Q2 2020 Earnings Call

Company Participants

- Gustavo Werneck, Director, President & Chief Executive Officer
- Harley Scardoelli, Executive Vice President and Chief Financial Officer

Other Participants

- Caio Ribeiro, Analyst
- Carlos De Alba, Analyst
- Daniel Sasson, Analyst
- Leonardo Correa, Analyst
- Marcelo Audi, Analyst
- Rodolfo Angele, Analyst
- Thiago Lofiego, Analyst
- Thiago Ojea, Analyst

Presentation

Operator

Good afternoon and welcome to Gerdau's Conference Call to discuss the Results related to the Second Quarter of 2020. At this time, all participants will be in listen-only mode and later on we will initiate the Q&A session. (Operator Instructions)

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

Gustavo Werneck {BIO 20318216 <GO>}

Good afternoon, everyone. I would like to start by welcoming all of you to Gerdau's conference call to discuss the results of the Company related to the second quarter 2020. I hope you're all well, healthy and safe and navigating through this period the best way possible.

Joining us today is our CFO, Harley Scardoelli, and we are both very glad to share with you our performance in the quarter and also clarify possible issues that might come up during our presentation.

I would like to point out that this conference call is being conducted in compliance with all social distancing protocols adopted by Gerdau. Scardoelli will talk about the highlights of the results in the quarter and also, he will talk about the performance of our operations. After his presentation, I will comment on the markets where we operate and the landscape looking forward, even though the moment still poses many uncertainties. And as usual, at the end, both of us will be available to answer your questions.

So now I will give the floor to Scardoelli. You may proceed.

Harley Scardoelli {BIO 7283603 <GO>}

Thank you very much, Gustavo, and good afternoon, to you all. It's always a pleasure to be with you again for another earnings release call and I hope that you're all well. I will start by talking about the financial results for the second quarter 2020.

As you can see from the slide, in the second quarter '20, we posted a positive free cash flow of BRL205 million even considering the dire period of the COVID-19 pandemic. This improvement vis-a-vis Q1 '20 reflects the combination of an EBITDA 12% higher than in Q1, and maintenance of a stringent financial discipline in terms of CapEx and the control of some items like delinquency and accounts payable.

It's worth mentioning that in the last 12 months the Company posted positive free cash flow of around BRL4 billion reinforcing its liquidity position. The cash conversion cycle went from 83 days in March 2020 to 95 days in June due to lower net sales in the period. It's worth highlighting that part of the working capital increase was influenced by the exchange variation in the period caused by converting the working capital of the North America BDs into Brazilian BRLs.

Now moving to Slide 3, I would like to point out to talk about our debt position. Also, I would like to point out that, we ended the second quarter 2020 with a stable net debt of around BRL14 billion. I also take this opportunity to mention that 82% of the debt is long term, with an average tenor of 7.2 years and with an average cost of 4.7%, which is a very balanced and distributed scheduled for the next coming years. Currently, we have BRL18 billion in dollar-denominated debt, representing 85.5% of our total debt.

We understand that as a large portion of our EBITDA is generated in US dollars and having a significant portion of our assets and operations located in North America due to our geographic diversification, we have a natural hedge to support this debt position, coupled with the fact that it's a long-term debt with maturities scheduled along this period with no accrual of payments in any specific year.

The net debt over EBITDA ratio went from 2.55 times in Q1 20 to 2.78 times in Q2 of '20 due to lower EBITDA in the last 12 months and mainly due to the exchange variation in the period attributed to the dollar-denominated debt that was converted into Brazilian BRLs. The Company remains focused on reducing leverage and reaching the KPIs defined by the Board, which is between 1 to 1.5 times in the long term.

Now moving to Slide 4, one of the most frequently asked questions we get from the market, especially on the onset of the COVID-19 pandemic, refers to the Company's financial liquidity. Therefore, I take this opportunity to present our credit line position of BRL4.4 billion, also which by June 30, the cash and cash equivalent was BRL2.4 billion, which means, I mean together with our cash flow, it accounts for a total liquidity of BRL9 billion as seen on the previous slide.

It is worth mentioning that our credit line is committed and structure available at any time and structured at eight very soundly international banks with maturities in October 2024, and available for immediate withdraw in most of our operations and geographies.

It's also important to highlight that since 2015, the Company has not carried any financial covenants or MAC clauses. This allows us to be more comfortable and have enough time to adjust our operations and CapEx to our long-term commitment of maintaining debt aligned to the financial policy of the Company.

To finalize the liquidity topic, we would like to draw your attention to the low delinquency of our customers, which has been capped at historical levels despite the COVID-19 pandemic period. This is attributed to our policy of being proactive in close to our customer base.

On Slide 5, I will elaborate on the main factors that impacted consolidated EBITDA that went from BRL1.2 billion in Q2 '20 to BRL1.3 billion in Q2 '20. This increase was mainly attributed to higher shipments in the Brazil BD.

Moreover, adjusted EBITDA contemplates the elimination of non-recurring effects of fixed costs of the non-operating mills in the quarter, mainly due to the impact of COVID-19 in April, net of credit provision recoveries in the period. We emphasize that in the EBITDA of the operations these non-recurring effects were purged and in keeping with what has been done in the last few quarters.

Also another highlight is the EBITDA margin of 15.1%, notably, 18.6% margin in Brazil and 10.5% in North America. Together they account for over 80% of the consolidated EBITDA of the Company in the second Q. In Brazil, when compared to Q1 '20, EBITDA was higher due to increased shipments, including export opportunities and also a favorable exchange variation in the period.

I take this opportunity to highlight the 10% increase in total shipments of long steel mainly attributed to the resilience of the civil construction industry. In North America, EBITDA and EBITDA margin in Q2 '20 were flat when compared to Q1 of this year, despite lower shipments in the period that was offset by efforts to reduce costs of the operations coupled with more favorable metallic spreads that went from $411 per short ton in Q1 to

$415 dollars per short ton in Q2. In South America, lower shipments, mainly due to the state of emergency in Peru, that led to a decline in EBITDA.

To conclude in the special steels business division, the shutdown of the automotive sector resulted in utilization rates below 30%, impacting the main operating results. Still, the cost reduction efforts contributed to promote a relative stability in the EBITDA margin when compared to the second quarter of 2019.

I would like to thank you for your attention, and now, I'll give the floor to Gustavo who will comment on the market outlook.

Gustavo Werneck {BIO 20318216 <GO>}

Thank you, Scardoelli. So please let's move to the next slide so we can talk about how Gerdau has operated during this pandemic. The second quarter and particularly the month of April, was a very challenging period due to a landscape of uncertainties and volatility brought about by COVID-19. As we saw from Scardoelli's report on Gerdau's performance in the period, I would say that, we benefited from our business model that focuses on a strong proximity with our customers, flexibility of production routes, market diversification and also, an agile culture for decision making. And all of that achieved through a cultural transformation started a few years back.

Today, we are a Company that seeks to add even more value to our customers. We are lighter and less hierarchical, which allowed us to react faster, I would say, and even more efficiently whenever we saw signs of recovery in the markets that we operate along the second quarter.

Now, going to the next slide, Slide 7, now, I would like to talk about the markets served by Gerdau and the outlook for the next few months. I would start with Brazil. In Brazil, this agility in decision-making led to an efficient restart of the industrial activity in the country throughout the quarter and also led to the resumption of the blast furnace two in Ouro Branco, in Minas Gerais, allowing us to serve the demand of the different markets we operate in addition to capturing spot export opportunities because of the favorable exchange rate effect, and also, due to a better global scenario of product supply.

As we have seen, the pandemic hit Brazilian regions in different ways and moments. And our diversified geographic presence, as well as our flexibility in raw material routes, including barrel scrap, coal and (inaudible) allowed us to quickly respond to the needs of the market, which in turn performed better than initially anticipated.

According to data from Instituto Aco Brasil, steel consumption in the country grew 30% in June when compared to May when it grew almost 20% vis-a-vis the previous month of April.

The construction industry remained resilient during the period and due to that, 95% of all construction works remained active in the last three months according to data from the Brazilian Association of Real Estate Developers. The rebound of the retail industry was also surprisingly good, boosted by purchasers of construction materials from self builders, who benefited from the emergency support measures provided by the federal government in an effort to assist the population.

Looking ahead, we remain confident that the demand for longs in Brazil will be resumed given the continuity of the construction works, the increase in retail purchases and the resumption of the infrastructure projects.

On the other hand, the industrial sector was more adversely impacted this quarter, but we are, already seeing a gradual rebound of the activities in the different areas and sectors we operate. One of the highlights is the good performance of the wind industry and agribusiness, both sectors posted higher levels of activity in the period.

One positive example is an industry survey conducted by Foundation Getulio Vargas that shows an increase of almost 13 points of the industry confidence index, ICI, according to preliminary July figures when compared to figures from the end of June, reaching 90.1 points. If this result is confirmed the index we will have recovered 74% of the losses incurred in March and April.

Now, let's talk about our special steels operation. In Brazil, all automakers resumed their activities between May and June, but it's still at much lower levels causing us to take measures to reduce production. Sales and demand recovery is slow and gradual, and ANFAVEA, the national association of manufacturers of automotive vehicles had a review its projections for this year estimating a 45% drop in vehicle production when compared to 2019.

For the next coming months, we anticipate that the wind and the agricultural machinery industries will be even more resilient and we also see growth opportunities in the domestic production of auto parts driven by the new behavior seen in the international market.

In the United States, the demand for special steels was also affected by the shutdown of all automakers, and also, the low level of activity in the oil and gas industry. The North American automotive industry is already showing signs of a gradual recovery, with almost 2% increase in sales of light vehicles in June when compared to May. Furthermore, we move forward with our initiatives to optimize costs and increase productivity in the special steels operations in the US, with the shutdown of the Jackson unit in Michigan.

On the other hand -- and now, looking at our longs operation in North America, shipments of this BD suffered a slight decline early in the second quarter, especially in April, but returned to good levels in the following months, driven by the positive performance of the construction industry, which was active in the period.

Even in June, the order backlog in the US went back to pre-crisis levels, which was seen in March. As for metallic spread, it posted a slight recovery in the quarter above $415 per short ton, and this amount should remain stable throughout the following months.

Furthermore, I would like to mention our efforts to reduce fixed and variable costs, like our decision to shut down the St. Paul unit in Minnesota last June. The market supply will remain the same even with the shutdown of that mill as our customers will be served by our other plants located in the United States.

As part of our sustainability journey, we also announced an important partnership with 174 Power Global to develop a solar plant in Northern Texas that will generate clean and renewable energy to our Midlothian mill.

In the US, in the short term, we believe that both civil construction and the infrastructure sectors will remain resilient while the industrial and energy sectors will react slowly. Also, it is expected that major public infrastructure investments amounting to $1.5 trillion will be in part released thus boosting the recovery of the US economy and the consumption of steel. And we remain vigilant in regards to unemployment levels in the country and obviously, we are very attentive to the developments of the presidential elections next November.

And in South America I would like to highlight a return of the industrial and construction industries in Argentina and Uruguay, where we could resume our industrial activities in mid-April. And in Peru, we resumed steel production at the end of May, after almost two months of limited industrial activities and suspended deliveries to our customers.

Lastly, on this slide I emphasize that this quarter, we invested BRL271 million in PP&E, plant, property and equipment. CapEx spending for the three-year period between 2019 and 2021 remains at BRL6 billion, with an investment estimate of BRL1.6 billion for 2020.

And as I mentioned before, in Q1, we reviewed our investment plan and adopted a more conservative position to approve projects due to the uncertainties and the volatility of the market.

Now, moving to our next slide, Slide 8, I would like to highlight the creation of Gerdau Next, our new business arm that was recently announced. The arrival of Juliano Prado to lead this new VP position will certainly allow us to expand and accelerate the new businesses created by Gerdau in the last few years linked to the steel chain and its related products, reinforcing our view towards long-term growth.

Moreover, as part of our ESG strategy, in June, we launched the integrated report related to the year of 2019. For the first time the report contemplates the Company's materiality matrix and complies with the international reporting standards of the Global Reporting Initiative. This is another important move towards our commitments to transparency and sustainable development.

Finally, I reiterate that we have introduced a series of measures to mitigate the risk of spread of COVID-19 in our facilities to ensure the health and safety of our employees, all values that are non-negotiable to us. There is active care that follows all protocols from healthcare authorities has resulted in low levels of contamination in our units promoting an even safer workplace.

In addition, with most of our employees working from home for nearly five months, we managed to keep a high level of productivity and be quick at decision making. All that very much due to our enhanced culture that focuses on simplicity and independency.

We continue to invest and to operate collaborative in the communities where we are located, donating equipment and assisting the local health care structure, thus leaving a legacy to help society go through this difficult period in the best way possible.

And to conclude my presentation, I will then like to express my deepest thanks to the Gerdau team, to all of our employees and service providers, our partners for their outstanding work and efforts and dedication this last quarter, in particular. Without you we wouldn't be able to go through this challenging quarter delivering such solid results and especially, preserving the lives of people.

Well, with that, I conclude my part of the presentation. And now, Scardoelli and I, will be available to answer your questions.

Questions And Answers

Operator

(Operator Instructions) Our first question comes from Mr. Daniel Sasson from Itau BBA.

Q - Daniel Sasson {BIO 19234542 <GO>}

Good afternoon. Thank you, Gustavo and Harley for your presentation and congratulations for the results and thank you for the opportunity of taking my question. Gustavo, during our last call, you said that the May order book was only 25% below normal levels. Can you please try similar analysis and elaborate a little bit on your order book and how is the June order book behavior vis-a-vis the first quarter, and whether you believe that you may have more stable numbers through the end of the year or maybe increase the order book?

And my second question maybe to Harley. Harley, can you help us re-conciliate the numbers for your fixed cost of shutdown operations for each operation? This can help us figure out what could happen from now on after the third quarter because I imagine that the bulk of this impact may not be repeated, because I know that you interrupted the blast furnace 2 in Ouro Branco. So that's my question. Thank you.

A - Gustavo Werneck {BIO 20318216 <GO>}

Thank you for your question. It's been some time since we last talked and I hope you are all well and healthy. I'm located in a different geography than Scardoelli. So I will start answering your question and then, Scardoelli will answer the question about the reconciliation. This is a very good opportunity for us to give you more details and to give some color to how we see the markets in the segments we operate throughout the second quarter. And maybe this is an opportunity to tell you what we see, what is the outlook.

Daniel, back on May 6, that's when we had our last results release, some people were surprised when I said that maybe the worst period is over. In fact, back then, we already saw some clear signs that the recovery was already taking place in a more consistent way. If you recall, what I said, that the worst is behind us. It means that maybe I think we are very optimistic with the second half of the year, but in general terms, when you look at the main segments where we operate, particularly in Brazil, Daniel, I will start with the civil construction sector, particularly if we refer to residential and commercial construction, this segment is very intense with a lot of activity. There were some highlights in the second quarter and we noticed that when the sector resumed their sales, in fact, sales exceeded expectations of the sector. And throughout the quarter, we also saw some construction companies that they believed in the pickup of the demand, that's why they are accelerating their works and expediting their steel orders.

This segment paid an important contribution to our steels operation, especially on concrete and the sales of steel was very important because of rebar sales, profiles, et cetera, in the second half of the year. We saw 10% more steel for concrete in the second quarter of this year when compared to the same period of 2019. And when we compare the second quarter of this year to the same period of this year, there was an increase of 20%. This shows that this sector paid an important contribution to our shipments.

Now, going to the second segment that is equally important, which is the infrastructure sector, that was stagnated for some time. We also notice a slight recovery. I would like to mention some projects that were resumed, the Yellow Line, the Green Line of the subway, the subway in Fortaleza, the beltway in Sao Paulo. So there was a slight recovery in this industry and there were also other important advances in the energy sector, wind farming, and every business, they all posted a strong demand.

And the third segment out of the four, which is the retail segment, was another major highlight in the second quarter. When it comes to the retail construction business, they launched a lot of products. Our deliveries in the segment in June alone were the best one ever since March of last year because of all of the government incentives, we had a very good performance. We also noticed an increase in self construction. People were home during the quarantine and decided to make renovations. We had record sales of nails and wire for the agro industry. We had an excessive sales through our digital channels in June and this just reinstates our success in the digital area. And I once told you that you can also sell steel on the web. The Internet is playing an important role and our digital company posted very good performance reaching about 80,000 construction stores with more than 600 participants.

And now, Daniel jumping to your last question, the industry is also another segment that showed signs of recovery, maybe not as robust, but also a good recovery. The agricultural side was more robust because of agribusiness. The Yellow Line, I mean Brazilian companies are taking advantage of the current export advantages and so they are exporting more. And I would also like to mention White Line, springs for mattresses. Therefore, we were able to take advantage of all of these opportunities. I do not want to refer to the numbers from June, but June and July were strong months. And June was not a single month, but we are already on August 5, and I'm sure we will have some very good developments this month. I think it's important to give you a general overview of our businesses so that you know where these results are coming from and what we expect looking forward. So now I'll give the floor to Scardoelli to talk about reconciliation. Thank you.

Q - Daniel Sasson {BIO 19234542 <GO>}

Thank you, Gustavo. That was very clear.

A - Harley Scardoelli {BIO 7283603 <GO>}

Good afternoon, Daniel. In terms of reconciliation and the fixed cost of all of the different shutdowns, out of the BRL119 million that we announced BRL75 million refer to business operations in Brazil, BRL28 million related to special steels operations both in Brazil and in the US, BRL28 million for both, and South America BRL26 million. So BRL75 million Brazil, BRL28 million specialty steels. And still along the same lines, we want to keep consistency so that you can see some non-recurring items in our results, that's why we open up the figures. And you can see that we had positive advances in credits and provisions and there were also some other negative aspects, like losses in terms of fixed costs of the operations that were shutdown.

Q - Daniel Sasson {BIO 19234542 <GO>}

Okay. Thank you. Thank you. Scardoelli.

Operator

Our next question comes from Thiago Ojea from Goldman Sachs.

Q - Thiago Ojea {BIO 17363756 <GO>}

Good afternoon, everyone. Thank you for taking my question. My first question, I think, it's addressed to Scardoelli, refers to CapEx. CapEx was reviewed as expected because of the pandemic, but could you tell us what you anticipate for CapEx, not only for this year, but for next year as well? And what will be your priorities in terms of expanding CapEx and where do you see the market having further opportunities?

And my second question maybe addressed to Werneck. It's more like a long-term view. We've seen a major change in the last few years. Gerdau is one of the major players in this industry. Now, we have already seen some behavioral changes on the part of the consumers, which are using online shopping more frequently. Can you tell me something more about this Gerdau Next initiative? Do you think that this will encourage further collaboration from the steel milling industry, what are your main targets of the Board looking a little bit further ahead?

A - Harley Scardoelli {BIO 7283603 <GO>}

Hi, Thiago. Well, I will refer to your first question about CapEx, right? Good afternoon, Thiago. In terms of CapEx, we still focus on the plan that was reviewed earlier this year. So our CapEx for the year should be BRL1.6 billion. Well, we have spent BRL271 million in this quarter, so we have about BRL740 million in the year. So the idea is in fact to reach BRL1.6

billion for the total year of 2020. After that, Thiago, we usually wait until the end of the year to review our bi-annual plan or our multi-annual plan like we do every year. So we will have to wait, particularly considering the volatility of the market this year. So we were very cautious when we review our position for 2020 and we will revisit it again at the end of the year.

Q - Thiago Ojea {BIO 17363756 <GO>}

Scardoelli, if you could tell us about what is the main project in the short and mid-term of the Company, if there is any priority?

A - Harley Scardoelli {BIO 7283603 <GO>}

We have already announced, Thiago, that we will give continuity to our refurbishing project of Ouro Branco. So I think this is one of the major projects that we have for the near future. As a reminder, you may recall that we had plans or things that we did in the past and there are things to be done until 2021. It's part of the schedule, but I would say that this is one of our top priorities, it is the Ouro Branco mill.

A - Gustavo Werneck {BIO 20318216 <GO>}

Thiago, talking about the future, next January, the Company will celebrate its 120 years anniversary. When a Company has 120 years of history, I think, we have to be even more humble and reflect more because when we look abroad a lot of companies that are more than 100 years old, sometimes they do not keep pace with the current momentum. And we have to work hard not to be left behind. What is causing us to accelerate our transformation is the fact that all of the studies show that there is no other material with the potential of steel that could replace steel in the long run. So it will all depend on how we will serve our customers and this will change and it has been changing significantly. Who would say that we would be able to sell steel through digital channels and this is a reality that is here to stay.

So certainly in the sectors where we have expertise, some others will come and will try to take advantage of that, but we wanted to take the leadership and reap the opportunities before everybody else. There is still some investment in civil construction that is wasted. I mean we can build things very fast in Brazil. We built up a hospital in only 40 days using modular construction, metallic construction. We used to see the constructions in China and they could do amazing things, but now we can do the same things in Brazil. So opportunities like that can be found everywhere.

We started looking for opportunities in the past through operations. As you know in Brazil, I think that we have the opportunity to talk to you about things that we were doing like logistics companies and other things, but things gain such proportion that we couldn't do everything at the same time and accelerate and generate new business, that's why we decided to create Gerdau Next. And I am pretty sure that this new arm of the Company will be very successful and we will be able to deliver good results with the good businesses that were created in the past. We are very optimistic because we will be able to generate good value through Gerdau Next. We believe that in 10 years' time Gerdau Next will be able to have sales of BRL10 billion.

And at the same time, there is another topic that is here to stay and that will certainly occupy most of our conversation, and this is ESG. Now that we are creating everything that is necessary to become a very young 120-year old and continue to generate value to our customers to continue our journey for another 100 years.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Thank you, Werneck. I only have two very quick follow-ups. Well, the sound is not very clear. You said that Gerdau Next hopes to achieve BRL10 billion in sales in 10 years. In this context of change, do you believe that the steel milling industry will be further consolidated worldwide?

A - Gustavo Werneck {BIO 20318216 <GO>}

Thiago, as we announced before, we hope that 20% of Gerdau's revenue in 10 years' time -- we will be able to generate new businesses with annual revenues of BRL70 billion. So that figure comes from that curve that I mentioned before. Now, Thiago, I particularly see a period of further consolidation of the steel industry in the world. We see this happening in China despite the crisis. And I take this opportunity to reinstate changes that we made to our strategy in the past. What matters to us is profitability now. We are very attentive to profitability and we are constantly seeking for further opportunities to add value to our customers by offering more services, less commodities and this is an important path forward.

And we also look at niche market opportunities. And a practical example is Gerdau Summit. This involves our JV with the Japanese and we continue to grow. This is a segment that continues to grow in Brazil, and I'm referring to wind farming. Most of the steel for that industry was imported, the steel used in the wind generators, but now we can produce that steel locally in Brazil. That was a niche opportunity, and we will certainly look for other opportunities of that type in Brazil.

Q - Thiago Ojea {BIO 17363756 <GO>}

Fine. Thank you, Werneck and Scardoelli, and congratulations for you results. I know that this was a very challenging quarter.

Operator

Our next question comes from Caio Ribeiro from Credit Suisse.

Q - Caio Ribeiro {BIO 18420483 <GO>}

Good afternoon, everyone, and thank you for this opportunity. My first question is about the margin for Brazil. In this quarter, it was almost 19%. When we look towards the third quarter, you could benefit from the stronger volumes and better prices announced in July. You see the price of scrap that has been increasing recently. I just wanted to understand what do you think should prevail? And whether we could see or not any margin expansion towards the second quarter? And about Resolution 232, if we could shed some light about the benefits that you attribute, given the review of tariffs or even the removal of the tariffs, this would be very helpful?

A - Gustavo Werneck {BIO 20318216 <GO>}

Hi, Caio. When we talk about margin in Brazil it's important to consider some elements throughout the second quarter. And the first is, I will talk about product, then scrap and then exports and then export premium. As I was saying, there was a rebound of certain segments and we were able to deliver nicher products that have a higher margin when compared to the mix that we delivered before. So the mix is better now. And about scrap, scrap in Brazil -- just to help you understand what happened, because this is an important topic for us. Scrap in Brazil in the first quarter of this year had prices very similar to prices at the end of 2019, but already showing signs of increase. So in the first quarter it already reflected increases of the international scrap prices. During the crisis we saw also a rebound in the domestic market. In April, there was a total collapse of the market so we were able to navigate through an opportunity in April. We were able to buy scrap at very competitive prices. We expanded our spread because of that. And now, with the recovery experienced in the last few months, we already saw that scrap prices resumed to the levels of the first quarter. There was a very significant contribution of metallic prices in our results.

Also, I would like to add another element, which is exports. In 2018, we had strong exports and the international prices were down. But now, also due to the transformation that the Company went through and our agility in making decisions and considering the international market landscape, we were very quick to identify good export opportunities. We were able to close some very good export deals when we saw that that they could turn into businesses with positive margins. We made a decision to resume our blast furnace 2. We were one of the first companies to resume production, not only at our many mills but to resume production of the blast furnaces that were shut down. We have export businesses going until December, with margins that are interesting when you look at the average margin margins of the market.

And finally, I should say that we navigated with negative export prices also in terms of our coil hot rolled strips, it was 20% negative, but now with increased prices, our objective is to lead our margins to where they should be. And even with all of that, at the end of this price round, our export price should be close to zero. Traditionally, that export premium fluctuates around 10% positive. All of these elements explain a little bit of what happened in terms of our margins in Brazil in the second quarter.

But also now I can talk about Resolution 232 in the US. The 232 Resolution impacts the US operation, but not the Brazilian operation because we do not export from Brazil into the US. So the 232 impacted our operations in the US, but I would like to remind you that after our divestment in rebars, we are less susceptible to the impacts coming from exports. So at this at this time, I do not see the elimination of 232, but I must say that we are much better prepared today to operate in the US market without the benefits that Section 232 promoted in the market. So these are my answers to your two questions.

Q - Caio Ribeiro {BIO 18420483 <GO>}

Thank you. That's very clear. Thank you, Werneck.

Operator

Our next question from Thiago Lofiego from Bradesco BBI.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Good afternoon. Thank you, Werneck. I have two questions. The first is about exports. I just want to understand what is the level expected of exports looking forward? Should we continue to expect a sequential recovery and where are you exporting, where do you see better export opportunities? And the second question is whether you could comment on Silat? If you could tell us a little bit about the outlook numbers and synergies, et cetera?

A - Gustavo Werneck {BIO 20318216 <GO>}

Hi, Thiago. So let's split the questions and I'll give Scardoelli the opportunity to answer part of them too. We are very much up to speed in terms of the this topic about Silat. We can see increased exports this quarter vis-a-vis the first quarter. We are ready have a portfolio for the next few months, we have a good outlook for September and October and we are already negotiating a portfolio for November and December. So there will be an increase in exports. I believe that the major change that that we saw in the market is that after 11 years, China became a net steel importer. Last time, they imported any steel was 2009. So the fact that China is exporting steel gives us other opportunities, because we were able to identify opportunities with good margins, maybe not as good as the ones we had in the past, but it can certainly contribute to give us a positive average margin in Brazil.

And the markets are the traditional ones. Our affiliated companies in Latin America and we are also identify other opportunities in the Middle East, in Asia. Therefore, I believe that our export portfolio for the second half, it's well underway with very good opportunities. In the next 30 to 40 days our exports portfolio will be fully concluded until the end of the year.

Q - Thiago Lofiego {BIO 16359318 <GO>}

So does it make sense for you to go back to an export annual regime as we had last year? When you compare this quarter to the same period of last year, it was still lower. I just want to have a better idea of the level. DO you think that now the levels are better than it was in the past or not?

A - Gustavo Werneck {BIO 20318216 <GO>}

Thiago, in terms of comparison, I think, we can resume exports in the second half at the same levels we had earlier last year, I think it's, that's a good comparison parameter. Scardoelli, can you talk about Silat?

A - Harley Scardoelli {BIO 7283603 <GO>}

Good afternoon, Thiago. In terms of Silat, the latest news is that we received CADE's approval in June and early July, still pending a last resort to get the final authorization and approval. This final approval will come probably late August and early September, but this certainly depends on CADE's internal schedule. It's just a matter of time. And I believe that in the next two months, we will have the final approval and the company will then be part of our business. It makes a lot of sense because strategically speaking, it's a region where we are already present and there are lots of synergies with the company in the region, therefore, it's important that we take advantage of the growth that this will give us in Brazil.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Do you think you can talk a little bit about numbers or you would like to leave that for the next earnings release call?

A - Harley Scardoelli {BIO 7283603 <GO>}

I think we should better wait for the final approval because it has a lot to do with logistics, et cetera. But we would rather wait before we give you any solid figures.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Okay. Thank you. Thank you, Scardoelli, Werneck.

A - Gustavo Werneck {BIO 20318216 <GO>}

Thank you, Thiago.

Operator

Our next question from Rodolfo Angele from JPMorgan.

Q - Rodolfo Angele {BIO 1541593 <GO>}

Good afternoon. I have two questions. First, in addition to being very surprised with the market recovery, we were also surprised with your performance vis-a-vis costs and expenses. Many of your businesses posted high margins. You already talked about some of the reasons why you were so successful, but maybe you could tell us a little bit about SG&A and costs, what is here to stay and what will be compensated further on?

And then, my second question is about tax reform, weather you have any study or any view about the impact that this could have to Metalurgica Gerdau?

A - Gustavo Werneck {BIO 20318216 <GO>}

Hi, Rodolfo. I will talk a little bit about costs in a more qualitative way and then, Scardoelli can add any figures related to costs and expenses, and I think you can also talk about our impact analysis both for good for Gerdau SA and Gerdau Metalurgica in relation to the tax reform. Rodolfo, in the last few years, I mean, our Company is very lean and very well prepared to navigate despite the scenarios. And the more we reduce expenses and the more we look for more competitive costs, the Company can move even faster. This is quite interesting. This quarter we saw that this agility that we brought into the Company has been crucial for us to capture other opportunities. Sometimes we talk about transformation, not only of SG&A or fixed or variable costs, but we also refer to a cultural transformation. These are the times that we can put all that to a test. And we realize that

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there is speed to market and the fact that we are making some appropriate decisions is something that has been very present in our day-to-day operation. We drew up a very robust plan to reduce expenses, fixed and variable costs, during the pandemic period. Some of these costs and expenses will not continue with time, like the decision we made to reduce working hours and the reduction of the pay check of our employees. I mean things will eventually go back to normal, but we were able to identify opportunities to cut more structural expenses.

Where we thought there was no more opportunities, we found additional opportunities. Even with declining revenues, we were able to reduce 3.5% of our net revenue. We can always look for better results. And there were also some other initiatives that they will certainly help us our special steels operation. In North America, we shut down our Jackson mills. In terms of our longs operation, we should down the Minnesota mill. So these are all structural costs that are being reduced. It's a combination of both things that will help us have a more competitive and lean Company. Scardoelli, if you want to add to what I said or add more figures and also, answer the question about the tax reform, please be my guess.

A - Harley Scardoelli {BIO 7283603 <GO>}

Okay. Good afternoon Rodolfo. There is another minor component related to cause our SG&A in the quarter when compared to the first quarter went from BRL360 million to BRL306 million, as a percentage of our sales net revenue even from 4% to 5%. That means that 0.5% of the improvement of our EBITDA margin from the first and second quarter. What Gustavo said we were very quick to move and deal with our cost structure and this produced very significant impact. In terms of the tax reform, there are two important points. First of all, I believe that this proposal deals with goods and services and I believe the tax reform is moving in the right direction, I mean a better legal security and other things. We also know that it's pending Congress approval, but there has been many suggestions for improvements and we have to monitor that closely. We believe that in fact it's moving in the right direction.

There is another specific aspect of your question related to the impact of a decree, law about the accrual and this refers to the gross revenue of the Company. I think the main objective is to participate in holdings. We think that in a way interest on equity comes as a revenue that is included in the core business of Metalurgica, of the steeling mill, and this remains our recurring revenues of interest on equity. But again, this still has to be further improved, (Foreign Language). I mean, it's still very soon to tell what will happen, but this is just our first reading of the situation.

Q - Rodolfo Angele {BIO 1541593 <GO>}

Excellent, thank you very much.

Operator

Our next question is from Leonardo Correa from BTG Pactual.

Q - Leonardo Correa {BIO 16441222 <GO>}

Good afternoon, Werneck and Harley. I had some problems with the connection. So I do apologize if I repeat myself. I know that this call has extended over an hour, therefore, I will try to be very brief. First of all, in terms of demand in Brazil in 2020, there are still some differences in numbers between steel and longs. And when we look at the data for long steels there has been an increase in June and probably, the same thing will happen -- I mean, happened in July and will happen in August. I just want to make sure that it makes sense for Gerdau to think about some sort of stability or maybe an increase in shipments in the domestic market for long steels and whether it would make sense for us to work with the scenario you would rather be more conservative?

The second question, I mean Werneck, I know you do not comment on pricing and we are aware of that, but as it is a public issue widely publicized, well, we've talked about long steels, I mean between 7% to 10% increase and there were also talks about another increase in September. Is it fair to say that there will be an increase in September? And how do you see that zero parity? Does that contemplate the increase in July and in September, or only the July increase? I Just want to have an idea. And if you can also give me an idea about capacity increase?

A - Gustavo Werneck {BIO 20318216 <GO>}

Well, it's a pleasure to talk to you again. It's been quite some time since our last conversation. Looking at the IBDR [ph] numbers, they have given average of the entire industry, including different segments. Obviously, it depends on the situation. There are companies that operate in different segments, so the numbers maybe could be up or down. The numbers are just drawing some comparisons. When we look at Gerdau numbers in the numbers from the IBDR. If we look at the first three months of -- the first six months of 2019 and the first six months of 2020, the institute informs a drop of 5% and our drop was lower than that. When you look at flats the IBDR number in the first half of ' 19 when compared to this year they informed a drop of 14% and in our case, it was zero. When we look at flats, it was less in the automobile industry and more in the construction. So data collection covers the average of the industry, but then you have to look at the specific segments. And certainly companies have different performances, as it was our case in the second quarter of this year.

In terms of pricing, even though we are very cautious when it comes to talking about commercial details, as announced, we had our first price adjustment between 8% to 10%. This has been in the market for some time and great part of these increases have been captured in the June results. And in longs, the second increase of 8% will happen in August, not in September. This increase has been announced and it's been negotiated with our customers now in August. In September, there will be an increase in flats. So this is for a September, about 11%. When we talk about export premium, if all of these increases are materialized, the export premium will go down to zero, and then, maybe the numbers will go to the positive side, if you compare the expert averages.

Q - Leonardo Correa {BIO 16441222 <GO>}

That's fine. It's very clear. Thank you though.

A - Gustavo Werneck {BIO 20318216 <GO>}

Thank you.

Operator

Our next question is in English from Mr. Carlos de Alba from Morgan Stanley.

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

Thank you very much and good afternoon, everyone. So my question is, the Company posted a very strong quarter definitely from an EBITDA perspective. The only thing that I was a little bit -- the numbers could have been a little bit better for working capital. So I wonder if you can comment, how do you see the evolution of these in the coming quarters? Typically, the Company tends to have a much better -- much reduced working capital levels in the second half of the year than in the first half of the year. Do you still expect to see the same development into full 2020?

And then, you maybe (Technical Difficulty) spread increase quarter-on-quarter from $411 to $415 but the gross profit declined about 22% quarter-on-quarter. So I wonder if you can comment more specifically maybe about some of the other expenses or costs that could have affected the North America business unit's gross profit in the quarter? Thank you.

A - Gustavo Werneck {BIO 20318216 <GO>}

The first part of Carlos question refers to our free cash flow and the impact of working capital because we posted an increase in working capital this half year. I think the second question is about the US cost structure, whether there was an improvement. So I will answer the first part of the question about working capital. In fact, in this second quarter, we used up more cash and there was -- I mean this result reflected better shipments in our operations, especially in Brazil and North America also, but not as much. And this has an impact in working capital, especially concerning accounts receivable. We consume working capital and this was mainly in the second part of the second half.

In terms of cycle days, there is a cycle, it captures working capital with the end of the quarter and the average of the last three months, meaning that, there is an increase in the cash conversion cycle. From now on till the end of the year, the trend is that we will be able to revert the number of cycle days. One point, at the end of last year, we were close to 60 days and then 70 days to 80 days. So the trend for us is to go back to 70 days to 80 days. So our trend is to reduce working capital looking forward, as we move towards the second half of the year.

The connection was poor at a certain point, but I understood that this his question refers to metallic spread in North America. In terms of North America, I can mentioned three variables: volumes, purchasing price of scrap and pricing of products. There was a slight recovery of the metallic spread. On average in the first quarter of 2010 it was $410 per short ton and then at the end it was $415. We see some stability in the main variables, but at the same time, we are improving our cost competitiveness in the US. Two years ago, when we had margins we did some very extensive work in terms of productivity because there was a gap of $25 per ton vis-a-vis our competitors. And we said that we will try to reduce that gap and part of that would come through CapEx. So part of that CapEx is something that has not materialized as of yet, because we are still making the investments. And the other part will come through performance improvements. We've managed to make some improvements and we make other decisions like the shutdown of the Sao Paulo mill, it's something that also contributed to that. But our operating performance is now much more robust when compared to six months ago in North America. We are making progress. And we are now focusing on closing that gap. It's just a matter of improving costs in our North America operation and our efforts have been very consistent.

A - Harley Scardoelli {BIO 7283603 <GO>}

Gustavo, I think an additional point that Carlos made has to do with the decline of gross profit due to lower shipments. It grew more even with the metal spreads and the answer to that is, the reduction in fixed cost, because once volumes are down, there is a compression in our gross margin. So there is that aspect of the mix, but I think that is the reason why that explains why.

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

Thank you very much.

Operator

Our next question from Marcelo Audi from Cardinal Partners.

Q - Marcelo Audi {BIO 1550731 <GO>}

Hello, Gustavo. I have the following question. What could be worse looking towards the third quarter? And I would like to mention two points. You said that you've managed to take advantage of scrap prices that is now going back to normal levels and you said that you wouldn't have that benefit from now on.

And the second part of the question has to do with retail demand in the domestic market. My question is, what was the relevance of that segment considering total sales in the domestic market? Shouldn't we expect that after the fourth quarter with the end of the emergency package, don't you think that we could see the slowdown in demand? And probably this takes me back to 2012, when we had another tax incentive for My House, My Life project, because there was a spike in demand and then it came down again.

A - Gustavo Werneck {BIO 20318216 <GO>}

Yes. We understand what you're saying. This spike in demand is very much in tune with the current momentum and most of the demand is catered to the domestic construction segment. I don't think that in the next few months, we will see the same behavior, but certainly, if Brazil does not implement more structural reforms, there should be even a reduction in demand. We don't think that this will happen this year. If additional measures are not to be in place, we should see probably a decline in 2021. This is maybe one of the major risks we see.

In terms of scrap, we will navigate a period of spread because of the inventories, but we are reducing costs, we are looking for further export opportunities, we are reducing the costs of our mills. And I would say that we will be able to maintain good competitiveness, and we will be able to deliver good margins.

Q - Marcelo Audi {BIO 1550731 <GO>}

And how much the retail segment contributed to the whole scenario in the first quarter?

A - Gustavo Werneck {BIO 20318216 <GO>}

Could you repeat, Marcelo?

Q - Marcelo Audi {BIO 1550731 <GO>}

Specifically speaking about sales to the retail market, how much of that accounted for your total sales? Did you see an increase of retail sales when compared to your historical average?

A - Harley Scardoelli {BIO 7283603 <GO>}

In this retail segment, steel sales accounted for 25%. This is a very high figure when you compare to our historical averages. We were able to increase our penetration in the retail segment because of all of our measures that have been adopted in the last few months. Thank you.

Operator

We now conclude the Q&A session. Now, I will turn the floor back to Mr. Gustavo Werneck for his final remarks.

A - Gustavo Werneck {BIO 20318216 <GO>}

Once again, I would like to thank you all for joining us today. We are always very happy to talk to you. It's always a pleasure to clarify issues and questions. And I take this opportunity to invite you to join us once again for our next earnings release presentation related to the results of the third quarter 2020, that will take place on October 28. Thank you very much. Take care because there is nothing more important than the life and health of all of the people. Thank you very much and have a good day.

Operator

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