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GERDAU

Investor Day 24: Triggers are evident, but CAPEX generate suspicion

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Company

GGBR4 BZ Equity
Buy

Price: R$ 19.18 (04-Oct-2024)
Target Price 12M: R$ 23.40

Main takeaways:

(i) CAPEX curve has been updated, excluding the period already invested between 2021-2023. The **new adjusted guidance** totals **R$9.2bn** (2024-2027+); **(ii)** Investor criticism of the way CAPEX is being disclosed; **(iii) Brazil BD** investments remain the main focus; **(iv)** The Miguel Burnier mine project (MG) aims to generate incremental EBITDA of +R$1.9bn and BQ2 project in Ouro Branco (MG) will add +250Ktpy to HRC production line, with CAPEX of R$1.5bn (~90% already invested). The project's incremental EBITDA is +R$400mn (+16% vs. Brazil BD LTM EBITDA); **(v) North America BD:** Flexible and growth-oriented portfolio; **(vi)** Cyclical conditions vs. increased competitiveness; **(vii)** A subtle shift in CAPEX has been announced for downstream capacity expansion; **(viii)** Diversification and excellence in **Special Steel**; **(ix)** EBITDA already incorporated vs. potential (we give more details throughout the report); **(x)** Leverage remains lower than in previous downturns; **(xi)** Dividend policy vs. share buyback program (further explore on the "Our Take" section); **(xii)** Gradual improvement in the US; **(xiii)** Market valuation excessively discounted; **(xiv)** Triggers are evident: cost reduction at Brazil BD due to the hibernation of the Barão dos Cocais (MG) and Maracanaú (CE) plants, which should generate gains of **~R$1bn in EBITDA 25E**, as well as an improvement in demand at North America BD via a reduction in interest rates by the FED in the USA; **(xv)** Trading at an **EV/EBITDA** of **4x** (vs. historical average of 5x), we reiterate our **BUY rating**, with a **12M Target Price** of **R$23.40**, reflecting an **upside** of **+22%**.

On October 3rd and 4th, we participated in another edition of **Gerdau's Investor Day**. Divided into two days of events, the **first day focused on a presentation** by management on short-term trends and plans for the future. On the **second day** we visited the **Araçariguama mill (SP)**, which has a 900Ktpy melt shop, using an electric arc furnace (EAF), through the infusion of scrap as an input for the metal charge. Its rolling capacity is 550Ktpy.

A little more about the Araçariguama plant. The plant has ~400 own employees + 100 outsourced employees and works 3 shifts from Monday to Saturday and 2 shifts on Sundays. We also saw the plant's Shredder, an equipment used to process, separate and cut scrap metal so that it can go into the furnace at the melt shop. The shredder at the Araçariguama (SP) plant is the second largest in the world, with the capacity to process 500Ktpy of scrap, coming from a yard that receives more than 1Mtpy of recycled input from different decentralized suppliers (old iron, industry, small scrap collectors, etc). Although it's a smaller plant than the one in Ouro Branco (MG), which we visited on Investor Day last year, the level of automation and concern for work safety impressed us once again.

CAPEX curve has been updated, excluding the period already invested between 2021-2023. Gerdau's strategic CAPEX, initially projected at R$11.9bn between 2021-2026 at the 2023 Investor Day, has already seen 53% invested, with a focus on three main areas: **(i)** North America, **(ii)** Special Steels and **(iiii)** Brazil. In North America, the highlight is the Midlothian (TX) roadmap, with R$1.5bn invested. In the Specialty Steel division, the continuous casting and scrap processing projects have accumulated R$1.8bn. In Brazil, the BQ2 project at the Ouro Branco mill (MG) and sustainable mining in Miguel Burnier (MG) lead the way with R$3.2bn. The **new adjusted guidance** totals **R$9.2bn**, with 37% already invested. The main changes include downstream projects in North America (R$450mn of CAPEX) and readjustment of forestry investments in Brazil (+R$350mn of CAPEX vs. only +R$50mn of incremental EBITDA).

Investor criticism of the way CAPEX is being disclosed. The guidance updated by Gerdau's management did not show clarity as to the directional vector of the CAPEX forecast in relation to the same indicator presented in the past. Investors have been wary of this variable for some time now. As we have already published in previous reports, since the curve was initially presented in its first version, we maintain our upward bias for expected CAPEX under the assumptions used in last year's Investor Day report, which is attached (Stakeholder Day 2023). We recall that our bias proved to be assertive, since the future assumption in last year's event report was that realized CAPEX would be higher than indicated, and therefore assumed a conservative view of the company's capacity to generate FCF.

Brazil BD: Current low profitability must be reversed

Brazil BD investments remain the main focus. The company's future expectations are centered on the start of operations at the Miguel Burnier mine (MG), which will add a capacity of +5.5Mtpy of pellet feed, with iron ore quality of 65% Fe (maintaining the same parameters presented at last year's Investor Day). The mine is located ~13km from the Ouro Branco mill (MG), Gerdau's largest capacity plant in Brazil, and has the potential to guarantee self-sufficiency in the unit's blast furnace, as other mines go into depletion and the mix loses the quality needed to generate the burning power of the injected coke. According to the company's management, the mine would have the capacity to produce even more, positioning Gerdau as a player in the mining sector. However, this expansion is not among the priorities for the short term.

How much incremental EBITDA will the projects generate? The Miguel Burnier mine project (MG) aims to generate incremental EBITDA of +R$1.9bn and has a certified reserve with a capacity of 40 years until exhaustion. The mine and plant will be integrated by a pipeline, reducing logistical costs. Although the presentation of the project was nothing new (had already been commented on last year), Gerdau emphasized the strategic importance of its execution, since it is one of the projects that consumes the most of the company's CAPEX budget, reaching R$3.2bn (~35% vs. total CAPEX). Exploring further, the BQ2 project in Ouro Branco (MG) will add +250Ktpy to a new hot-rolled coil (HRC) production line, with CAPEX of R$1.5bn (~90% already invested), which is due to start up in January 2025 and has a total ramp-up of 5 months.

When asked if Gerdau would use 100% of its capacity in the short term, the company's CEO, Mr. Gustavo Werneck, replied to us that there are constant efforts by Comercial Gerdau, with long-term clients who have the need to buy HRC along with other more finished products. Therefore, the company feels that there is considerable demand from specific customers, in order to ensure that all capacity would be taken up with orderbook, even in the face of a more competitive market with imported flat steel product range. The project's incremental EBITDA is +R$400mn (+16% vs. Brazil BD LTM EBITDA). The company also detailed the R$1.7bn still to be invested in rolling capacity, expanding it by +500Ktpy and generating an incremental EBITDA of +R$250mn.

North America BD: currently the most profitable division with promising prospects

Flexible and growth-oriented portfolio. In the presentation, Mr. Chia Wang, Executive Director of North America BD, commented that massive investments in infrastructure and clean energy projects in the US create a favorable environment for the expected demand for steel, and this is compounded by the fact that Gerdau is becoming more resilient in the face of competition due to portfolio diversification. By 2024, the change in mix is already evident, with rebar representing only 1/8 of sales. Gerdau also excels in sustainability, with 96% of its steel produced from recycled scrap, 98% of water reused and the recent installation of an 80MW solar park in Texas. We therefore believe that the company has consolidated its position in North America with a better mix, although it continues to focus on long steel, where we believe there are good demand opportunities for 2025. This is because the FED's dovish economic tilt is underway and Gerdau's exposure in the US, which is through the infrastructure and non-residential construction sectors, is closely correlated with trends that are currently in vogue.

Two key points make us bullish looking ahead to 2025. We believe that two factors are key to the increase in demand for North America BD: **(i)** the interest rate cut cycle, which began with -50bps (vs. -25bps in the consensus), with a more aggressive intensity than we had expected and **(ii)** a reduction in uncertainty with a definition of the electoral race (Donald Trump vs. Kamala Harris). We expect a further cut of -50bps by the end of the year, bringing the FED rate to the 4.25-4.5% range. The interest rate, which until then had been too high by the standards of the US economy, interfered with the reading of the manufacturing PMI, which tends to break through the 50pt barrier next year. In addition, with the election period coming to an end, the new government's economic policy will become clearer to businesspeople and investors, who are currently holding off on capital allocation decisions and this is putting a temporary damper on steel demand.

Cyclical conditions vs. increased competitiveness. Mr. Wang made it clear that Gerdau maximizes its installed capacity through operational flexibility relative to the cyclical conditions of the economy and continuous investments in CAPEX to increase efficiency and competitiveness, aligning these investments with decarbonization goals. In line with this discourse, Mr. Werneck also mentioned during the presentation that today Gerdau competes on a level playing field with the main mills in the US, either by virtue of increased operational efficiency or by using digital tools as facilitators of experiential integration for clients.

A subtle shift in CAPEX has been announced for downstream capacity expansion. With a focus on the Petersburg (VA), Midlothian (TX) and Cartersville (GA) plants, the CAPEX initiatives of recent years include **(i)** expanding the production of beams in Petersburg to meet growing demand, **(ii)** increasing the production capacity of wide flange profiles in Midlothian and **(iii)** producing the line for solar supports, reinforcing the company's position in the renewable energy sector in the USA. The transformation journey, which began in 2017, is now at an advanced stage.

Unlike in the past, when projects such as the expansion of the Midlothian (TX) plant by +250Ktpy and the modernization of the Monroe (MI) plant by +200Ktpy were in the early stages, many are now significantly underway or completed (Midlothian has ~40% of the R$1.5bn CAPEX already invested). As a result, there are clearer expectations of additional EBITDA generation. For Midlothian's roadmap, the company expects +R$500mn in incremental EBITDA. For Monroe, which has already been 100% completed, the potential EBITDA gain is +R$400mn. Also, in order to further improve downstream capacity following a market trend, Gerdau chose to officially announce, during the event, the addition of +R$450mn of CAPEX for North America BD, with ~50% already disbursed to date. This investment could generate +R$250mn of incremental EBITDA.

Special Steels: Scenario improving in the US, but may decline in Brazil

Diversification and excellence in Special Steel. Gerdau leads the Special Bar Quality (SBQ) market in the Americas, with a production capacity of 1.2Mtpy of crude steel and a diversified portfolio that serves more than 300 clients, mainly in the automotive and industrial sectors. The automotive sector accounts for ~80% of SBQ deliveries, with half going to heavy vehicles in Brazil and 80% to light vehicles in the USA. Despite the risks identified earlier, such as the strike by UAW unionized workers in the US, the scenario for 2024 is more stable and we expect a recovery in 2025 with the fall in interest rates (FED rate), coupled with accelerated growth in demand for electric and hybrid vehicles. On the other hand, in Brazil, it is possible that this new cycle of increases in the SELIC rate will mainly hinder progress in the heavy vehicle segment, which had ANFAVEA's outlook for growth of ~30% y/y in 2024, calculated at the beginning of the year on a very weak 2023 base.

CAPEX in Special Steel. Gerdau is investing R$750mn in the Monroe (MI) plant in the USA, increasing its production capacity by +195Ktpy. Part of this amount is related to investments in the melt shop, which have already been completed between 2020-2021, generating an increase in production to 83t/hour (+30% vs. previously). Now, the rest will be allocated to the Cold-end part during 2024-2025, which should reduce the cost of converting raw materials into final products by ~15%. This investment is part of a strategic plan to meet the growing demand for hybrid and electric vehicles in the North American market. Previously only projected, CAPEX at Monroe is already generating visible results, in line with the operational efficiency and emissions reduction strategy, reaching 0.63t of CO_2 per 1t of steel produced (vs. 0.89t previously).

Capital allocation: CAPEX remains the central point of discussion

EBITDA already incorporated vs. potential. The projects completed so far should generate +R$1.4bn to EBITDA, according to the company's view, with North America contributing +R$500mn, and Brazil +R$1.1bn. On the other hand, we believe that this value is already integrated into Gerdau's current results. On the other hand, the total incremental EBITDA potential of the projects that have not yet been completed is +R$2.75bn annually (vs. R$9.2bn of CAPEX). The payback after the assets are generating this level of EBITDA would be ~3.3 years, which seems reasonable to us. We think that projects such as the Midlothian (TX) roadmap, the Whitby (ON) melt shop and the continuous casting plant in Pindamonhangaba (SP) are examples of how Gerdau intends to leverage growth with greater operational efficiency and lower costs. Even so, from what we spoke to investors after the event, many are still wary of a high level of strategic CAPEX in the short term (~R$2.5bn in 2024 and ~R$2.8bn in 2025), which should weigh negatively on FCF.

Leverage remains lower than in previous downturns. The company's trajectory is highlighted by its financial and operational resilience, even in challenging cycles. The **(i)** consistent reduction in indebtedness, which fell to R$5.9bn 24E (vs. R$19.5bn in 2015), and the **(ii)** improvement in the Net Debt/EBITDA ratio, which downtrend to 0.53x (vs. 4.24x previously), reinforce the company's financial discipline with gains in profitability promoted by investments in the diversification of the mix and in production efficiency. We highlight that Gerdau continues to have a strong liquidity position, with R$6.6bn in cash and equivalents and a comfortable average debt maturity of 7.2 years. In addition, the debt structure is well distributed, with 65% in USD, which provides flexibility and lower funding costs.

Mr. Rafael Japur, Gerdau's CFO, also emphasized strict management of the cost of debt (Kd), with an average of 106.7% of the CDI for domestic issues in BRL and 5.5% for bonds issued in USD, consolidating its stable financial position, with credit risk more closely following the yield curve of US treasury bonds, while its peers in Brazil (Usiminas and CSN, for example) have a higher Kd. In this way, we see Gerdau's capital structure being more comparable to Nucor and ArcelorMittal (international players). We note that the company's bonds mature between 2027-2044, and the debentures have maturities up to 2029, which seems to us to be a profile with a satisfactory average term.

Our Take on Gerdau

Dividend policy vs. share buyback program. With regard to capital allocation, Mr. Japur mentioned that the company remains focused on guaranteeing shareholder returns, with a minimum dividend policy of 30% of net income (+) the share buyback program, which aims to generate value for shareholders who remain positioned in the company for the long term. The share buyback program is active until August 2025, with the highlight being the investment of R$348mn until September 2024 (ex. Metalúrgica Gerdau - GOUA4), representing 27% of the total or 0.9% of the Market Cap. We continue with our projection of a **24E Dividend Yield** of **5.5%** (which is low compared to the company's payout potential for 2025).

Even so, we believe that the company will have to accelerate the pace of buybacks if it wants to get close to 100%, as there are 11 months left until the end of the program and 73% of the 69 million shares still to be repurchased. The challenges to accelerating the pace lie in the **(i)** moderately high CAPEX in the short term, **(ii)** weak profitability cycle for steel in Brazil BD and **(iii)** short-term delay for the FED rate cut to hit steel consumption in the US. The three factors mentioned make it difficult to generate FCF, and therefore reduce room for more aggressive buybacks, although we agree with Mr. Japur that Gerdau's shares are excessively discounted and penalized beyond what is fair.

Gradual improvement in the US. We see North America BD as well positioned to capture medium-term value from its diversified long steel portfolio, with the US economic recovery, driven by the sequencing of interest rate cuts expected by the Fed, as well as the trend of consolidation of new projects after the US elections, although we maintain our projection that the metal spread tends to regress to a value a little closer to the historical average (it will be above average in 2025, but not at the current level).

Market valuation excessively discounted. During the presentation, Mr. Japur drew attention to a revaluation perspective for Gerdau, comparing the market valuation with the implied potential based on LTM EBITDA up to 2Q24. By applying FV/EBITDA multiples more in line with global peers for each business division (**5.8x** for **Brazil BD**, **6.7x** for **North America BD**, **3.3x** for **South America BD** and **4.2x** for **Special Steel**) and summing the parts, Gerdau sees a possible +50% appreciation in its Firm Value (FV), which suggests a market undervaluation relative to the current share price. As we have commented, in support of our view that the **company is in fact being misvalued** by the market at the moment, we believe that if certain factors materialize, the shares will tend to show a considerable upside.

Triggers are evident. The factors that we see as the most obvious triggers are: **(i)** cost reduction at Brazil BD resulting from the plan to cut fixed costs due to the hibernation of the Barão dos Cocais (MG) and Maracanaú (CE) plants, which should generate gains of ~R$1b in EBITDA 25E, as well as **(ii)** an improvement in demand at North America BD via a reduction in interest rates by the FED in the USA. Therefore, the tendency is for the value of the shares to converge to something closer to what we consider fair over the course of 2025 and come to expunge this difference, which, by the way, was well pointed out by management during the Investor Day.

We are confident that Gerdau will be able to consolidate interesting results through the **cost-cutting initiatives**, which promise to generate an additional **+R$1-1.5bn** to **EBITDA 25E** and **26E** (already included in our estimates since the 1Q24 reports). As most of the **footprint relocation** project is in Brazil, the trend is that these anemic margins we see (8.7% in 2Q24) will undergo a strong **expansion** process to **20-22%**. However, the short-term trend is getting worse before it gets better. Expenses with workforce layoffs and one-off costs with the shutdown of old mills increased COGS in 2Q24. However, we believe that Gerdau is taking one step back and then two steps forward, taking advantage of future cost reductions. Therefore, trading at an **EV/EBITDA** of **4x** (vs. historical average of 5x), we reiterate our **BUY rating**, with a **12M Target Price** of **R$23.40**, reflecting an **upside** of **+22%**.

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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under Review	Under review	**5%**

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