Q4 2017 Earnings Call

Company Participants

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

Other Participants

- Caio Ribeiro, Analyst
- Carlos F. De Alba, Analyst
- Ivano Westin, Analyst
- Leonardo Correa, Analyst
- Thiago Lofiego, Analyst
- Thiago Ojea, Analyst

MANAGEMENT DISCUSSION SECTION

(Operator: Good afternoon and welcome to Gerdau's Conference Call to discuss the results related to the fourth quarter of 2017. 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 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 the valuation.

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 give the floor to Mr. Gustavo Werneck. You may proceed, sir.

[Technical Difficulty] (01:12-01:52).

Ladies and gentlemen, please hold until we reconnect the speakers.

[Technical Difficulty] (01:59-04:09).

Ladies and gentlemen, please hold until we reconnect the speakers. We will reconvene momentarily. Thank you very much.

[Technical Difficulty] (04:22-06:21).

Ladies and gentlemen, please bear with us for a few more moments. We are resetting the same connection. Thank you.

[Technical Difficulty] (06:27-07:18).

You may restart the conference call. Go ahead, sir.

Gustavo Werneck da Cunha {BIO 20318216 <GO>}

Good morning and thank you all very much, market analysts and investors, for accepting the invitation to participate in our conference call under our results for 2017. Initially I would like to apologize because there was a problem in our building PABX and we are connecting via cell phone, so I hope you are listening well.

I just want to start by saying that it's a pleasure to me to be here with you in my first call as Gerdau's CEO. We will start by commenting on the main highlights of Gerdau's transformation trajectory and also the outlook for the markets where we operate. And right after that, we will talk a little bit about our investment forecast for 2018. Next, Scardoelli, who is right next to me, will elaborate on Gerdau's financial highlights. And at the end, we will be totally available to answer your questions.

So, to begin with, I would like to talk about the current momentum of Gerdau. We are going through a moment of profound transformation, and this has been very good for the company. Our business culture changed and it continues to change for the better. And that means that we are empowering people, reducing hierarchies, and working in a more agile and stable manner, and I do particularly believe in that very much.

Also, we are encouraging people to present innovations in all fields and areas of the company, which oftentimes represent unprecedented initiatives in our market. As many of you know, and I had the opportunity to talk to some of you when I was leading the Gerdau operation in Brazil, in the last few years, we put a lot of efforts into digitalizing all our plants. And now, our next step aims at accelerating Gerdau's digital transformation to better serve our customers and also to help them grow.

Throughout our history of 117 years, recently celebrated this past January, the relationship with our customers has always been the backbone of our growth and longevity, and we have several initiatives in place to give our customers the most unique experience whenever they buy a Gerdau products. And, of course, we do that through the use of artificial intelligence, IoT, state-of-the-art digital relationship portals and more. Therefore, we are working hard to consolidate our position as one of the most innovative companies in the global scale industry. Innovation, for instance, has also helped us be globally competitive in cost and productivity amongst other initiatives.

And the results from all of these at first are already starting to show very clearly in the company's financial figures. A clear example that certainly illustrates this point is the reduction of almost BRL 600 million in SG&A in 2017. Also, we conducted a very broad revaluation of our assets that resulted in divestments of BRL 6.3 billion throughout the last four years.

At the moment, this initiative is in its final phase and it has allowed the company to steer its efforts towards access to greater return potential in the steel industry. To that end, I would like to take this opportunity to explain the rationale behind our divestment strategy in the United States as we announced the sale of units in early 2018. First of all, I would like to tell you that we will continue to have a very strong presence in the region and the U.S will remain a priority market for Gerdau and so is Brazil.

The sale of rebar and wire rod producing mills will allow us to focus on markets with better profitable margins such as bars, structural profiles and also Special Steels. Moreover, we announced the sale of two of our hydroelectric plants in Brazil, in line with the strategy that I just mentioned to you.

Now, looking at our performance in 2017, we can say that our management efforts, coupled with the improvement of the markets, allowed for the evolution of our results in the year. I would like to reinstate that in view of non-recurring items non-cash effect, Gerdau has a net income and adjusted EBITDA.

Net sales of BRL 37 billion in the year was down by just 2% due to lower shipments. Adjusted EBITDA, and that is net of non-recurring items, was up 7% reaching BRL 4.3 billion. And adjusted net income went from BRL 91 million in 2016 to BRL 522 million last year. I would also like to highlight the improvement in the company's indebtedness indicators. In 2017, our net debt over EBITDA ratio was 2.98 times. At the end of 2016, I recall that this ratio was 3.5 times.

Now, let's move to the following slide when I will elaborate on the market outlook. We are seeing a moment of positive outlook in the markets where we operate. The World Steel Association, for instance, foreseeing 1.6% growth in steel demand worldwide in 2018, mainly coming from developing countries, except for China, whose levels should still remain stable.

In terms of Brazil, we believe that the economy will continue to evolve positively in 2018, particularly the industry segment at a more gradual pace that of a construction industry. According to Aço Brasil, domestic demand for steel is expected to grow 4% in 2018. And also I would like to emphasize, and as I said in previous occasion, that we are absolutely ready to cater to the potential expansion of Brazilian demand. But until then, we will continue to export part of our production.

However, there is a caveat that we have also mentioned in the previous quarters because in order to be competitive in the international market, it is crucial that Reintegra's tax rate is raised from the current 2% to 5%. Reintegra is a demand from the entire downstream industry and is being debated on a continuous basis by Instituto Aço Brasil. Reintegra, I recall, is the tax mechanism that allows for the restitution of non-recoverable taxes already paid in previous phases of the productive chain.

As for North America, market studies point to a 3.7% growth in long steel consumption in the United States in 2018, considering all the main consumer segments. In the case of the U.S., I'm referring to non-residential construction, the industry, and the oil and gas segment. At the same time, we are still waiting for the outcome of Section 232 and the government plan to boost infrastructure. In January, the U.S. Department of Commerce in the U.S. submitted its recommendation about Section 232 to President Trump, who has 90 days to present his decision on the matter.

Infrastructure funding is another topic that merits our close attention as the government recently showed signs that it plans to address this topic. Our estimate is that the steel market in North America throughout 2018 will continue to use less than 70% of its installed capacity and, as a consequence, the margins will be pressured.

Imports, on the other hand, should be lower than those from 2017 due to higher steel prices in the international market and, therefore, that remains a point of concern. In relation to Special Steel, the Brazilian automotive industry should post a significant growth in sales to the domestic and also foreign markets.

If market expectations materialize, the sector will go back to the level of 3 million units in Brazil, and it is worth reminding you that this hasn't happened since 2014. Demand in India continues to grow. In relation to the automotive market in the U.S., the forecast points to a strong demand as well.

Now, looking at the other countries in South America, the outlook points to economic growth in the region, notably in Peru, Colombia and Argentina. And in Argentina, we inaugurated a melt shop in the second half of 2017.

Now moving to slide 4, next slide, I would like to comment on the investments we did in 2017 and the plans for 2018. In 2017, our CapEx investments in PP&E totaled BRL 873 million. From that total, 40% was invested in Brazil; 33% went to North America; 13% went to Special Steel, and Special Steel BD includes our mills in Brazil, in the U.S. and India; and the remaining 14% went to the other countries in South America.

For 2018, we anticipate a CapEx spending of BRL 1.2 billion, focusing on performance improvement and maintenance of our operations. This increase in CapEx is due to a shift of part of the investments of 2017 to 2018 that was added to the amount foreseen for the year.

I now conclude this part of the presentation and give the floor to Mr. Scardoelli, and I will be back later on to talk about our challenges for 2018.

Harley Lorentz Scardoelli {BIO 7283603 <GO>}

Thank you, Gustavo, and good afternoon. So let's talk now about the results and the performance of Gerdau in the fourth quarter of 2017. In consolidated terms, adjusted EBITDA of Gerdau was BRL 1.2 billion in this fourth quarter 2017. If we look at the chart on the upper part of the slide, we'll see the good evolution of the adjusted EBITDA during the year 2017 when the margin went from 8.3% in Q4 2016 to 12% in Q4 2017. This evolution is mainly due to the improved performance of Brazil BD, which posted higher net sales per tonne, surpassing cost increases during the period.

These results demonstrate our effort to improve the margin with significant reductions in SG&A expenses, both in the quarter vis-à-vis Q4 2016 as well as in the year of 2014. Also, I would like to say that in all of our operations posted a positive evolution year-on-year on the fourth quarter, both in EBITDA absolute terms and also interims of EBITDA margins.

Now, moving to our next slide, and as a continuation of the previous one, the bridge chart shows the performance of EBITDA in the fourth quarter 2016 vis-à-vis Q4 2017 and the increase in net sales per tonne, which was higher than the growth of cost per tonne. In addition, the reduction of BRL 137 million in expenses with SG&A also contributed to EBITDA growth, a reflection of our rationalization efforts in all business operations throughout 2017.

As for net sales, these expenses represented 6.2% in Q4 2016 and went down to 4.1% in Q4 2017. Now, looking at the bridge chart in the lower part of the slide and also stressing again that we are looking at adjusted numbers with no cash effect – net of cash effect and nonrecurring, right, we see that we went from a negative adjusted result of BRL 203 million in Q4 2016 to an adjusted net income of BRL 262 million, which was positive in Q4 of 2017 due to an EBITDA improvement and the reduction in financial expenses. And this means an increase of more than BRL 400 million when we run a quarter-on-quarter comparison.

Now, as for dividend in the fourth quarter 2017, we paid out dividend of BRL 51 million to shareholders of Gerdau S.A. the equivalent to BRL 0.03 per share. These proceeds will be paid on March 21 based on the closing position of March 9.

During the year of 2017, as a whole, Gerdau S.A. allocated BRL 136.5 million, BRL 0.08 per share to pay out dividend from the retained earnings reserves. Likewise, in 2017, Metalúrgica Gerdau S.A., Gerdau Holdings allocated BRL 19.5 million, the equivalent of BRL 0.02 per share to pay out dividend also from the retained earnings reserves and also reflecting an improvement in the entire balance sheet of the holdings throughout the year of 2017.

Moving on to slide 9, next slide. We talk about our debt and liquidity positions. Gross debt on December 31, 2017 was BRL 16.5 billion, down by 11.6% in relation to September 2017, mainly due to the amortization of 2017 bond that matures in October. I also highlight that on a year-on-year comparison, the reduction of gross debt was 20% going from BRL

20.6 billion in December 2016 to BRL 16.5 billion at the end of 2017, BRL 4.1 billion in reduction of our gross debt.

The average weighted cost of debt was 6.4% a year. On December 31, 2017, 12% of gross debt were short term. The reduction in the net debt over EBITDA ratio was 2.98 times in December 2017. And that, when compared 3.5 times at the end of the previous year, was mainly a consequence of the amortization of the 2017 bonds as well as higher cash generation in the fourth quarter.

The effect of this debt reduction was very important, and this is clearly seen noticed in the reduction of the net financial debt of the company that went from BRL 1.758 billion in 2016 to BRL 1.449 billion during 2017, a BRL 166 million in reduction or 15% of reduction of net debt.

The average time of the debt is 5.3 years in December of 2017, went to 6.7 years on December 31, 2017 due to the liability-managed transaction carried out by the company in October. We bought back $552 million of 2021 bonds and $31 million of 2020 bonds.

These are notional amounts of each issuance and, to do that, we issued $650 million in new debt securities, taking advantage of a very attractive market window and with maturity in 2027 and a coupon of 4.875% a year. It's worth mentioning that in year-to-date, the credit rating agency, Moody's, on January issued a report upgrading Gerdau's rating from Ba3 to Ba2 with a stable outlook. On the same date, the credit rating agency, Standard & Poor's issued a report, reaffirming Gerdau's investment grade, despite the downgrading of Brazil's sovereign rating to BB- on the previous year. This reflects our strong commitment to maintain adequate financial policy, focusing on improving our capital structure, reducing debt and leverage.

Now moving to slide 10, the last slide of my presentation, we will now talk about the free cash flow of the company. As we can see on the chart in the upper part of the slide, in the last 12 months, the company generated positive free cash flow of BRL 1.5 billion. Greater CapEx discipline, lower indebtedness and our efforts to manage working capital were important aspects that allow us to reach those results.

Since 2013, the company has always posted positive free cash flow year-on-year. In the fourth quarter 2017, now looking at the bridged chart in the lower part of the slide, EBITDA was more than enough to pay our CapEx commitments, income tax and interest rates, in addition to the freeing up of working capital amounting to BRL 430 million. As a result, free cash flow in this quarter was positive by BRL 1 billion, twice the amount posted in the third quarter of the same year.

Thank you very much. And now, I'll give the floor to Gustavo for his final remarks.

Gustavo Werneck da Cunha {BIO 20318216 <GO>}

Thank you, Scardoelli. And to conclude, I would like to comment – and before we get into the Q&A session, I would like to talk about our main challenges for 2018. While we continue to carry out Gerdau's digital transformation focusing on our customers, we firmly believe in our capacity to innovate and also to position Gerdau as one of the most innovative companies in the steel industry in the world. At the same time, we will continue to pursue the reduction of our debt positions.

Moreover, free cash flow generation remains as one of our top priorities as demonstrated in previous years. And as I said before, we will strive to improve the profitability of our operations because, regardless of the external factors, I see that we still have room for further improvement mainly because, at Gerdau, we have a phenomenal team willing to overcome any challenge. Therefore, we are building a more profitable Gerdau, with greater potential to generate returns to our shareholders. And with that, I conclude my presentation.

But before we open the floor for questions, I would like to reinstate my thanks to our customers, employees, shareholders and wherever the communities where we operate. Thank you very much for the support you gave me throughout 2017.

And now, with no further ado, we will go to the Q&A session, Lorentz Scardoelli and myself will be pleased to answer any of your questions.

Q&A

Our first question comes from Ivano Westin from Credit Suisse.

Q - Ivano Westin {BIO 17552393 <GO>}

Good afternoon, Gustavo and Harley, and thank you for taking my questions and congratulations for your excellent results in the fourth quarter. Gustavo, in your initial remarks, you talked about the outlook at the industry, a 4% growth that is forecasted by Aço Brasil for 2018. Could you please comment on the utilization level you have today in Brazil and what kind of growth is expected for Gerdau or whether this goes beyond the guidance presented by Aço Brasil?

And what would be the normalized parity you see today? And looking at the results in the fourth quarter, I think that BD Brazil (sic) [Brazil BD] had a very significant margin. It's a high margin and you still have to factor in increases in prices and volumes. If you still believe that you will have a normalized EBITDA margin for Brazil above 20%.

Now, the second point is about North America. I would like you to comment on the outlook for price and volume for 2018 with or without Section 232 and after the conclusion of the sale of your assets, what kind of margin expansion you think you would have?

And still speaking about the Brazil BD, could you also say something about the metal spread for Brazil? Thank you.

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

Well, thank you. Thank you for your question. I will give you a more conceptual answer and then I'll give the floor to Scardoelli, will give you the figures.

Well, at the end of 2017, our utilization capacity for steel in Brazil was around 67%. We, therefore, believe that this capacity will grow throughout 2018 particularly because we noticed a growth in demand coming from the industry and the automotive industry so much so that we are resuming the operation of one of Special Steel melt shop, one in Moji das Cruzes, and we are now concluding the preparation of that melt shop. So in the next few days, we should be producing steel again in that melt shop.

Now, in relation to civil construction, we also noticed a recovery, even though it's a more gradual recovery once we compare, which is the other segments that I mentioned now. In relation to our parity, in the last few months, we tried to recover some of the cost pressures that we had, be it in terms of electrodes or scrap, but more particularly, in rebars we still have a negative parity.

Now in terms of the EBITDA margin, In Brazil, it is important to recall that between 35% to 40% of the production in Brazil is exported. So, therefore, this general margin for Brazil that you mentioned part of it comes from the domestic market and the other significant par comes from the export margin.

International prices. You should recall continued to stay a good level. Export regular or a current price levels help us to have an overall higher EBITDA margin in Brazil. Also, I would like to highlight some important aspects, it was not only related to the Brazil BD, but also the others, but it is more significant in Brazil and that is a profound reduction in our SG&A expenses.

Gerdau, as a whole – at Gerdau, we were able to post a reduction of BRL 600 billion in these expenses when we compare it to the year 2017. Also, all of these expense reductions are based on a very stringent methodology that allows us to continue posting further reductions. So at Gerdau's operation today and speaking more particularly about Brazil with zero or – with ZBB or zero-based budget, this methodology does not – use as a base of the expenses from the year before, because it usually discusses in detail all of the expenses considering market realities.

And we also deploy digital transformation to deal with admin expenses. We use digital robots and other state-of-the-art technologies. This reduction in SG&A expenses have a significant impact on our margins. Now, going to North America, regardless of any speculation regarding the final decision of President Trump regarding Section 232, we are not comfortable with the margins. But throughout the last few months, we've been taking measures to increase margins regardless of Section 232.

Our decision to divest in the U.S. aimed at the company's leverage, but also we aimed at increasing margins. We understand that with this change in management and, more recently, I recall that we announced this engagement of our manager in the U.S. So we are trying to look for more advantageous margins.

And now, I'll give the floor to Scardoelli, he can probably give some more color to what I said.

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

Good afternoon, Ivano. In fact, Gustavo already talked about all of the main concepts. I just have two comments. One, regarding results for Brazil and you look at the numbers from our releases. You see an evolution from the third to the fourth quarter of 2017. So despite the seasonal effect, when it comes to shipments to the domestic markets, there were also other increases. And this has two things. When we look at the fact that international expenses are advertising (36:18) a positive impact and it takes an important contribution to our business. This is good. Obviously, it comes in keeping with what Gustavo said, because we still see some further discount in our domestic prices when compared to international prices as they are currently.

And to give some color to our very strong efforts to reduce SG&A expenses, I try to pick some numbers in 2008. In the peak of the market, our shipments back then were about BRL 42 billion and today it's BRL 37 billion. But our SG&A expenses, which at year-end was at BRL 1.7 billion, they were BRL 2.7 billion. So there was a BRL 1 billion reduction during the period. And this is very significant. So, all in all, these expenses accounted for 4.5%, but in the quarter they accounted for 4.1% of our net sales. So this is an effort that should not be disregarded.

Q - Ivano Westin {BIO 17552393 <GO>}

Thank you, Gustavo and Harley. I just have a few more questions. You said that, today, you have a negative parity. I just want to know whether you could quantify when do you think this parity would be more normalized at about 10%. And when you talk about margins sold in the domestic market and exported from the Brazil BD, what kind you expect in allocation from ME to MI? And I know that you cannot anticipate what will happen with the final decision regarding Section 232. But regardless of that, with the conclusion of the sale of your asset, what kind of margin expansion should we expect to see?

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

When we start drawing projections about how far this parity can go, we have to look at the commercial policy of the company because, usually, there aren't so many details about it. Parity will probably continue to evolve to make up for possible cost increases. But when we look at the company's commercial policy, I would like to just comment on how this parity could evolve in the assortment.

About MI and ME, when there was a drop in demand a few years back, great part of our production was geared to export. Therefore, we are ready to transform the production geared to the external market, the foreign market, and stir it to the domestic market. We can do that very quickly, and I mentioned the example of our melt shop in Moji.

During the most difficult months experienced in the past year, we interrupted the production at that melt shop and now we see a significant recovery of the automotive industry. And, therefore, we are starting up another melt shop. In the next few days, we will communicate the starting up of the melt shop. Therefore, I can say that we are ready to cater to any changes in the demand coming from the domestic market.

Now, regarding Section 232 in the U.S., I will give the floor to Scardoelli.

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

It's still too soon to tell. It would be just a speculation to talk about the effect, but what we've been saying is that the effect would be positive for Gerdau. Our production base is there, and this should bring about a positive effect, but currently it's very difficult to quantify.

And the same thing goes when it comes to margin changes, I mean pro forma after the sale of our asset. It's still too soon to give you any figures. But certainly these products were sold and together with wire rod that was sold in Beaumont, these products had lower margins. And that's why they should bring about a positive effect. But it's too soon to give you any figures about that.

Q - Ivano Westin {BIO 17552393 <GO>}

That's fine. Thank you.

Next question is from Thiago Lofiego from Bradesco BBI.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Good afternoon and congratulations on your results. I have two questions. If you could elaborate a bit more on the cost pressure, particularly the cost of scrap, and what could be expected in the next quarter both in the U.S. and Brazil? We've seen an increase in the scrap prices in Brazil and U.S. And so, I just want to know whether this should be a matter of concern or whether you are just transferring that to prices?

Now, going back to the debate on the domestic market, when I look at your figures in the fourth quarter, you had a drop in long steels, which was a bit higher than what was shown in 2015 against 10%. I just want to understand the reason for this performance and I think it's probably due to the different mix between the companies. But maybe you could shed some additional light to that subject.

And what can you see today considering a rebound coming from infrastructure, industry, machinery, civil construction? And where do you see some green shoots and what areas are not yet recovering? Thank you.

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

Hi, Thiago. This is Gustavo. In terms of rest of the world and in Brazil, we know that there is no direct correlation because there are several factors that do not allow to draw a direct comparison between the behavior of the scrap prices in the foreign market and scrap prices in Brazil. All we know is that scrap in Brazil follows a very peculiar market dynamics.

In the case of Gerdau, we have to factor in the uniqueness of our industrial plan. We can quickly operate a mix between scrap and big iron. In the very specific case of Gerdau, we have an asset of, especially in Minas Gerais that allows us to produce long steels through our integrated mills.

And another factor that we notice is growth in scrap generation in Brazil as a result of the economic rebound that began last year. Therefore, I would say that the scrap behavior that could be expected in the next few months is a model that cannot be fully swallowed. And considering Gerdau's characteristics, we can have a very good cost equation regardless of the recent movements involving scrap in Brazil.

Now, in terms of the domestic market, and you talked about the fourth quarter of last year, there is no structural reason that led us to reduce our stake in long. There is nothing in our radar that tells us that this participation in the next few months will change somehow, quite the contrary.

In terms of the civil construction, we're already seeing signs of recovery even though they are too gradual. It's a gradual recovery, but it's continuously moving forward. In São Paulo, for instance, when we look at indicators such as new launches or new projects, we see that this recovery is actually happening, but large infrastructure projects and more particularly about this topic, I think, it will take a few more months until we can see a more accentuated recovery in the infrastructure market in Brazil.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Thank you. Can you say a few words about electrodes and what is the impact that you anticipate for the U.S. and Brazil? We know the price of contracts was up and your spot exposure is about 30%. I mean, you chose to have that exposure. Could you please elaborate a little bit more on that?

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

Thiago, before Gustavo answers the issue on electrodes, I would still like to say something about scrap. We have a strategy at Gerdau. We buy scrap in many areas. We have our own inventory and we buy all over the country. So, scrap is under more pressure in the central part of Brazil, but we buy from the south and the north, and pig iron as well and this helps us to use pig iron as an alternative to scrap.

So, we have a lot of alternatives and this is part of our business in Brazil, and that continues to be so. So, even though you see short-term pressure, we can factor that in. I always like to remind people that all in all increase for scrap demand has only a reason due to exist because we will have better margins when we see that the market is up. We have more scrap as well. We have to look at the whole picture.

Thiago, you asked about electrodes. In this case, our supply of electrodes has been ensured by a strategy of different vendors. We have many contracts with them. So, in terms of the supply of electrodes to Gerdau plant, that's not a concern that we have.

Our next question is from Leonardo Correa from BTG Pactual.

Q - Leonardo Correa {BIO 16441222 <GO>}

Good afternoon. Thank you. My first question is addressed to Werneck. You clearly allocated free part of your time in your introductory remarks talking about the digital transformation that Gerdau is deploying. I would just like to get a better understanding about value generation. Should we think that this digital transformation would bring about premium regarding pricing or whether this could bring about market share gains. Is that also a possibility of having cost reductions? I just want a little bit more detail, because you focus a lot on that subject and we know from our past discussions that this has been a recurrent search. I mean, you've been focusing in that area for quite some time. So, I would just like to get some more detail on that subject.

And now, moving on to some other questions of mine, I just want some help related to export margin. All the analysts that followed Gerdau in Brazil in the last few years, we know that export hasn't been very profitable and at times it is even negative. So, what about this gap vis-à-vis domestic market? Can you give us some order of magnitude whether it's half or close? I mean, we know that the export market has been a big buffer and it had an important contribution in the last quarter, because the international landscape helped in terms of long steel. There is now a merger between Votorantim and ArcelorMittal, so how do you see competition?

And what about the price formation in this more total scenario? And I also heard some arguments when you talk to the press when you refer to Gerdau's tax rate in the U.S. Could you elaborate a bit more on that? What is the reduction angle or whether you could share with us anything related to tax benefit considering new tax plans? Thank you.

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

Leonardo, how are you? Let me talk a little bit about the digital transformation, and right after that I will give the floor to Scardoelli because you talked about the margins of the domestic export market in Brazil and then you also talked about consolidation and the tax reform in the U.S.

In terms of the digital transformation, as you recall, we started this journey a few years back. At first, we were naïve. We just wanted to verify whether indeed digital transformation could bring about good financial results for the company. So, following state-of-the-art methodologies for digital transformation, we tested out a few things, a market called NBC, so we started by testing the technology, new mindsets, and new ways of developing projects in the company. And we were able to clearly see important gains that could be obtained through this digital transformation.

In the first two years, we focused as digital transformation in-house. We put in place several initiatives in different areas of the company in order to capture a good potential because through the traditional tools, these improvements were not being captured. So, when we see reduction of BRL 600 million in SG&A, it would be very difficult to capture this amount in a short period of time if it were not to the concept of digital transformation.

And Leonardo, whenever we talk about digital transformation, we are talking not only about technology but we are talking about a mindset, cultural transformation. We are talking about giving new approaches to traditional issues.

So, during my remarks, I mean, if you consider a complex company as ours and when we look at all of the number of documents and invoices that are traded every day in our company, we can do a process like that with a lot more efficiency in terms of speed and agility. And we already incorporated this technology mindset in our plants. We apply the technology and digital concepts in our maintenance. There is a very robust contract with GE, GE together with Gerdau, and sold more than 40,000 sensors in the equipment in our plants in Brazil.

So today, online, we can collect all of the data. And then, we have a digital map of what happens in our plants. We can, for instance, forecast a possible failure in one of the equipment a week in advance. So, we avoid equipment failure.

Throughout several quarters, we were able to notice important improvements. Year-on-year, Gerdau has tried to deploy state-of-the-art technology and management tools. But there is a point when that's not enough to capture all of the results. Therefore, I can say that in 2016 and 2017, we were able to capture important gains. So, as of this year, we want to promote a digital transformation in other areas with our customers so that our customers can have unique experience and can also grow. So, therefore, we want to promote a digital transformation with our customers. And it's important that we can share these gains with our customers.

Therefore, Leonardo, in general, this has been our digital journey. And then, I'll give the floor to Scardoelli who can give you figures about margins, consolidation and also tell you a little bit more about the tax reform in the U.S.

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

Good afternoon, Leo. Now, speaking about the other points of your question, you talked about export margins. As you said, this is a very volatile number because it certainly depends on the pricing environment abroad. And there are moments that that is very close to zero.

Well, obviously, at the end of the year, we had more positive international prices. And so, this margin pays a contribution. But without mentioning any specific figures because we hardly disclose these figures, there is an assumption that that is around a half of our gross margin in the domestic market. So, this is an assumption that is not very far from the current moment. Once again, this reflects current positions only, reflecting what we saw in the past few months.

When it comes to consolidation, usually we would rather not say anything because things are still under way. There are still some remedies that have been recommended. So, we do not like to comment on the process. Now, certainly, we know that the Brazilian market is very fragmented. And it's been more fragmented lately. So, this is positive and, obviously this is still a very fragmented and competitive market.

And finally, speaking about the tax reform in the U.S., we've been – whatever we are saying, it's been together with what we hear from others like the announcement that the Trump administration is pointing out to the fact that they want to put together a new proposal to fund infrastructure in the near future together with the tax reform, so that in the middle long range, it's very positive to our operations in the U.S.

We do have a good footprint in the U.S. and this tax reform aims at increasing competitiveness of the businesses in the U.S. which is our case. So this should attract potential investments, and this has a very good effect on steel consumption. But it's difficult now to give you a number. So, the outlook is positive particularly when we consider the news that is coming from the U.S.

Q - Leonardo Correa {BIO 16441222 <GO>}

That's very clear. Thank you very much.

Our next question is from Thiago Ojea from Citi.

Q - Thiago Ojea {BIO 17363756 <GO>}

Thank you. Good afternoon. I will try to just ask two questions. First question is on flat steels whether you could comment on the utilization level that you had in 2017 and more particularly on heavy plate. And how do you see the evolution of that in 2018?

And the second question relates to the M&A process, more particularly in the U.S. whether you still see possible opportunities or whether now you already have an asset base that is comfortable enough for the company and also that whether the CMC deal had any clear due to the implementation of Section 232.

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

Thiago, this is Gustavo. Scardoelli and I will answer your question. I'll start speaking about flats and then I will give the floor to Harley to talk about M&A and opportunities in the U.S.

In terms of flat steels just as a reminder, we have two rolling mills, flat rolling mills in our Ouro Branco mill in Minas Gerais. These two rolling mills together, they sold last year 1.3 million tonnes. We produced and sold 1.3 million tonnes. Our (29:51) hot-rolled strips rolling mill in October 2013 now has capacity of 800,000 tonnes and our heavy plate rolling mill started up in July of 2016, therefore a year-and-a-half ago with an installed capacity of 1.1 million tonnes a year.

More specifically, concerning the heavy plate rolling mill, I think that we are very pleased with the performance of the rolling mill. We have a contract for technology transfer with JFE, and they are a worldwide reference in the production of heavy plate. There is a learning curve of that rolling mill that is now being accelerated. Therefore, we were able to produce better specifications of heavy plate. And we've been successful in the approval of these products with our customers. I'm not going to break the production of the rolling mills. But together, they produced hot-rolled strips of 1.3 million tonnes last year.

Now, I'll give the floor to Scardoelli, who can tell you more about the U.S. and the opportunities in that geography.

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

Good afternoon, Thiago. In terms of the U.S. and particularly regarding our assets in the U.S. and Canada, we arrived at a point in our portfolio that we consider to be very adequate; adequate, because from then on we will begin to see growth in performance improvement.

In terms of our deal with SMC and the Section 232, there is nothing there. Section 232 benefits the production of U.S. steel as a whole, not necessarily only in rebars. Therefore, we have a very good exposure. So we will be well exposed to any benefit and any benefit as well. We produce rebars in the U.S. and Canada in mills where we still have a good portfolio, because these are mills that have a more noble exposure. They may have some exposure in terms of rebars. Therefore, we didn't suffer any losses vis-à-vis potential benefits that could come from this decision. Thank you.

Q - Thiago Ojea {BIO 17363756 <GO>}

Thank you both of you.

Our next question from Caio Ribeiro from JPMorgan.

Q - Caio Ribeiro {BIO 18420483 <GO>}

Good afternoon, and thank you for this opportunity. My first question is about the company's debt position. There should be an important reduction in 2018 with a possible stronger cash generation because of all of the divestments already announced, maybe will be to a level of 2 times net debt-over-EBITDA ratio. I just want to understand what your priorities are looking forward? Whether you would increase the dividend payout or whether you have any other kind of capital benefit in mind that could generate good potential?

And, secondly, what are the reasons behind that BRL 1 billion reduction that you posted this quarter? You also posted an important reduction in working capital in the quarter. I just want to understand whether you see this working capital level as comfortable enough looking forward?

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

Good afternoon, Caio. Here is Scardoelli. First of all, in terms of indebtedness, there was a reduction mainly due to cash reduction which continues to be a positive, and also that stems from the proceeds from the divestment of our assets. From the end of the year until now, I think we announced something close to BRL 1 billion in asset sales; and these proceeds will enter our cash and, this will certainly reduce our debt position.

This also has an impact on dividend payout because when the money comes in, and we don't know when that will happen, the debt will be paid and interest expenses will also benefit our free cash flow position, but our focus is currently to continue pursuing this reduction in net debt-over-EBITDA ratio.

Another aspect is that we are not thinking in terms of changing our dividend policy because dividends should increase, maintaining the 30% payout level. But with the improvement of our results, the dividend payout would also increase. Gustavo said that we are now beginning a new phase. Gustavo said that we are approaching the end of our divestment program. And so, now is the time to start thinking about new opportunities. And the digital transformation will also require some additional capital that will generate profitability improvements and investments.

Another point you mentioned, the second part of your question. I'm sorry, could you repeat it again?

Q - Caio Ribeiro {BIO 18420483 <GO>}

Sure. It refers to working capital. There was a significant reduction in the quarter. I just want to know whether that is sustainable looking forward.

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

Yes, working capital. In terms of days of the cycle, I would say that we are very optimized. Just as with SG&A, there is also always room to do more. This 50-day cycle I would say that if we just maintain the cycle at these levels, maybe reducing a little bit more, but our effort in working capital will be proportional to our business. We will only lose cash (01:06:25) if business improve, if we increase our sales revenue. So this 70 to 75 days that we've had in the past few years, I think we will be able to maintain it. And obviously we will try to be always below that bracket.

Q - Caio Ribeiro {BIO 18420483 <GO>}

Thank you. That's clear.

Our next question in English from Carlos De Alba from Morgan Stanley.

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

Yes, thank you. Just wanted to explore again, so is there any exploits to further improve SG&A in (01:07:15) in the U.S. with the changes in the management structure in that business unit and what about the other business units?

And second, how far or how close to completing the divestiture program are you, given the recent announcement, but also considering that you still have a presence in terms of (01:07:39) and it's not likely to move (01:07:42), so if you could comment on those two that would be useful.

And then, there is very aggressive expectations in terms of consensus in regulatory – the EBITDA for 2018. Have you seen the evolution in the coming quarters of your EBITDA and cash flow generation: one, to be able to make market expectations: and, two, to accelerate the reduction in net debt-to-EBITDA which, while it has been coming down, has been not as rapid as well given it's life (01:08:25)? Thank you.

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

Let me repeat Carlos De Alba's question. First, he asked about SG&A. We continue putting a lot of efforts into a further reduction. And the second question was about divestments, whether we are approaching the end of this divestment cycle. And the third question is about market consensus on EBITDA.

Now the first question on SG&A, well, rest assured that we will maintain a very strong focus. We also mentioned during our remarks that we are reaching about 4% in net sales revenue. And these expenses, I mean, the drop in expenses will go further once the shipments will continue to increase. So once shipments increase, we will be able to reduce that even further.

So this is a constant focus of the company, all of the operations are focusing on that reduction. In some instances, we are more aggressive than in others. But certainly, we see a lot of room to promote further improvements in that regard.

Now in terms of divestments, we already said that we are approaching the end of the divestment phase. I think what still remains to be done is still something very marginal, vis-à-vis, what has already been announced. We talked about BRL 6.3 billion in proceeds in the last four years and almost BRL 3 billion were announced from the end of last year to now.

And so we are approaching the end of this process. What remains is just very marginal, because the bulk of it has been done. And the third aspect about the EBITDA consensus, we do not give out guidance and we do not give specific comments on market expectations.

It's still too soon in the year to say anything. I think you've noticed from our remarks that, well, at least last year and we started the year with a more optimistic view to our divestment plan and the leverage position, place us in a very good position. The company is quicker, more agile, and we all talked a lot about that. So I would say that the market range, I mean, everything is within the possibility. So we do not give any specific guidance about that.

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

Thank you.

The next question is from Caio Ribeiro from JPMorgan.

Q - Caio Ribeiro {BIO 18420483 <GO>}

If you allow me one last question considering that you're giving us another chance. My question relates to the U.S. metal spreads, and I do apologize of you said something to that end. Could you please tell us how you see that today and what would be evolution of metal spreads vis-à-vis the third quarter?

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

Caio, this is Harley. We are not used to giving specific guidance. But rest assured that the trend at this time of the year in the U.S. is that they're leaving winter and the climate will be a bit warmer and they will find scrap more in the northern part of the continent. So there are more construction being done. So the tendency is for an improvement in metal spreads. But I cannot say anything else than that.

Q - Caio Ribeiro {BIO 18420483 <GO>}

Very good. Thank you, Harley.

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

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

Well, I would like to thank all of you for participating in this call and I would like to invite you to participate in our next conference call related to the first quarter of 2018, which will be on May 9. So on my behalf and on behalf of Mr. Scardoelli, it was a great pleasure to talk to all of you. I wish you a very good afternoon. See you later. Thank you.

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