentos

Net income contraction. We project a financial result of -R$430mn Genial Est. (vs. -R$476mn in 1Q24). Given the margin compression in our model mainly caused by short-term cost increases, we expect a sequential decline in net income to R$1.1bn Genial Est. (-7.2% q/q; -46.1% y/y).

Table 5. Income Statement Gerdau (2Q24 Genial Est.)

(R$ millions)	2Q24E Genial Est.	1Q24 Reported	% q/q	2Q23 Reported	% y/y
Net Revenue	**16.749**	**16.210**	**3,3%**	**18.265**	**-8,3%**
COGS	(14.650)	(13.790)	6,2%	(14.987)	-2,3%
Adjusted EBITDA	**2.758**	**2.813**	**-2,0%**	**3.792**	**-27,3%**
EBITDA Margin (%)	16,5%	17,4%	-0,89p.p	20,8%	-4,29p.p
EBIT	**1.793**	**1.944**	**-7,8%**	**2.885**	**-37,9%**
EBIT Margin (%)	10,7%	12,0%	-1,29p.p	15,8%	-5,09p.p
D&A	(831)	(726)	14,5%	(752)	10,5%
Financial Result	(430)	(476)	-9,6%	(423)	1,7%
Net Income	**1.156**	**1.245**	**-7,2%**	**2.143**	**-46,1%**
Net Margin (%)	6,9%	7,7%	-0,78p.p	11,7%	-4,83p.p

Source: Gerdau, Genial Investimentos

Our Take on Gerdau

China's export bias likely to persist. We have commented on the adverse macroeconomic scenario faced by Brazilian steel companies for some time. As we mentioned in our weekly report (Straight out of the Blast Furnace: Week 4, July 2024), we observed a decline in rebar production, especially in eastern China, particularly in Jiangsu province, where some plants stopped operations or switched production from rebar to flat steel products in an attempt to achieve better returns, as we had anticipated in last week's report. Therefore, HRC-producing plants continue to present satisfactory output levels driven by downstream demand related to durable goods exports. 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 troubling Brazilian steel mills. With the implementation of new import quotas for imported steel in Brazil since June by the Ministry of Commerce (MDIC), we should expect slightly better days for companies. However, we do not yet feel that the bad situation will be quickly reversed in 2H24. In addition to Brazil, we saw Mexico, Chile, and the U.S. increasing tariffs on crude steel imports. However, we do not believe that Chinese mills will change their strategy since exports continue to be the outlet for weaker domestic demand, either through embedded steel or the shipment of raw steel, finding in Brazil a market with a complex and potentially ineffective tariff protection through complementary quota systems. Among the national steel mills, Gerdau should theoretically suffer less from this Chinese export bias, as it is less exposed to flat steel than its competitors Usiminas and CSN, for example. Even so, we have already seen the company implementing initiatives in the microeconomic scenario (within its reach) to cut costs.

Mexico vs. USA: Special treatment for Brazilian steel. Earlier this month, Mexican President Andrés López Obrador negotiated conditions in response to the Biden administration's initiative to impose higher tariffs on steel from other countries entering the U.S. through Mexico. The USA and Mexico announced new import restrictions, reinstating Section 232 tariffs of 25% and 10% on some steel and aluminum products from Mexico. However, the law states that steel imported from Brazil, processed in Mexico, and then exported to the U.S. will not be subject to tariffs. In June, Brazil exported approximately ~68Kt of slabs to Mexico, more than 2x vs. 2023. We understand that Brazilian mills, which mainly sell lower value-added products to units in Mexico where they are rolled, tend to benefit more from this increase.

USA: FED rate cut gaining visibility for September. The outlook for a FED rate cut seems to be improving, with the market consensus believing in a cut in September (vs. our initial expectation of December). Thus, 2Q24 should reflect slowing consumption, precisely what is necessary for the FED to feel confident in the data to promote the cuts. Since it is now almost unanimous that a -25bps cut will occur in September, it is possible that there will be two cuts in 2024, with another of the same magnitude in December. Additionally, we continue with our view that the metal spread should decrease throughout the year due to the greater difficulty that Gerdau is already facing in passing on prices. It is worth noting that even if the metal spread decreases, we still believe it will remain above the historical average, just at a more subdued level than the current margin, which seems excessive given the tighter market conditions for the downstream.

Brazil: Is there room for more price pass-through? We believe that the major producers of long steel (including Gerdau) will try to negotiate another round of increases for August (+6-8%). However, we assess that it will be challenging to implement it, especially to this extent, given the low visibility of the capacity to accommodate new increases amid a housing construction demand still heavily dependent on low-income projects from the "Minha Casa Minha Vida" (MCMV) package.

It will get worse before it gets better. As mentioned above in this report, the company announced a strict plan to reduce fixed costs. Considering this measure, we are more bullish about the case. The supplementary quota model for the 11 NCMs seems not to have much effect, so we trust the management's ability to reallocate the asset footprint to allow better production efficiency without significant volume loss. The **2Q24 results** will likely already **reflect the short-term pain for the margin gain only in 2025** as **(i)** workforce terminations and **(ii)** one-off costs of plant shutdowns **drive COGS/t**. We made it clear last quarter that our Buy rating could take some time to impact on the stock price.

It will get worse before it gets better… Trading at an **EV/EBITDA of 4.0x** (vs. a historical average of 5x), considering the **cost cuts the company is already implementing this year to reap benefits in 2025**, we believe the market has not yet fully reflected Gerdau's austerity plan. We emphasize that the short term continues to be challenging with reduced margins and a slowdown in EBITDA in 2024. **Our focus is on the expected margin increase for 2025, not the immediate challenges of 2024.** Therefore, we reiterate **our BUY rating** with a **12M Target Price** of **R$23.40**, reflecting an **upside** of **+29.78%.**

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**

Disclosure Section

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Genial Rating

	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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