Q1 2018 Earnings Call

Company Participants

- Gustavo Werneck da Cunha, President and Chief Executive Officer
- Harley Lorentz Scardoelli, Chief Financial Officer & Executive Vice President

Other Participants

- Carlos F. De Alba, Analyst
- Ivano Westin, Analyst
- Leonardo Correa, Analyst
- Marcos Assumpção, Analyst
- Milton Sullyvan, Analyst
- Thiago Lofiego, Analyst
- Thiago Ojea, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon and welcome to Gerdau's Conference Call to discuss the results relating to the first quarter of 2018. At this time, all participants will be on listen-only mode; and later on, we will initiate the question-and-answer session.

We would like to emphasize that any forward-looking statements that might be made during this conference call related to Gerdau's business outlook, projections, and financial and operating goals are mere assumptions based on management's expectations related to the future of the company.

Even though Gerdau believes that its comments are based on reasonable assumptions, there is no guarantee that future events will not affect this evaluation. Here today are Mr. Gustavo Werneck, Director, President, and CEO of the company; and Harley Scardoelli, Vice President and CFO.

With no further ado, I would like to turn the floor to Mr. Gustavo Werneck. You may proceed, sir.

Gustavo Werneck da Cunha {BIO 20318216 <GO>}

Good afternoon, everyone. I would like to start by welcoming you to our conference call to discuss the results of the first quarter 2018. As you know, this is the first quarterly report under my administration since I took over as CEO since January. But to begin with, I would like to tell you about some of the main highlights of Gerdau's transformation path and the outlook for the market where we operate.

Next, Scardoelli, sitting next to me, will elaborate on Gerdau's financial performance. And at the end, we will be available to take your questions.

Moving on to slide 2. To begin, let me comment on Gerdau's highlight in the first three months of 2018. The quarter ended with good results, reflecting management efforts carried out by our teams in the last few years and also improvements in the market where we operate. As you can tell from this slide, we grew shipments and net sales. Adjusted EBITDA also grew significantly. And more importantly, we managed to revert the adjusted negative result of BRL 34 million at the same period of the previous year, reaching BRL 451 million of adjusted net income in the first three months of 2018.

How do we manage that? Well, first of all, we remained focused on our priorities to grow profitability and competitiveness of our business operation and also to lower our debt position. At the same time, we took advantage of the commercial opportunities in the market.

This quarter, we were also very stringent in terms of investments, and our CapEx amounted to BRL 270 million. We lowered our SG&A in relation to net sales and generated positive free cash flow of BRL of 65 million. Moreover, we are about to conclude our divestment plan started back in 2014 that already totaled BRL 6.3 billion.

As for indebtedness, our net debt over EBITDA ratio is 2.7 times this quarter and I would like to remind you that at the end of the fourth quarter 2017, you might recall that figure this ratio was 3 times. Therefore, we are paving the way to resume growth. All of these achievements are based on the transformation of our business culture that allowed us to be simpler, more independent, and agile.

I would also like to say that we are also engaging in partnerships with relevant companies in the markets where they have expertise. This is the case of our joint venture called Gerdau Summit located in the town of Pindamonhangaba in São Paulo. It's a partnership with two Japanese companies, Sumitomo and Japan Steel Works. At present, the construction of the plants that we produce parts to wind farm industry is already concluded. The equipment and machinery are being installed according to the schedule and investments are lower than anticipated. Production should start-up in June and the licensing process with customers is already in motion.

We are also encouraging our people to submit innovations in all areas, but most of the times are unprecedented initiatives in our market. And now our next step is to accelerate Gerdau's digital transformation in order to better serve our customers and also help them grow. We already have a series of initiatives in motion. But let me just mention an example. Approximately 70% of fabricated rebar orders from construction companies in Brazil is already placed electronically. We are now expanding this platform to serve customers of flat steel.

Another interesting example that is important to mention comes from the special steel operation for the development of new products or the improvement of existing ones. To give you an idea, for every new product we produce, we have to understand demand, we have to evaluate the technical capacity and commercial feasibility to produce these products. This analysis involves dozens of consultations, more than 40 technical variables, and about 8,000 references.

The average time necessary to drive a final response was approximately 10 days, but now we are using artificial intelligence, and the pilot project arrives at a production feasibility response in a matter of seconds without compromising the safety and quality of the analysis. We continue to invest in automation and deployment of IoT in our equipment always aiming in reducing cost than increasing efficiency.

Now, let's move to next slide, slide 3, when I will talk about the market outlook. The outlook remains positive in all the markets we operate. More recently, the World Steel Association published a new forecast for steel demand in the world for 2018 indicating a 1.8% growth over 2017 despite the significant install access capacity worldwide that has historically impacted margins in the industry as you well know.

This percentage from World Steel Association also includes demand growth in developed and emerging countries except China where levels should remain stable this year. As for Brazil, we believe that the gradual recovery of the economy will continue, but we are prepared to face some possible volatility throughout the year, due to the next coming election.

According to Instituto Aço Brasil, and I think you read the vast numbers that were published, domestic sales in the country should increase 6.6% in 2018. We already view the gradual rebound of the industry, even though it's gradual, and we expect a slight increase in residential civil construction starting in the second half of the year. It's also very important to mention that, at Gerdau, we are ready to cater to the growing demand for steel in Brazil. But until then, we will continue to export part of our production. As for exports, prices remain flat, but higher when compared to that of previous years.

Now, speaking about the U.S. market, I would like to mention a 35% reduction in long steel imports during the first quarter of 2018. At the same time, we had to face higher costs of scrap and other inputs that normally increase during the winter season. And in 2018, the winter season was longer than usual. But also, I must say that the outlook is still very good, and we will continue to work hard to improve our margins even further.

Looking forward, 2018 is supposed to post a solid demand particularly coming for civil construction and the industry segments throughout the year. The World Steel Association, for instance, estimates that demand in the U.S. should grow 3% in 2018. Also, I would like to take this opportunity to mention the recent appointment of the new CEO of Gerdau in the region. It is Chia Wang, an executive with longstanding and successful career in Gerdau, and he previously served as Procurement VP.

Moving now to Specialty Steel (sic) [Special Steel] (10:28) segment, we believe that the automotive industry in Brazil and export should increase in 2018. ANFAVEA for instance has indicated that automotive output should grow 13% this year vis-à-vis 2017. And in view of this scenario, in March, we reactivated the melt shop of our unit in Mogi das Cruzes in São Paulo to – in order to serve the automotive market.

Now, in terms of the special steel market in the United States, automotive production should continue to continue grow, especially when it comes to the heavy vehicle segment. In addition, the oil and gas market tends to gain momentum throughout the year, and the demand for agriculture and construction machinery should also increase. I would like to remind you the demand in India continues to grow.

Now, looking at the other South American countries, the outlook also points to economic growth in the region, and I would especially mention Peru, Colombia and Argentina.

Now, moving to slide 4, I would like to comment on investments that occur this first quarter of 2018. Of the amount invested, 43% was allocated to Brazil, 37% went to North America, and in both cases, we exclude the special steel mills. 15% went to Special Steel BD, including the mills in Brazil, the U.S. and India, and 5% went to other countries in South America.

There is something new that I would like to share with you. In March, the board approved one of the main investments of 2018. They are the expansion of the production capacity and the technological update of our Monroe mill in the U.S. that produces special steel. The investment amounts to BRL 240 million, reinstating our commitment to the important automobile market in North America. And at the end of the investment, the Monroe mill will be capable of producing 720,000 short tonnes of steel a year.

CapEx projected for 2018 remains BRL 1.2 million (sic) [BRL 1.2 billion] (13:07), focused on improving performance and the maintenance of our operations.

With that, I conclude the first part of the presentation. I will give the floor to Scardoelli. I will come back to you at the end of Scardoelli's presentation.

Harley Lorentz Scardoelli {BIO 7283603 <GO>}

Thank you, Gustavo, and good afternoon to you all. I will now talk about our results and performance in the first quarter of 2018 starting on slide 6, where we analyzed the EBITDA of the quarter. In terms of consolidated, adjusted EBITDA reached BRL 1.5 billion. And if you look at the chart on the upper part of the slide, we will notice the evolution of adjusted EBITDA, which margin went from 10.1% in Q1 2017 to 14.3% in Q1 2018. This positive evolution in the EBITDA margin and EBITDA is mainly due to improved performance in all of our business divisions, led by the Brazilian BD.

It is also important to notice the continuous growth of EBITDA since the first quarter of 2017. These results, the results that we are presenting, really illustrate our efforts to improve margins such as the significant reduction in SG&A that used to account for 5.2% of net sales in the first quarter of 2017, and is now down to 4% this quarter.

If we look back and look at the numbers in 2008, this figure was something like 7% of net sales. So, in fact, even with a drop in net sales during the period, we were able to increase significantly in terms of reducing our SG&A. Another important aspect that is important to mention is that in terms of EBITDA margin, this quarter, we had the best margin in the last seven years. The last time we had a strong margin was back in 2007. And in terms of total figures, this is certainly the best quarterly EBITDA in the past eight years. It was only back in 2010 that we had such strong figure. So, it's important to highlight this aspect.

Now, moving to page 7, the next slide, we just added to what was previously said. So, in this bridge chart, on the upper part of the slide, we look at the evolution of EBITDA from the first quarter of 2017 to first quarter of 2018. And we notice an increase in net sales per tonne that more than offset the higher cost per tonne. It's also important to mention that our operation managed to improve margin successfully despite all of the pressures we had in terms of our inputs in the period.

Another important assessment is looking at the bridge chart on the lower part of the slide. We see that we went from a negative adjusted result of BRL 34 million in the first quarter of 2018 (sic) [2017] (16:34) to an adjusted net income of BRL 451 million in the first quarter of 2018, and that was mainly due to EBITDA improvement in addition to lower financial expenses. Also, I must say that this came as a consequence of reduction in financial expenses because of lower debt [ph] via (16:57) cash generation and liability management transactions that we had when we restructured our debt and everything happened in the past year.

Now, speaking about dividends, in the first quarter of 2018, we pay out dividends of BRL 136.1 million of dividends on interest on equity to Gerdau SA shareholders, the equivalent to BRL 0.8 (sic) [BRL 0.08] (17:24) per share. This is the equivalent to all the dividends distributed throughout 2017, and this certainly illustrates the improvement in our results. These proceeds – interest on equity will be paid out on June 1 based on the positions from [ph] May 18 (17:44). Now, the holding, Metalúrgica Gerdau, in this first quarter 2018 allocated BRL 39 million, equivalent to BRL 0.04 per share to the payment of dividend, an amount higher than what was paid out during the entire year of 2017.

Now, let's move to slide 8 when I will talk a little bit about the company's debt position and liquidity. Gross debt of Gerdau on March 31, 2018 was BRL 16.7 billion, down by BRL 3 billion vis-à-vis March 2017, and that was mainly due to debt amortization in the period. If we look back, we can look at our highest debt level in the past few years. Less than three years ago, in September 2015, net debt of Gerdau was BRL 20.8 billion, and today, it is down to BRL 13.5 billion. That means a 7.3% (18:46) reduction in this period.

This reduction, when it comes to the net debt over EBITDA ratio, was 13 point times (18:57) in March of 2017 and now this is – that was 3.5 times in March 2017 and it's now 2.7 times in March 2018. And this came as a consequence of the divestment program that focused on the financial deleverage of the company and the continued EBITDA improvement. It is worth mentioning that there is yet $1 billion to be captured coming from more recent divestments that will be then captured after the approval from the regulating agencies.

Another aspect that I would like to mention relates to the positive impact of this lowest debt, especially in terms of net financial expenses of the company. If we look from last year to this year quarter-on-quarter, we had a 12% reduction in net financial expense even taking into account the depreciation of our currency in the period that goes on the reverse side, because some part of our debt is denominated in U.S. dollar.

But even then, we had a drop of 12%, and this reduction is also one of the aspects that accounted for the significant improvement in net income in the period. And to finalize this part on the debt, if we look at the lower part of the slide, we have the maturity schedule of the debt. It's a long-term profile and very balanced in terms of maturity dates throughout the coming years. And we had high expenses in terms of cash generation and liability management expenses that occurred in the past periods.

Now, moving on to slide 9, the last slide of my presentation, we talk a little bit about cash flow. In the upper part of the slide, we show that the company generated positive free cash flow of BRL 65 million in the first quarter of 2018, and that is a reversal of a historical pattern of seasonality in the first quarter, meaning that usually in the first quarter, we have a cash consumption that stems from working capital.

But this year was different because we had positive free cash flow even considering this recovery in the business environment that usually requires higher working capital. And this cash generation has been very consistent in the past 12 months, resulting from our CapEx discipline, lower debt and working capital management efforts. And all-in-all, we were able to post good free cash flow generation.

Now, looking at the last slide, in the first quarter of 2018, in the lower part of the slide, EBITDA was more than enough to honor the CapEx, income tax and interest commitments, as well as working capital consumption that is very common to this first part of the year, and this improves the – accounts receivable increases and all of that affect working capital. So, our working capital turnover is about 64 days. Looking back, if we look at other quarters, we used to be around 100 days. So, working capital increase is natural just because now we are experiencing a better momentum.

Thank you very much, and I give the floor back to Gustavo.

Gustavo Werneck da Cunha {BIO 20318216 <GO>}

Thank you, Mr. Scardoelli. Well, to conclude on slide 10, I would like to reinstate that we will continue to work diligently to overcome our main challenges for the year. And as I said before, we will move forward with our digital transformation journey, seeking to boost the growth of our customer businesses, and innovation is crucial. We are preparing Gerdau for the customer of the future. We will also work to further reduce our debt. And I can anticipate that in the next quarters, our debt position will be even lower as we receive the proceeds from the divested assets like the HPPs in Goiás, the operation in Chile and the rebar producing units in the U.S.

Therefore, we are certainly getting ready to resume growth in segments and geographies that allow us to grow our profitability in the future. What I mean is that we will grow in a safe manner with both feet on the ground looking for opportunities that help us in our challenge to be leaders in profitability in the markets we operate, as well as we want to share the preference of our customers. However, we don't have any additional details to share with you at the moment on that topic.

Free cash flow generation will remain one of our priorities. It should grow this year even because we already posted a positive flow this quarter unlike in previous years when, due to seasonality, working capital requirement was usually higher. And at the end, these and other initiatives aim at improving profitability and competitiveness of our operations even despite a challenging landscape marked by excess installed capacity and growing competition in our market. This is our focus and innovation has been paramount in our transformation trajectory.

And with that, I conclude our remarks and it will be our pleasure to discuss our results with you right now.

Q&A

Operator

Ladies and gentlemen, we will now initiate the Q&A session. Our first question is from Thiago Lofiego from Bradesco BBI.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Thank you and good afternoon. I have two questions. The first is looking at your mix in the Brazil BD, in the domestic market, prices were flat. And I would just like to understand why, given the fact that there is a change, and I just want to know whether that was due to the effect of the mix. Now, looking again at the situation in Brazil, the average prices came as a surprise and you exported less semi-finished goods. Now, a question about the U.S. market, I know that it's growing. I just want to understand and whether you think it's possible to reach the goal of reaching higher margins in the second quarter, and how do you see the dynamics in the U.S. market after all of that volatility that we saw in the first quarter?

A - Gustavo Werneck da Cunha {BIO 20318216 <GO>}

Hi, Thiago. This is Gustavo. In the beginning of your question, the call was really poor. I don't know whether we were able to understand everything. So, I do apologize if we're not able to duly give you – to give you a right response. In Brazil, the domestic market in this first quarter – in the first quarter and unlike in previous similar quarters of previous years, we had a different mix. We saw an increase of our cost, mainly scrap, and then we deployed measures to mitigate the impact of these costs in our results. We reinstated our strategy to spread around our scrap collection and we also revisited our production mix through the electric furnaces and other sources. We're also looking for other alternative metallic sources. And eventually, we are also looking at scrap imports in situations where we think that there is some advantage to our costs.

Now, speaking more specifically about pricing, as you all know, Gerdau never gets into details about our commercial policy. However, we can say that prices in the international markets are still high. There is a discount in the prices in domestic markets. Then, we compare our domestic prices to international prices that are currently being practiced. During my remarks, I said that a great part of our Brazilian production is exported, and we can have some visibility of export prices in terms of the next three to four months. So, these prices are still high as they were in the first quarter, if we look back what happened last year. So, when we look at the second quarter for Brazil operations, the performance will be very similar to that of the first quarter. Now, speaking about the U.S. – so, I'm sorry. When you were talking about Brazil, could you repeat, Thiago, please? Your question could not be heard very well.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Can you hear me now?

A - Gustavo Werneck da Cunha {BIO 20318216 <GO>}

Now, I can hear you. I was about to tell you about the U.S. and margins.

Q - Thiago Lofiego {BIO 16359318 <GO>}

I just had another question about Brazil before you move forward.

A - Gustavo Werneck da Cunha {BIO 20318216 <GO>}

Okay. Go ahead.

Q - Thiago Lofiego {BIO 16359318 <GO>}

I know you don't talk much about pricing strategy, but was there any relevant change in terms of product mix for imports and exports? I just want to know whether you sold less semi-finished goods, I'm referring to exports.

A - Gustavo Werneck da Cunha {BIO 20318216 <GO>}

Thiago, when we compare our performance to previous quarters when we used to deliver more semi-finished, it's important also to say that as part of the recovery of Brazilian economy, when we look at our shipments and numbers, there has been a significant evolution in industrial segment. So, considering these two aspects, there was a difference in the mix when we compare to the fourth quarter of the year before and the first quarter of 2017.

Now, in terms of North America, we still pursue our objective to reach a two-digit EBITDA margin. This is something that we want to achieve very quickly. But it's difficult for me to tell you in what quarter this figure will be reached, because it has to do with possible volatility and some other restrictions. The first quarter in the U.S. experienced lack of raw material, especially scrap. The winter in the U.S. was more rigorous and longer than in previous years, and this really damaged the flow of scrap to our mills in the end of April and early May.

So, winter began to give in, and so now we see scrap becoming more available, where we saw some cost increases. They were then transferred to the market. In the coming months, we believe that the movements in the price of steel will be in keeping with the prices of raw material, and with increase in demand, we should see an improvement in our margins in the coming months. Moreover, Thiago, the sale of our rebar assets should also contribute to an improvement in our margins as soon as the transaction is approved and concluded – approved by the regulatory agencies.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Okay. Thank you.

Operator

Next question comes from Leonardo Correa from BTG Pactual.

Q - Leonardo Correa {BIO 16441222 <GO>}

Good afternoon, everyone. I have two issues, and I do apologize for insisting on the Brazil BD. I think that the first point – and also speaking about prices, Werneck, we saw some signs related to demand where the industry – especially construction industry and real estate market that are – probably demand in these segments are lower than what we would anticipate, and there is also a de-acceleration in other areas. So, how do you see this evolution in the Brazilian demand, in the domestic market for April and May and whether you are expecting stronger demand before you deploy some adjustments? So, in keeping with my previous question, everybody does the calculation and they look at the prices in Brazil from adjusted to non-adjusted, and they question why is it that Gerdau hasn't yet made the adjustment. And so, we look at the demand and the question is whether you see some lowering of demand.

And the second topic still referring to Brazil, the Brazil EBITDA margin is very surprising, because it's very strong and higher than anticipated. We thought - we saw like some 21% even with a very slow scenario of demand recovery. Maybe I'm just looking forward too much, but I just want to - want you to elaborate on the potential of the company. You talked about a two-digit EBITDA growth. So, what will be the outlook for Brazil, if we are already at 21%? You talked about scrap and changes in the supply mix. There is also the issue of pricing, reduction in fixed cost, and the expense level was still very low, just 4% of your revenue. But I would just like to see - to understand a little bit better your margins, because that 21% level is already very good.

A - Gustavo Werneck da Cunha {BIO 20318216 <GO>}

Thank you for your question. Now, in terms of your first topic related to demand in the domestic market, we look at the indicators very carefully, because it's also very important that we look at comparable figures. It's natural to see some short-term volatility. So, when you compare industrial and civil construction indicators quarter-on-quarter, month-after-month, and we look at volatility, when we look at the quarterly indicators for this year and the year before, we remain very optimistic in terms of the outlook for Brazil this year. We do see an improvement in the economy at different levels.

There are also segments that are evolving quicker like industrial and automotive industries. Our shipments to these two industries demonstrate an evolution once compared to numbers from 2017, in terms of residential and civil construction, even though our numbers and the published numbers - numbers published by the Instituto Aço Brasil does not really demonstrate higher shipments of steel per segment. But when we look at numbers of launches and use of steel for foundations that could impact short-term steel consumption, they demonstrate that there is a good outlook for improvement, even though this improvement should be gradual. Now, speaking about infrastructure, we don't see any demand growth in 2018. We believe that, particularly for that segment, demand growth will occur only in 2019.

Now, speaking about EBITDA in Brazil, it's important that we remember that part of this result comes from management efforts that have been taken by the company for quite some time. We've been very stringent in terms of controlling our expenses. We deploy a methodology that the market calls zero-based budget. And when we look at SG&A over net sales demonstrated, even though our shipments are growing and the market is evolving, our expenses have been kept under control. There is a significant reduction in SG&A over net sales. We are also focusing on the operating performance of our mills in Brazil, not only because we want to find alternatives to reduce our costs related to the acquisition of inputs and scrap, but also we are looking for improvements in operating performance that will help us improve our margins.

And now, speaking about the other side of the equation, which is pricing, we do not comment on possible pricing increases or the commercial policy of the company. But as you said, Leonardo, there are some indicators that show that prices internationally are still high. Our exports until July have been consistent with the amounts from previous months. And when we look at the discount on imported goods, it still remains at a negative level. Then the numbers speak for themselves.

Q - Leonardo Correa {BIO 16441222 <GO>}

It's clear. Thank you very much.

Operator

Our next question comes from Ivano Westin from Credit Suisse.

Q - Ivano Westin {BIO 17552393 <GO>}

Good afternoon, Gustavo and Harley. Thank you for the questions, and congratulations for your sound results. My first question is on Special Steels. There was no margin expansion this quarter, when compared to the last quarter. I would like you to comment on that. And where do you see the level of utilization both in Brazil and the U.S.? And a little bit of the outlook for the rest of year? And what would be the annual margin that could be expected?

The second question is on CapEx. I know that you had guidance of BRL 1.2 billion. There is the seasonality factor, but the rating is still much lower than what was indicated for the year. So, what would be the maintenance and expansions break down for the year? And if we look forward for 2019 and 2020, what would be the expected CapEx? What is denominated in U.S. dollars and reals and BRLs? Thank you.

A - Harley Lorentz Scardoelli {BIO 7283603 <GO>}

Good afternoon, Diego (sic) [Ivano] (40:41). This is Harley. Now, concerning Specialty Steels (sic) [Special Steels] (40:46), I don't want to be repetitive but in our Specialty Steel (sic) [Special Steels] (40:51) operations, we also have our mix of shipments. The margins in Brazil were higher, vis-à-vis the U.S. And in this first quarter, our shipment volume was in keeping maybe slightly higher. But these changes margins a little bit. But despite all that, we see that the margins for that operation are still very sound, very good. And there are at [indiscernible] (41:18). They are kept in a high level. This is an operation where we are developing new products. Gustavo already talked about the use of AI in new products. That's why we are really confident about this operation, because we think that we'll be able to generate very positive margins. And so, quarter-on-quarter we see good improvements. There is also a fact that some markets are different than others.

Now, about CapEx, the second part of your question. Once again, and I remember that, in the past, we presented CapEx approved and CapEx used. Today, we only talk about CapEx used. And there are differences from one quarter to the next. But I must say that the number that was presented for this quarter, this BRL 217 million does not necessarily mean that we are not already spending all the CapEx for the year. The focus is still in maintenance, but adding to what Gustavo said, there is divestments and what happened in the Monroe mill.

In terms of approved CapEx, it means that only part of that is already included in that BRL 1.2 million (sic) [BRL 1.2 billion] (43:02). This is already an investment mix that is much more normalized when compared to levels of the year before, of last year. Another aspect refers to outlays in currencies. That hasn't changed much. We have to look at – I mean 43% of CapEx in Brazil, and great part of this CapEx is denominated in local currency, I mean in BRL, and half of it is back to the dollar, but we have a good estimate for the year.

Q - Ivano Westin {BIO 17552393 <GO>}

Harley, thank you very much. I would just have another follow-up question. What is the break of this CapEx maintenance and expansion?

A - Harley Lorentz Scardoelli {BIO 7283603 <GO>}

This year, the bulk of it is allocated for maintenance, but this BRL 240 million that we just announced has to do with capacity expansion. And as I said, most of the outlay will occur in the next few years. We already migrating into different mix. This year, this BRL 1.2 billion focuses on the performance and maintenance of our operations.

Q - Ivano Westin {BIO 17552393 <GO>}

Okay, Harley. Thank you very much.

A - Harley Lorentz Scardoelli {BIO 7283603 <GO>}

You're welcome.

Operator

Our next question is from Thiago Ojea from Citibank.

Q - Thiago Ojea {BIO 17363756 <GO>}

Good afternoon, and thank you for taking my questions. I would like to go back and revisit the Brazil BD and maybe Werneck can answer that. We saw an increase at least in the numbers published. And it's still – when I talked to people in the market, I mean scrap prices are increasing more than 30% quarter-on-quarter. But we didn't see that reflected in your cost, and your cost just had a marginal increase about 1% per tonne. Is there any risk for the third quarter or you are just managing your stock better or you think that this risk of scrap increases is just marginal?

And then I have a second question to Scardoelli. You just talked about CapEx. Now, thinking in terms of capital allocation, we had still an insignificant cash generation, and I believe there was a great variation in working capital that affected the quarterly results, so there might be a cash generation. Just thinking in terms of that strong operation, what is your capital allocation intent? Would you increase the dividend payout? Do you see any possibility of having inorganic growth? So, if you could shed some light into that subject, I would appreciate it. Thank you.

A - Gustavo Werneck da Cunha {BIO 20318216 <GO>}

Thiago, about scrap in Brazil, there is no carryover. From 2017 to 2018, we had additional inventory of scrap. There was no inventory of scrap at a lower amount that could explain cost dilution on average inventory. What we have here is just Gerdau's strategy. It has to do with the way we operate metallics in Brazil, and this strategy that we adopt to prevent any impact from increases in scrap prices.

We pursue a verticalization strategy to buy strategy. Our strategy is spread around. We have our own storage facilities, and we buy in the local territory, and eventually, we also look at opportunities to import scrap, and we try to optimize the mix via electric furnace and integrated mills. Therefore, we are constantly seeking to reduce our production costs. And I think I already said in a previous occasion that Brazil is already generating enough scrap for its domestic consumption with the improvement in the industrial economy. So, we will see maintenance or even lower prices of scrap in the future.

A - Harley Lorentz Scardoelli {BIO 7283603 <GO>}

Thiago, this is Harley. And I would like to answer the second part of your question. In terms of cash generation, despite a small cash generation, I would say that a good part of – it already is good part of working capital requirement. So, I wouldn't like to give any guidance, but I would say that this year, our cash generation vis-à-vis expenses will be significant. And the trend is that, in the next quarters, the levels will be higher than in the first quarter. And this has to do especially with the working capital position. So, the outlook is very positive in terms of cash generation for the rest of the year.

Another aspect related to cash generation that is important to mention, and I know that it's difficult to estimate it. But taking into account the fact that we have about $1 billion of incoming proceeds, this is something very relevant, and certainly once the proceeds come on board, this will reduce interest commitments, because that really consumes a lot of cash. And with investments throughout the year, this will improve our overall scenario.

In terms of capital allocation, I mean, rest assured, the outlook remains very positive. We are still very much focused in this final part of the divestment program. We have that incoming proceeds of BRL 1 billion, and certainly we will have better results. We also mentioned that every – all the dividends from previous years were paid in just the first quarter of this year, because our results were better, and part of that also has to do with improved EBITDA, positive free cash flow. And all in all, we were able to pay out better dividends. I mean, the minimum payout is 30%. Other projects will come as we start delivering everything that we promised. Naturally, we are working diligently to deliver the expected results.

Q - Thiago Ojea {BIO 17363756 <GO>}

Thank you, Mr. Scardoelli. If you allow me, I have a follow-up question. Do you have a target level of net debt over EBITDA ratio? What would be a comfortable level for you? What would be the minimum level? Thank you.

A - Harley Lorentz Scardoelli {BIO 7283603 <GO>}

This is a very interesting question. Certainly, we are constantly working to deleverage. Our industry works with commodity. So, we have to work with a low debt level. Even if you don't give any guidance, if we look at our – the documents that we have at CVM, we have some targets for net debt over EBITDA. And so, I think we will reach levels lower than the 1% today. I think our position is to be lower than this current number. Thank you very much.

Operator

Next question is from Marcos Assumpção from Itaú BBA.

Q - Marcos Assumpção

Good afternoon, everyone, and congrats on your results. My first question refers to the foreign exchange impact, because there have been a depreciation of foreign exchange. How do you look at that looking at your local (52:05) operations? I think this time, things will be different than 2015, as Harley said, because net debt back then was twice as much as the current debt. I mean, considering the amount of the assets that you already sold, and demand is also growing versus a demand that was in decline back then.

And my second question is about the South America operation. I would just like to understand the dynamics of net sales per tonne. There was a two digits drop in your net sales in South America, whereas in the Brazil BD, net sales per tonne was up. And as you were operating with similar commodities, I just want to understand why there was this difference.

A - Harley Lorentz Scardoelli {BIO 7283603 <GO>}

Well, speaking about the exchange rate, obviously, I think you're talking about Argentina. I mean, the current numbers are positive to our business, because there is a natural hedging. And part of our prices – part of that is also due to our prices which are very stable.

We also seek further improvements in the U.S., and this will improve our cash generation, due to a better exchange rate. I mean, on the debt side, I think this problem has been minimized because we are also getting the proceeds from the divested assets, so this gives us a natural hedge toward debt.

And also this is due to the fact that today we are much better prepared in terms of having a better capital structure. In accounting terms, part of our dollar denominated debt is attached to our assets, so this removes the volatility from our results. So, all-in-all, I must say, that we can say that things will appreciate naturally and the results are positive to our business.

Another foreign exchange aspect relates to South America. The biggest effect in pricing in South America was the foreign exchange risk in Venezuela. There was a strong depreciation of bolivar in the period and this - all in all, the results in South America were positive. And the performance in general was quite good.

Q - Marcos Assumpção

Thank you. Thank you, Harley. I just have one last question, if you allow me. Could you please comment a bit on Gerdau's leverage? And what is your strategy for Metalúrgica Gerdau?

A - Harley Lorentz Scardoelli {BIO 7283603 <GO>}

Thank you. That's a good question because we usually focus a lot in Gerdau and I would say the Metalúrgica Gerdau is about to become debt free. We have convertible debentures that were converted in August of 2016. And the other part will be next year. I think that they will be all be converted in the next 14 to 15 months.

Today, their cost is very competitive, 85% of CDI and this is very significant to the company. So we believe that our debt will become equity in the next coming months. The remaining of the debt is a debt that we have with Bank of Brazil with competitive costs. And it will mature in April of next year. And we will be able to pay in full. Gerdau is paying out dividends. This is not concerning for Metalúrgica. And I think that next year, we will be debt free.

Q - Marcos Assumpção

Thank you. Thank you, Harley.

Operator

Next question is from Milton Sullyvan, XP Management.

Q - Milton Sullyvan {BIO 19085202 <GO>}

Good afternoon and thank you for taking my question. My first question is about cost. I would like to hear more about a possible carryover. If you could separate the answer between Brazil and the U.S., both in Brazil and the U.S. when we look at the cash cost of the company or the cash cost of the company per tonne, the evolution quarter-on-quarter was very small. And that was a surprise given the raw material cost.

And when we look at your figures, we see that there was inflation in metallics, and there was a difference between Brazil and North America. We believe that that impact would occur as of the second quarter, but I would just like to confirm with you whether that impact is already offsetted. And so therefore, we should start seeing margin improvement both in Brazil and in the U.S. if we were to continue to see raw material prices as they are today. I mean, this is my first question.

The second question is about SG&A for North America. SG&A as a percentage over material, I mean it was very strong, so I would like to understand whether this is already a reflection of changes mentioned by Werneck or whether there was another one-off situation. And finally something very quickly, the sale of asset, so that $1 billion of proceeds that would be internalized, that $1 billion would come in the day of the closing of the deal. So this will enter your balance sheet. In that hard currency according to the exchange rate of the date, right?

A - Gustavo Werneck da Cunha {BIO 20318216 <GO>}

Well, let me start with Brazil. The costs for the second quarter are absolutely minimized. Now, I would say no. If we look at our basket of inputs, we maintained a very stringent control. There are some elements like alloys and electrodes, and this debate does not exist anymore. We have global contracts. All the prices are duly negotiated in long-term contract. So this is no longer a concern to the company.

As I said before, our strategy for scrap is very diversified. We generate our own ore which gives us competitive edge in our (01:00:20). So in the next quarter, we continue to pursue alternatives to minimize possible scrap impact into our costs. And what I said before, the way we structure ourselves and as we are continuing to look for other opportunities, we will certainly be able to minimize increase in scrap prices.

Now, referring to the U.S., I talked about the difficulties we encountered during the winter season in terms of moving scrap around the country. At the end of April and in early May, we noticed a higher flow of scrap, and this has translated in to a drop in prices of scrap which could also continue in the next coming months. We are trying to transfer prices increases to the market. We hope that – we hope to see a change or an increase in spreads in the U.S. in the coming months still speaking about the U.S., there through the methodologies that we utilize we want to eliminate waste and nonrecurring expenses even when we look at a growing landscape. So the expense reduction promoted in the U.S. is consistent, and we will continue to look for further opportunities.

Now, I'll give the floor to Scardoelli so that he can answer the second part of your question.

A - Harley Lorentz Scardoelli {BIO 7283603 <GO>}

Good afternoon, Milton. This question makes a lot of sense and this is something that we monitor very closely. That $1 billion that is about to enter $600 million referred is denominated in U.S. dollars, and it's hedged. There is another $150 million also denominated in U.S. dollars, and there is $250 million that is the equivalent to BRL 800 million that stems from HPP in Brazil. So 65% is denominated in U.S. dollars and 25% in Brazilian reals.

Q - Milton Sullyvan {BIO 19085202 <GO>}

Congratulations for your cut and costs.

Operator

Next question in English from Carlos De Alba from Morgan Stanley.

Q - Carlos F. De Alba {BIO 15072819 <GO>}

Yeah, hello Gustavo and Mr. Scardoelli. Thank you for taking the question. Regarding the outlook for the recovery of construction in Brazil that you expect to start taking place in the second half of the year, was that considering the uncertainty around the elections, or do you think that this could be an additional risk to potential downside and therefore both property construction and infrastructure are more likely to accelerate in 2019?

And then my last question would be on selling expenses. We saw then almost two-year decline on a year-on-year basis coming to an end in the first quarter, year-on-year selling expenses grew around 9%. Is this just a reflection of what your revenues did? Or do you think that we basically saw the bottom as to how much any expenses can the company take out? By the way general and administrative expenses continue to do well, but your selling expenses caught my attention. Thank you.

A - Operator

Well, Carlos was asking about the recovery of the civil construction that could be projected in the second half of the year and up to what point we should consider volatility stemming from the next coming elections in Brazil?

A - Gustavo Werneck da Cunha {BIO 20318216 <GO>}

In our figures we are factoring some volatility, and we already face volatility if it comes, even though in the civil construction industry, we have to look at the economic fundamental, and they are still present regardless of any volatility. In this first quarter, we noticed some indicators that lead us to believe that the civil construction recovery should occur in the second half of the year. There are some macroeconomic indicators like interest rates and credit increase and in our rolling mill operation. We are noticing a higher demand for steel for civil construction. Therefore, we believe that possible volatiles will not be an impediment for the recovery of civil construction in the second half of the year even though we believe that this recovery will be gradual and it will be more intensified in 2019. Now, I'll give the floor to Scardoelli so that he can answer your question about selling expenses.

A - Harley Lorentz Scardoelli {BIO 7283603 <GO>}

Good afternoon, Carlos. I think that we have to look at the fact that basically one-third of these expenses are selling expenses and there is one-third of general administrative expenses. There are still some room to reduce SG&A further. Our numbers still include operations that at some point will leave our balance sheet. There are some divestments still in the pipeline and some cost structures still remain in our SG&A.

This one-third of selling expenses varies according to the level of activity. So with an improvement in the business, better prices and higher volumes, this should also be adjusted. It's interesting probably to monitor from now on, and it's important to remember that we to continue to make a lot of efforts to improve numbers further.

Back in 2008 and 2009, that level was above 7%, and today it's down to 4%. So, at some point this year we will probably see a number closer to 3%. So, this is an important number and important point. So, yes, we do have opportunity to lever our results and improve them further.

Q - Carlos F. De Alba {BIO 15072819 <GO>}

Thank you.

Operator

We now conclude the Q&A session. I would like to give the floor to Mr. Gustavo Werneck for his final remarks.

A - Gustavo Werneck da Cunha {BIO 20318216 <GO>}

Well, thank you, all, for your participation. It was very good to talk to you. And before I say farewell, I would like to also invite you to participate in our next conference call to discuss the results of the second quarter of 2018 which is scheduled to happen on August 8. Thank you very much and I'll see you next time.

Operator

Gerdau's conference call is now concluded. Thank you very much for participating, and have a nice afternoon.