Equity Research

GERDAU

3Q24 Preview: Recovery on the horizon!

LatAm Metals & Mining

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Company

GGBR4 BZ Equity
Buy

Price: R$ 18.42 (30-Oct-2024)
Target Price 12M: R$ 23.40

Main takeaways:

(i) For **Brazil BD**, we are projecting a **slightly higher realized price**, reaching **R$5,212/t Genial Est.** (+0.6% q/q); **(ii) shipments should rise** in **Brazil**, projected at **1,258Kt Genial Est.** (+6.2% q/q %; -0.2% y/y); **(iii)** For **North America BD**, we expect **prices pressured by discounts**, reaching **R$6. 545/t Genial Est**. (-1.9% q/q); **(iv)** Distributors are buying again and **shipments will evolve slightly**, projected at **998Kt Genial Est.** (+1.1% q/q; +5.9% y/y); **(v) South America BD**: Peru's positive performance should help offset still weak operations in Argentina. We expect shipments of 263Kt Genial Est. (+5.8% q/q), with flat prices; **(vi) Special Steel:** Light vehicle purchasing momentum in the US is still below what we would like to see. However, improved demand in the heavy vehicle segment in Brazil offset. We project **shipments** of **376Kt Genial Est.** (+0.1% q/q); **(vii)** Projected consolidated **Net revenue** of **R$17.1bn Genial Est.** (+3.1% q/q); **(viii) Brazil COGS/t showing a decline** due to the cooling of the cost of metallurgical coal, reaching **R$4,622/t Genial Est.** (-4.7% q/q); **(ix)** At **North America**, **COGS/t should** rise due to the delay in the scrap cost going through P&L. We expect **R$6,518/t Genial Est**. (+1.6% q/q); **(x) Consolidated EBITDA** reaching **R$2.8bn Genial Est.** (+11.5% q/q); **(xi) Net income** projected at **R$1.3bn Genial Est**. (+34.0% q/q); **(xii) Brazil:** Negotiations with homebuilders continue for **long steel**. We expect a **readjustment of +3%** vs. the mills' demand for +8%; **(xiii) USA:** Attenuation of the metal spread in the short term; **(xiv)** Trading at **3x EV/EBITDA 25E** (vs. 5x historical average), the market valuation does not yet reflect the company's austerity plan. We reiterate our **BUY rating** with a **12M Target Price of R$23.40** and an **upside** of **+27.04%**.

Table 1. Shipments Summary (3Q24 Genial Est.)

(Thousand Tonnes - kt)	Genial Est.	Reported		Reported	
Summary (Shipments)	**3Q24E**	**2Q24A**	**% q/q**	**3Q23A**	**% y/y**
Brazil BD	1.258	1.185	**6,2%**	1.260	**-0,2%**
North America BD	998	987	**1,1%**	943	**5,9%**
South America BD	263	249	**5,8%**	290	**-9,0%**
Special Steel BD	376	376	**0,0%**	345	**8,8%**

Source: Gerdau, Genial Investimentos

Table 2. Income Statement Summary (3Q24 Genial Est.)

(R$ millions)	Genial Est.	Reported		Reported	
Income Statement	**3Q24E**	**2Q24A**	**% q/q**	**3Q23A**	**% y/y**
Net Revenue	17.138	16.616	**3,1%**	17.063	**0,4%**
Adjusted EBITDA	2.803	2.514	**11,5%**	3.171	**-11,6%**
Net Income	1.328	990	**34,0%**	1.592	**-16,6%**

Source: Gerdau, Genial Investimentos

Gerdau is set to announce its **3Q24 results on November 5**, after market closing. We forecast consolidated **Net revenue** of **R$17.1bn Genial Est.** (+3.1% q/q; +0.4% y/y), with **Brazil BD** expected to be the **primary positive driver** this quarter. This performance is supported by an increase in **shipments**, projected to reach **1,258Kt Genial Est.** (+6.2% q/q), alongside a modest recovery in **realized prices** (+0.6% q/q). In contrast, **North America BD** and the **Special Steels** division remain under pressure due to **softer demand and lower price realizations**, particularly in the U.S., where the macroeconomic environment showed signs of contraction amid persistently high interest rates in 3Q24.

We anticipate an adjusted **consolidated EBITDA** of **R$2.8bn Genial Est.** (+11.5% q/q; -11.6% y/y), reflecting a sequential margin expansion to 16.4% (+1.96p.p. q/q). **Net income** is expected to come in at around **R$1.3bn Genial Est.** (+34.0% q/q; -16.6% y/y), showing a **gradual improvement in profitability**. Our key expectation for Gerdau centers on the continued implementation of its **fixed cost reduction strategy**, aimed at margin expansion, especially within its Brazilian operations. This focus, combined with tariff adjustments and a more favorable USD/BRL exchange rate for export volumes, could lead to a steady improvement in Brazil BD's margin, which still faces strong competition from imported steel in the domestic market.

3Q24 Preview: In detail!

Brazil BD: Quota system has proved insufficient. The quota system, implemented by the Ministry of Trade (MDIC) in June with 11 NCMs for flat steel, ended up reducing the parity premium with imported steel specifically for HRC. According to data from S&P Platts, the premium fell to a level of +13% during September (vs. 19% on average for 3Q24), after importers filled 90% of their quotas and the 25% rate came into force (vs. 11.8% previously).

Although this has happened, two points are worrying: **(i)** the low number of NCMs, making it impossible to validate the entire flat steel market based solely on HRC dynamics, and **(ii)** the quota system works on a 4M basis. So, every 4M the quotas are renewed and the tax returns to the 11.8% level until it reaches 90% of the volume filled. In fact, in October the second quartile came into effect and the parity premium went up again.

Brasil BD: Slight increase in prices. Because of the two points mentioned above, the current system of tariff barriers does not yet give us a degree of confidence that the mills will have part of their bargaining power returned to them. As a result, we believe that price adjustments in the portfolio of flat steel products will continue to be a challenge for the company. On the other hand, our analysis indicates that the realization of prices should register a slight increase, justified by the graduation of adjustments in long steel. This movement was supported by data from S&P Platts, which highlighted that in rebar the premium vs. imported steel was marginally positive throughout 3Q24 (+2-3%), thus highlighting the possibility of implementing adjustments, without having to renounce competitiveness. Consequently, we project a slightly better realized price, reaching R$5,212/t Genial Est. (+0.6% q/q; -1.0% y/y). We believe that new adjustments for long steel are being discussed with the construction companies.

Brazil BD: We expect a sequential increase in shipments. For this quarter, we expect an opportunistic reversal of the commercial strategy we saw last quarter, when the foreign market (FM) volume was delivered at a lower level than usual. This expectation of channeling shipments predominantly to exports should be favored by **(i)** the high level of the USD/BRL exchange rate and **(ii)** distributors' appetite for demand due to low price realization.

Therefore, we believe that the volume directed to the FM should be reported at 208Kt (+38.7% q/q; -5.8% y/y). In addition, our expectation is that the domestic market (DM) will continue to show a gradual increase in demand, with an estimated sales volume of 1,050Kt (+1.4% q/q; +1.1% y/y). Thus, looking at the consolidated figure (DM + FM), we project shipments at Brazil BD to reach 1,258Kt Genial Est. (+6.2% q/q; -0.2% y/y), with a sequential increase showing resilience, even in a scenario where the dispute with imported steel remains.

North America BD: Prices remain under pressure. We believe that price realization for North America BD will contract to R$6,545/t Genial Est. (-1.9% q/q; -2.6% y/y). Among the main reasons for the price slowdown are: **(i)** discounts applied to the merchant bars line, which represents ~1/3 of the portfolio; **(ii)** a sales mix with more volume allocated to rebar, with lower added value and **(iii)** a deficit macroeconomic condition for steel demand, in the face of a high interest rate. Although the FED rate was indeed cut by -50bps by the FOMC, reaching a range of 4.75-5% in mid-September, the cut had no effect on demand in 3Q24. We believe that, given the natural delay in the application of the interest rate cut cycle within the real economy, demand for steel in the US should start to rise towards 2Q25.

Until then, it seems to us that the pressure on realized prices in USD will continue. Nucor (Gerdau's peer) recently announced another price cut of -US$120/t (-14% vs. rebar in 3Q24). We believe that Gerdau should follow this cut for 4Q24, so the realized price should continue to downtrend. Nucor claims that the competitiveness of US mills continues to be affected by the influx of imported steel, even with section 232 offering more protection. On a smaller scale, it's a similar situation to what we're seeing in Brazil.

North America BD: Distributors are buying again, and shipments will evolve slightly. Our analysis indicates that distributors, who make up 50% of the company's client base in the US, seem to be starting to place orders again, taking advantage of the scenario of compressed prices in order to accumulate inventories. This can be explained by: **(i)** the concrete retraction in scrap costs, leading mills to come under pressure to cut prices, **(ii)** the high US interest rate, **(iii)** the market share dispute with imported steel. We therefore project shipments of 998Kt Genial Est. (+1.1% q/q; +5.9% y/y).

South America BD: Shipments should rise slightly with flat prices. As a result, for 3Q24, the South America division is expected to increase its shipments sequentially, with Peru dominating in terms of operational relevance, in contrast to Argentina, which is expected to reduce its representativeness.

Although there are some soft signs of improvement, the country still has an unpredictable and highly volatile USD/AR$ exchange rate. Therefore, it is seen as reasonable to assume a sales volume of 263Kt Genial Est. (+5.8% q/q; -9.9% y/y) given this intrinsic reallocation between operations.

Special Steel: USA and Brazil continue in opposite directions. For the Special Steel segment, we expect vectors in opposite directions between the two weightings. For Brazil, we believe it will be a quarter with more demand, especially in the heavy segment, which represents ~50% of the order book. Both for trucks and buses, through the government program "Caminhos da Escola", helping the heavy-duty segment to reach the +32% y/y growth indicated by AFAVEA in 2024. For 2025, our analysis suggests that the segment should grow by +7%, with a less intense expansion, as the 2023 base was very weak. In addition, it is possible that this new cycle of increases in the SELIC rate will influence a drop in the credit supply, leading to a slowdown in 2H25.

In the US, the high interest rate should continue to impact volumes, since the light vehicle segment (~80% of the order book) continues to be in low demand. We understand that the value of new cars is high and that the sales dispute with the used car market is even more competitive than in Brazil. As a result, we expect weak quarters (both 3Q24 and 4Q24), with the reduction in the FED rate only taking effect from 2025, in the opposite direction to what we see for operations in Brazil. In other words, the tendency is for growth in Brazil to cancel out the decline in the US in the short term.

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

(R$ millions)	3Q24E Genial Est.	2Q24A Reported	% q/q	3Q23A Reported	% y/y
Net Revenue	**17.138**	**16.616**	**3,1%**	**17.063**	**0,4%**
Brazil BD	6.557	6.142	6,8%	6.635	-1,2%
North America BD	6.532	6.587	-0,8%	6.332	3,2%
South America BD	1.489	1.405	6,0%	1.566	-5,0%
Special Steel BD	2.865	2.853	0,4%	2.771	3,4%
Eliminations	(305)	(371)	-17,8%	(242)	26,2%

Source: Gerdau, Genial Investimentos

Net Revenue: Good sales momentum. We project consolidated Net revenue of R$17.1bn Genial Est. (+3.1% q/q; +0.4% y/y), driven by multiple trends in the business units. We expect a slightly negative performance at North America BD and an improvement in the Brazil, South America and Special Steel divisions. For Brazil BD, we project net revenue of R$6.5bn (+6.8% q/q; -1.2% y/y), supported by both higher prices and shipments. At North America BD, we estimate net revenue of R$6.5bn (-0.8% q/q; +3.2% y/y), justified by the improvement in distributors' purchasing impetus, but erased by less than desirable price realization.

In South America BD, we project revenues of R$1.4bn (+6.0% q/q; -5.0% y/y) driven mainly by the good performance of operations in Peru, offsetting the challenging scenario in Argentina. Finally, in the Special Steel division, we estimate revenues of R$2.8bn (+0.4% q/q; +3.4% y/y), which is mainly explained by the vectorial ambiguity between Brazil and the USA.

Brasil BD: COGS/t down reflecting operational readjustment. Brazil's BD COGS/t is expected to fall, with the company gaining operational efficiency due to: **(i)** the fall in costs arising from metallic inputs added to **(ii)** the contraction in the price of metallurgical coal. These two factors offset **(iii)** severance costs arising from the relocation of employees incorporated by the effects of the plant's hibernation. Even so, to our surprise, when we spoke to the company, we had the feeling that there could be a partial compression in 3Q24, already reflecting the cost-cutting plan. In this context, we reached a COGS/t of R$4,622/t Genial Est. (-4.7% q/q; -2.7% y/y).

North America BD: COGS/t impacted by delay and stoppages. For operations in North America, we believe that costs will end up expanding due to two main points: **(i)** the delay in passing on the P&L cost for ferrous scrap. We would point out that although the availability of scrap has indeed increased in the US, thus resulting in a spot contraction, on the other hand we will probably only see this reduction effect in the following quarter. In addition, this quarter will be credited with **(ii)** an increase in maintenance costs, impacted by stoppages planned by the company. Given this scenario, it is plausible to assume a COGS/t of R$5,531/t Genial Est. (+0.7% q/q; +3.9% y/y).

South America and Special Steels BD: COGS/t in opposite directions. If, on the one hand, South America BD shows a reduction in costs to R$4,594/t Genial Est. (-5.9% q/q; +12.5% y/y), on the other hand the Special Steel division will probably suffer a mild setback to R$6,518/t Genial Est. (+1.6% q/q; -4.1% y/y). This should occur since the inputs will be processed through the P&L at an increased value.

Table 4. EBITDA Gerdau (3Q24 Genial Est.)

(R$ millions)	3Q24E Genial Est.	2Q24A Reported	% q/q	3Q23A Reported	% y/y
Adjusted EBITDA	**2.803**	**2.514**	**11,5%**	**3.171**	**-11,6%**
Brazil BD	945	534	77,0%	868	8,9%
North America BD	1.122	1.289	-13,0%	1.376	-18,5%
South America BD	299	227	31,6%	502	-40,5%
Special Steel BD	492	541	-9,2%	475	3,4%
Eliminations	(53)	(77)	-30,8%	(51)	5,2%

Source: Gerdau, Genial Investimentos

EBITDA showing recovery. We project an adjusted EBITDA of R$2.8bn Genial Est. (+11.5% q/q; -11.6% y/y), reaching a margin of 16.4% (+1.96p.p q/q; - 2.86p.p y/y). Brazil will be the business unit that will contribute the most, reaching an EBITDA of R$945mn (+77.0% q/q; +8.9% y/y), mainly due to the decompression of COGS/t, an increase in shipments and a slight improvement in the realized price. North America BD has an estimated EBITDA of R$1.1bn (-13.0%; -18.5%) and is expected to show a slowdown in results due to the drop in realized price and the increase in COGS/t, factors that should not be offset by the timid increase in shipments.

As for South America BD, we believe that the better performance of operations in Peru should provide support for volume increases and cost-cutting initiatives will probably be sharper, leading to an acceleration in estimated EBITDA to R$299mn (+31.6% q/q; -40.5% y/y). The Special Steel unit is marked with an EBTIDA of R$492mn (-9.2% q/q; +3.4% y/y), with the still sluggish demand in the automotive segment in the US not entirely offset by increased shipments in Brazil.

Net income accelerating sequentially. It is understood that the financial result will have a slight decompression, reaching our estimate of -R$367mn (vs. -R$373mn in 2Q24). Based on that, it is elementary to assume a positive variation in net income, which is projected at R$1.3bn Genial Est. (+34.0% q/q; -16.6% y/y).

Table 5. Income Statement Gerdau (3Q24 Genial Est.)

	3Q24E	2Q24A		3Q23A	
(R$ millions)	**Genial Est.**	**Reported**	**% q/q**	**Reported**	**% y/y**
Net Revenue	**17.138**	**16.616**	**3,1%**	**17.063**	**0,4%**
COGS	(14.697)	(14.429)	1,9%	(14.271)	3,0%
Adjusted EBITDA	**2.803**	**2.514**	**11,5%**	**3.171**	**-11,6%**
EBITDA Margin (%)	16,4%	15,1%	1,23p.p	18,6%	-2,22p.p
EBIT	**1.904**	**1.519**	**25,3%**	**2.384**	**-20,1%**
EBIT Margin (%)	11,1%	9,1%	1,96p.p	14,0%	-2,86p.p
D&A	(814)	(771)	5,5%	(789)	3,2%
Financial Result	(367)	(373)	-1,6%	(478)	-23,2%
Net Income	**1.328**	**990**	**34,0%**	**1.592**	**-16,6%**
Net Margin (%)	7,7%	6,0%	1,79p.p	9,3%	-1,58p.p

Source: Gerdau, Genial Investimentos

Our Take on Gerdau

Dividend policy and share buybacks. We project a minimum 30% payout for dividends, combined with an ongoing share buyback program. Up to September 2024, R$348mn was invested (excluding GOUA4), equivalent to 27% of the total or 0.9% of the market cap. Our projected **Dividend yield 24E** remains at **5.5%**, which, though conservative, could increase significantly in 2025. However, several factors contribute to some caution: **(i)** high short-term CAPEX, **(ii)** the delay in U.S. interest rate cuts by the Fed, and **(iii)** only partial reversal of low profitability in Gerdau's Brazilian operations. Net-net, these challenges could constrain FCF in the short term, potentially limiting more aggressive buybacks, despite the view that Gerdau's shares are significantly undervalued.

Brazil: Negotiations with homebuilders continue. In Brazil, we expect the cost-cutting program to lead to a strong margin expansion in 2025. On the other hand, faced with a demand for housing construction that is still very dependent on low-income projects that adhere to the Minha Casa, Minha Vida (MCMV) program, the mills are still discussing price increases with the homebuilders, without a concrete definition.

Considering that the new high- and middle-income projects are slowing down and should have a more compressed demand scenario due to the SELIC increase cycle, we understand that there will be accommodation of adjustments to the price of long steel with construction companies at a level that still doesn't recover the profitability of the **mills**, which **are asking for adjustments** of **+8%**. However, we expect the round of price increases to be **only +3%**. Our expectations are intertwined in a challenging environment that is sensitive to this operating performance, in the face of a premium vs. imported steel that remains low for the long segment. In this case, it seems to us that demand has been the problem.

US: Attenuation of the metal spread in the short term. Improvement in 2Q25. 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 from the FED, as well as the consolidation trend of new projects post-US elections. This should take shape from 2Q25 onwards, improving demand for steel and generating potential for price recovery after successive discounts.

On the other hand, we reiterate our view that the metal spread should shrink as early as 3Q24 due to the difficulty Gerdau is already facing in being able to pass on prices even when the scrap costs slow down. It is worth remembering that, even if the metal spread compresses a little, we still believe that it will remain above the historical average, just at a cooler level than the current margin, which we feel is excessive given the tighter market conditions.

Market valuation is excessively discounted. During his presentation at the Investor Day held at the beginning of October, Mr. Rafael Japur (Gerdau's CFO) drew attention to a revaluation perspective, comparing the market valuation with the implied potential based on LTM EBITDA for 2Q24. By applying FV/EBITDA multiples more in line with global peers for each business division (**5.8x** for **Brazil**, **6.7x** for **North America**, **3.3x** for **South America** and **4.2x** for **Special Steel**) and summing the parts, Gerdau sees a possible +50% appreciation in its enterprise 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.

Value Triggers. The main value triggers we identify include: **(i)** implementing the fixed cost-cutting plan, with hibernations at the Barão dos Cocais (MG) and Maracanaú (CE) mills, projected to increase EBITDA by +R$1bn in 2025, and **(ii)** U.S. demand recovery fueled by FED interest rate cuts, benefitting Gerdau North America. With these factors materializing, we expect Gerdau shares to align with a fairer valuation throughout 2025.

Recovery on the horizon! Although cost pressures remain high considering the historical record, and operational adjustments should only have a **full impact in 4Q24**, our expectation is that **3Q24** will continue to be a quarter of adjustments, but **already showing a gradual improvement**. We believe that Gerdau is taking the necessary steps for a solid recovery in the medium term. Trading at an **EV/EBITDA 25E** of **3x** (vs. historical average of 5x), we reiterate our **BUY rating**, with a **12M Target Price** of **R$23.40**, reflecting an **upside** of **+27.04%**.

Appendix: Gerdau

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

Income Statement	2024E	2025E	2026E	2027E	2028E
Net Revenue	**65.953**	**67.829**	**66.093**	**65.557**	**65.344**
(-) COGS	(56.337)	(55.654)	(53.917)	(53.106)	(52.033)
Gross Profit	**9.616**	**12.174**	**12.177**	**12.451**	**13.312**
(-) Expenses	(2.441)	(3.023)	(2.957)	(2.940)	(2.933)
Adjusted EBITDA	**10.897**	**14.226**	**14.507**	**15.010**	**16.073**
(-) D&A	(3.011)	(3.853)	(4.098)	(4.319)	(4.518)
EBIT	**7.394**	**9.830**	**9.880**	**10.167**	**11.032**
(+/-) Financial Result	(1.099)	(453)	(342)	(50)	142
(-) Taxes	(880)	(1.275)	(1.296)	(1.375)	(1.533)
Net income	**5.416**	**8.102**	**8.241**	**8.742**	**9.641**
Profitability					
Net margin (%)	8,21%	11,94%	12,47%	13,33%	14,75%

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

Cash Flow (FCFF)	2024E	2025E	2026E	2027E	2028E
Net Revenue	**65.953**	**67.829**	**66.093**	**65.557**	**65.344**
(-) COGS	(56.337)	(55.654)	(53.917)	(53.106)	(52.033)
Adjusted EBITDA	**10.897**	**14.226**	**14.507**	**15.010**	**16.073**
EBIT	**7.394**	**9.830**	**9.880**	**10.167**	**11.032**
(-) Taxes	(880)	(1.275)	(1.296)	(1.375)	(1.533)
(+) D&A	3.011	3.853	4.098	4.319	4.518
(+/-) Δ WK	(663)	(260)	194	99	143
(-) Capex	(5.615)	(5.676)	(5.739)	(5.802)	(5.866)
FCFF	**3.248**	**6.473**	**7.137**	**7.407**	**8.295**

Disclosure Section

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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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