Q3 2019 Earnings Call

Company Participants

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

Other Participants

- Analyst
- Caio Ribeiro
- Carlos De Alba
- Daniel Sasson
- Leonardo Correa
- Thiago Lofiego
- Timna Tanners

Presentation

Operator

Good afternoon, and welcome to Gerdau's Conference Call to discuss the Results of the Third Quarter 2019 of Gerdau. 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 like to emphasize that any forward-looking statement that might be made be during this conference call related to Gerdau's business outlook projections and financial and operating goals are mere assumptions based on management's expectations related to the future of the company. Even though Gerdau believes that its comments are based on reasonable assumptions. There is no guarantee that future events will not affect this evaluation.

Here today are Mr.Gustavo Werneck, Director, President and CEO of the company and Harley Scardoelli, Executive Vice President and CFO. With no further ado, I would like to give the floor to Mr.Werneck. You may proceed, sir.

Gustavo Werneck {BIO 20318216 <GO>}

Good afternoon, everyone, and welcome to Gerdau's conference call on the results of the third quarter 2019. Here with me is our CFO; Harley Scardoelli. And for the both of us it's always a great pleasure to talk to you about our performance and also clarify Geradu's and answer questions that may arise during our presentation.

I will start by talking about our overall results in the quarter. And next Scardoelli will elaborate on the financial performance of the company. After that I will return to comment on the outlook for the markets where we operate, and we will also talk about our investment plans. At the end, we will both be available to answer all of your questions.

So let's move to Slide 2, and we will begin with our main highlights for the quarter. I would like to start the presentation of the slide highlighting that last September we successfully concluded the refurbishing of Blast Furnace 1 at the Ouro Branco Mill in Minas Gerais. The equipment has resumed operation within schedule complying with planned operating conditions. Over 5,000 people worked in this scheduled maintenance for approximately two months to ensure that the equipment in its peripherals would be up to speed when Brazilian economy resumes growth and demand for steel in the country increases.

Moreover, normalization of inventories at Ouro Branco led us to post the second best quarter in Gerdau's history in terms of free cash flow, something that will be further elaborated by Scardoelli later on. It's important to emphasize that despite the impacts from the Blast Furnace downtime and the lower pace of exports resulting from a weaker performance of the world steel industry, we begin to see signs of recovery in Brazil civil construction industry at the end of the third quarter.

We already noticed a gradual increase in incoming orders and increases in construction project contracts coupled with better funding terms and lower interest rates. As expected, the performance of the retail segment meaning self-construction and low-income housing remains strong.

Just to give you an idea, in August, we launched a new online retail platform of Juntos Somos Mais together we are more of which we are partners. And in less than 60 days, we reached 10% of all our retail sales through this channel demonstrating that we have the opportunity to further consolidate Gerdau as a preferred vendor to this important sector of the economy.

In regards to flat steels, we remain focused on the execution of our strategy to develop products and grow our heavy plate customer base as we are a reference in the Americas with state-of-the-art equipment and processes. This quarter, we made important advances with the consolidation of our market share in heavy plates.

Our sales of flat products, however, in the quarters experienced pressured margins due to increases in raw material costs mainly coal and iron ore. Although, our own ore production help to mitigate the spiking prices of this product. On the other hand, it is worth mentioning that long steel margins remained flat in the period. In addition, we posted robust results in our North America operation with EBITDA margin reaching historically high levels.

Here, I would like to highlight that unemployment rate in the U.S. was 3.5% in September according to the U.S. department of labor. This is the lowest rate ever posted since December 1969, indicating that the U.S. economy is quite stable.

Now, I'll give the floor to Scardoelli, and we'll get back to you after his remarks, so that we can talk about the outlook.

Harley Scardoelli {BIO 7283603 <GO>}

Thank you, Gustavo, and good afternoon to you all. I would like to start by saying on Slide on page 4 for those of you with us on the web, what are the most important financial highlights of the quarter as we will see further on. Free cash flow generation in the quarter was BRL 1.9 billion being the second best free cash flow generation in the quarterly history of the company. Adjusted EBITDA was BRL 1.5 billion, excluding the effects from Blast Furnace 1 downtime at Ouro Branco in Minas Gerais. EBITDA margin at North America BO remained high, because it was able to be maintained at high levels.

And finally, another highlight was working capital. Our cash conversion cycle went from 8 to 78 days. And in absolute terms that meant a reduction from BRL 9.4 billion to BRL 8.6 billion, down by 8.5% from the second to the third quarter of 2019 and all of that was positively impacted by inventory adjustments.

Now, let's move to Page 5, and I'll talk about the results and the performance of the company in the third quarter of 2019. In consolidated terms adjusted EBITDA was BRL 1.5 billion on Q3 '19. And looking at the chart on the upper part of the slide, if we compare to Q3 '18, adjusted EBITDA and adjusted EBITDA margin were down due to divestments in our North America BO lower volumes in special steels and also lower export prices from Brazil.

On the other hand, the drop was mitigated by excluding the nonrecurring effects of BRL 181 million, related to the downtime of Blast Furnace 1 at Ouro Branco, net of tax reversals, provisions in the period at the Brazil BO. Without these effects, EBITDA would have been BRL 1.276 billion. EBITDA margin at the North America BO remained high vis-a-vis Q3 '18 reflecting the new asset portfolio office operation with more profitable assets, and also the maintenance of metallic spread. It is also important to mention that EBITDA margin of the South America BO also reached an all-time high posting record profitability in the quarter.

Now, I'll talk a little bit about the company's debt and liquidity position on Slide 6. Gross debt on December 30, 2019 was BRL 15.5 billion. The reduction of BRL 2.7 billion vis vis September of last year, stemmed mainly from debt amortization in the period, which was made possible by a reduction in net debt of the debt position of the company. A reduction in net debt over EBITDA ratio from 2.23x on September 30, 2018 to 1.96x on September 30, 2019, is a result of our focus in maintaining a relevant free cash flow in previous quarters resulting in an accumulated amount of BRL 4.1 billion. In the first nine months of 2019, we were able to post BRL 2.4 billion.

Now moving to page 7. I would also like to mention that the profile of our debt denominated in foreign currency mostly in U.S. dollars went from 88% in 2013 to 77% currently. In that same period, our net debt went down from $6.5 billion to less than half $2.9 billion, which is the current figure. Leverage, which is seen on the lower part of the chart in the slide, went from an all-time high of 4.24x in December 2015 to the current level of around 2x net debt over EBITDA ratio.

Moving on to our next slide, Slide 8. We emphasize the strong free cash flow generation of BRL 1.9 billion in Q3 '19, which represents a significant increase when compared to the third quarter of '18 and the second quarter of this year 2019, due to the release of working capital in the period coupled with the resumption of inventories of Ouro Branco and a resumption of all of our business operations. The company remains very focused on cash generation, which is consistent to its financial policy. It's important to note is that in the last 12 months, the company posted free cash flow generation as I mentioned before higher than BRL 4 billion of which BRL 629 million were paid out as dividends and a significant amount was used to reduce BRL 2.6 billion of our net debt.

Now moving to Slide 9, I would like to conclude by showing a chart that illustrates what we said before. Strong free cash flow generation and in this case shown as a percentage of EBITDA. During the period depicted on the slide from 2013 until the first nine months of 2019 this percentage was on average 44% of EBITDA.

Before giving the floor back to Gustavo, I would just like to say, that we are working together with an IR consultancy company to make general improvements to our Investor Relations and market communications program at Gerdau in the next coming quarters. We will make changes in adjustments aiming at improving communication with our investors. Also, I would like to reiterate the importance of your participation and encourage you to share your comments with us.

I would also like to take this opportunity to mention that Gerdau was appointed by the IR magazine awards for having one of the four best IR programs in Brazil in the large category. And that's thanks to our IRT.

Now, I'll turn the floor back to Gustavo. Thank you very much for your attention.

Gustavo Werneck {BIO 20318216 <GO>}

Thank you, Scardoelli. Now, let's move to our next slide, Slide number 10, and to elaborate on some important aspects related to our business operation and also talk about the outlook looking forward. We continue to see good prospects for both Brazil and the U.S., our two main markets of operation.

In Brazil, there's optimistic look toward the improved demand for the coming months, including 2020 was reinforced by the relevant increase in steel orders observed in the last few weeks, especially coming from the residential and commercial construction sectors. According to figures for 2020 published by the World Steel Association, last October 14, in Monterrey, Mexico, steel global demand should grow 1.7% vis-a-vis 2019 reaching 1,000,806,000 tonnes driven by the performance of emerging economies despite a landscape of intense trade tensions.

In Brazil, we will see the effects of seasonality, which is typical for the last quarter of the year. However, right now, we believe on a more robust recovery of steel demand in the domestic market in 2020, which should be above GDP growth expectations that should be around 2% according to estimates from the Central Bank.

In the civil construction sector, recent real estate indicators show an important acceleration in launches of new construction projects in the main urban areas with growth rates around 10% to 20% when compared to the same period of the previous year.

Likewise, we've seen a significant reduction in real estate inventories, which in centers like So Paulo, for instance, went from 18 months in the beginning of the year to less than 10 months in the last few weeks. Another important indicator is the, so called, confidence index of the civil construction. They reached 87 points at the end of the quarter, being the best number in the last three years.

In regards to the industrial sector, despite the difficult landscape we've experienced throughout the year, as the industrial GDP was down by 1.9% when compared to 2018, we are now seeing signs of improvement in the automotive and capital goods sector and mainly in the oil and gas supply chain sector as well. The outlook for 2020 is positive with the consolidation of a trend towards a gradual improvement, and oil and gas should post a more robust growth with concrete investments coming from the proceeds from recent auctions.

In addition, we see good prospects with the approval of the pension reform last week and we continue to monitor the progress of other structural reforms, such as the tax and administrative reforms, in addition to the privatization package and the proposed solutions to solve the problems of competitiveness in the Brazilian steel industry.

The correction of competitive symmetries as in the case of the tax burden needs to be resolved before the commercial opening of the country. Moreover, the reinstatement of the Reintegra program is crucial in view of the challenging conditions of the foreign market at the moment.

We believe that it makes no sense to lose competitiveness exporting taxes in a very volatile and competitive global steel market. Also Gerdau is optimistic with the initial progress of the new gas market in Brazil, and confirmed its interest in participating in this market. To that end, the company became eligible to participate in the options to understand and help develop the new dynamics of this market.

In regards to our North America operation, we believe that a low unemployment rate should continue towards 2020 and the U.S. economy will remain stable even in a year of presidential elections. The most recent IMF forecast is that North American GDP will grow 2.1% next year. Local steel production should benefit from the maintenance of Section 232 and inventory replacement throughout the steel chain.

Now, looking at special steels Brazil, we believe automotive production levels should grow and an important development coming from the wind energy sector. More recently a Gerdau Summit received approval from customers to produce and sell new products through the wind farm industry, strengthening our position in our industry.

Sales of vehicles were up 9.9% in the period between January and September 2019, according to the most recent data from ANFAVEA. Increasing our optimism in relation to this market for next year, according to ANFAVEA production of vehicles should grow 2.1% this year with a positive perspective for 2020.

The negative aspect that concerns us is a significant reduction of 40% in Brazilian exports of vehicles, when compared to the same period of the year before, mostly impacted by the crisis in Argentina. This reduction affects the Brazilian automotive chain and the hopes for any rebound is best found for next year depending on the measures to be adopted by the new Argentinean government. In regards to the North America special steels division, we recently announced to the market that we appointed Rodrigo Belloc as the new CEO of the operation with the intent of moving forward with the cultural and digital transformation program in the U.S. in addition to anticipating what will happen.

In 2020, we anticipate a scenario of inventory replenishment and signs of rebound coming from the automotive market. I was also like to emphasize that in January of next year, as we anticipated before we anticipate the startup of the new Furnace in Monroe Mill in Michigan. Now the new electric Furnace should begin operation in August of next year according to the original schedule.

In terms of other countries in South America, Peru and Colombia remain in a prominent position. On the other hand, Argentina. While we hope the new administration announces incentive measures to encourage the return of investments in the country based on a pro-market and pro-industry agenda.

Well, now, let's move to our next slide, Slide 11, to talk about investments. During the third quarter 2019 Gerdau invested BRL 532 million in CapEx, of which BRL 201 million went to general maintenance, a BRL 169 million went to the maintenance of Ouro Branco Mill and a BRL 162 million was spend in technological expansion and updating. Considering their first nine months of the year, we earmarked BRL 1.3 billion barrels to Gerdau's operations globally mainly dedicated for the maintenance of our units.

As mentioned during the second quarter '19 conference call, we are maintaining our investment schedule for the three-year period between 2019 and 2021 estimated in BRL 7.1 billion. However, we decided to redistribute this amount, lowering disbursements in 2019. This year, we will invest BRL1.8 billion and this amount will escalate to BRL 2.6 billion in 2020 and also 2021.

To conclude and moving to the next slide, I would like to say that now we are part of the larger sustainability initiative in the world, the United Nations Global Pact. Last August Gerdau became a signatory of the Pact confirming its commitment to be a company with actions based on social responsibility and aligned with the 17 sustainable development goals, the SDGs. This is another step towards building the future we want to leave for our people as a legacy.

Recently, we were voted the best company in Brazil in the mining and steel milling category, and we were the recipients out the Epica business 360 degree award in partnership with Fundacao Dom Cabral. The award acknowledges all the efforts we've been undertaking in the last few years to promote a profound culture transformation, modernizing the company and preparing the company for the next 100 years. Therefore, I'm very grateful to our employees, customers and partners, who have joined us throughout this journey.

And now, we conclude the presentation and move now to the Q&A session.

Questions And Answers

Operator

(Question And Answer)

Ladies and gentlemen, we will now initiate the Q&A session. (Operator Instructions) Our first question is from Leonardo Correa, BTG Pactual.

Q - Leonardo Correa {BIO 16441222 <GO>}

Hello, good afternoon, and thank you for taking my question. My first question Werneck you mentioned during your introduction. You talked about the evolution in the real estate market, in new launchers. I would just want to explore this topic a bit more because we've seen a frustrating demand in the country and we've been looking at the real estate market abroad and there is a general euphoria. And you see that in some Paulo. I mean, inventory levels came down from 18 to 10 months, interest rates are at a record level. We don't know exactly how the economy will react with all of these stimulus, an increase in credit, but we see a very different landscape. It is clear that you are beginning to fuel this positive impact because obviously, you are heavily exposed in the real estate market because of steel milling.

But I would just like to know whether you could quantify this impact better. I understand that in this first week, you're already feeling an improvement in the number of orders, particularly coming from the real estate industry. But is there's a 10% increase when compared to the previous phase? Or maybe less or more if you can quantify that would be helpful.

And if you could probably remind us of what is Gerdau's exposure percentage in regards. I mean, the longs unit over Gerdua, How exposed is it to the real estate market? And this will help us have an idea of the magnitude of this positive impact looking forward in 2020.

And the second question, still talking about Brazil. It's difficult for us to map or quantify exports margins, but you increase shipments and giving the prices abroad. It is clear that we this is a loser business and correct me, if I'm wrong. Can you get any positive EBITDA margin with this level of external prices and what kind of measures you would take. I mean, I just want to understand your rationale in terms of growing experts in such a pressure scenario. Thank you very much.

A - Gustavo Werneck {BIO 20318216 <GO>}

this is Gustavo. It's a pleasure to talk to you. I like your expression and a structurally different scenario because in fact now I think this is a major piece of news. We are bringing out because we've been talking about optimism and good outlook, but I think it's the first time in the last quarter is that I talked to you about this with concrete figures that really prove that in the last few weeks, the real estate market construction residential and commercial construction market is experiencing a rebound.

If we compare the first 9 months of this year with the first 8 months of last year. There was a drop of 18%. But it's also important to look at the comparison of the third quarter of this year vis vis the second quarter. And what we see in our case is a very important increases of 6% in longs. Now if we break down the 6% growth as you asked to do. We will realize that in that segment that we call steel for armed concrete like rebar and cut and band, we grew 17%.

We can't say that this 17% only refers to market, but this also includes our growth strategy and the strengthening of our channel of Gerdau commercial. Our new company called Juntos Somos Mais, so

So there are a few things included that should be taken into account. But this is a number that I want you to consider 17% was the overall growth of our shipments in the armed concrete segment And this growth was more accentuated in the third quarter. It came in September, it was maintained in October and we see a good outlook looking forward when we look at launches and the reduction in the real estate inventories. This gives room to further growth looking forward it's also important to remember that we will experience a seasonality period in January and February because of the holidays and the vacation season. But unlike previous years when this seasonality period ends at the end of January, we will start seeing February and March with higher levels of deliveries and shipments.

The other question relates to the level of exposure that our operation in Brazil has vis vis the civil construction industry. I would say it's about 25% for longs. And so we will be exposed to this growth, even though, we should recall that there is another segment, where we are also present which is for industry construction where we also experienced a gradual increase. And the last topic about the Brazil risk and export volumes. In fact, international prices are very low and we've been seeing that for the last two three years. Shipments of billets in the international market reached a $130, and now business is turning around $360. This doesn't leave us much margins. We were being very selective in our businesses, but by the same token, we believe that the prices hit the bottom lowest level and we believe there should be a recovery in the next coming years. We have no doubt about that.

Q - Leonardo Correa {BIO 16441222 <GO>}

It's very clear. Thank you very much.

A - Gustavo Werneck {BIO 20318216 <GO>}

Thank you, Leo.

Operator

Our next question is from Daniel Sasson from Itau BBA.

Q - Daniel Sasson {BIO 19234542 <GO>}

Thank you Gustavo, thank you Scardoelli. Thank you for your presentations. My first question refers to your net debt. Maybe Scardoelli, you can help me reconciliate that BRL 1.9 billion. And with that drop of BRL 5 million in your net debt because even considering the depreciation of the currency in the period, which increases that in about BRL 1 million in the payment of the debt of about a BRL 100 million. That net debt should have come down a bit further. So if you can help me do the reconciliation, I would appreciate it.

And my second question refers to the U.S. Even with that $20 decrease in metal spreads in the quarter it is still over 10.5%. So if we put together COGS and SG&A per tonne it is dropping 5% to 6% vis vis the second quarter. Therefore my question is whether you could comment a little bit on the metal spread levels, the current levels and going towards the fourth quarter? And whether you have already reached higher efficiency levels, in order to have more sustainable margins of around 10% in a longer period of time? Or you still believe that you'll still have room to reduce COGS as a percentage of your revenue? That's all. Thank you.

A - Harley Scardoelli {BIO 7283603 <GO>}

Good afternoon, Daniel. This is Harley. In terms of reconciliation of the variation of that almost BRL 1.9 billion vis vis the net debt. You almost got there. There was just a few minor points that I will clarify. So let's look at the big figures. Free cash flow generation BRL 4 billion. We -- there was a variation of 9% of the U.S. currency. So there was BRL 1 billion in exchange rate variation. And this was a. Now we see the reversion of that so this effect should be made null. But BRL 1 billion of exchange variation. And now we have to include the nonrecurring effects, BRL 0.2 million that you subtract of nonrecurring events. So then we subtract that and now so we have dividends that we pay out this quarter. And related to the second quarter about BRL 0.1 billion, 100 and something million reals. And that was a interest rates that became part of this calculation. So 1.9. minus 0.1 dividends and accrued interest, you get to that variation of net debt.

Q - Daniel Sasson {BIO 19234542 <GO>}

Thank you Scardoelli.

A - Harley Scardoelli {BIO 7283603 <GO>}

Now, let me refer to metal spread in our North America BO. Looking at a further -- looking further 2017 that was one of our worst years in terms of metal spreads. In the entire steel industry in the U.S., we were at a level of $350 for a short ton and the metal spread in general. Was that in the U.S.? And throughout 2018 things changed a bit because of section 232. So I think we saw an increase of about $100 from 2018 to 2019 considering $450 per tonne in 2019.

In 2019, I will say that on average, I think it increased metal spread increased by $20. And the peak of that metal spread occurred around March of this year. And at one point it was $502 per short ton. I think, I mentioned that number in a previous occasion. So, since that spike from February through March there has been a reduction, but it has been a gradual reduction. So, that reduction of $20 that you mentioned meaning that what we see looking forward is that there should be a slight reduction and a certain stability, but we don't have any indicator that can tell us that we will experience a very sudden drop in metal spreads in the coming years. And I think that we're moving towards stabilization, especially considering what we've seen in the last quarters.

Now in terms of the performance of our operation. I would like to remind you Daniel, that there are two large avenues of opportunities that will allow us to improve our longs performance in the U.S.

In terms of longs, we will recover margins. And I think that with the plans that were deployed up to now we were able to recover 50% of our performance, but we still will have the opportunity to capture increased performance throughout 2020. And there is another path to recover performance, through the technological advances of our equipment and this depends on CapEx that I was approved last year. And as of next year that CapEx will be materialized and will increase our performance.

I would also like to take the opportunity to say that our special steel operations in North America, I mean more recently we promoted changes in the leadership of the organization. Mark Marcucci, our former CEO is retiring now after several years of excellent contribution to Geradu. And now the new CEO is Rodrigo Belloc who's been with the company for many years and he has a long time expertise in long steels and he will take the CEO position of our joint venture in the Caribbean. So I have no doubt that with Rodrigo in the special steel segment, we will lead you down to another level. And as we promoted this performance improvement in Longs I am sure that throughout next year, I'll come back here to tell you more about the achievements that we will be able to get in the special steel operations.

Q - Daniel Sasson {BIO 19234542 <GO>}

Thank you very much Gustavo.

Operator

Next question from Timna Tanners from Bank of America Merrill Lynch.

Q - Timna Tanners {BIO 6766897 <GO>}

Yes, hey thank you for taking the questions and for the time. I wanted to follow up if I could please on the speak to market outlook for specialty steel, because if you look at the volumes they are the lowest I could find on record. So I appreciate that you have a better outlook, but I'm just trying to quantify how much better given again how much it's dropped. So just to understand what the delta could look like and what you're seeing there?

And then to follow up on the second question is on the U.S. market. Some of the latest leading indicators on construction like the ABI and construction spending levels are pointing to more of a downturn or a stall in activity. So, can you tell us what your customers are indicating to you there? What you're seeing in terms of activity? And also help us understand some of the competitive behavior in the market like the sharp decline in bean prices? If you could elaborate a bit more on that, please? Thank you.

Operator

Timna, we had a difficult time listening to your question. So we are trying to get things here and there to be able to get the full scope of your question. So in general she's asking about the fundamentals of the U.S. economy the possible weakening of the economy and our business in the coming years, coupled with the announcements of new discounts particularly in the large structural profile. So in general, how do we see the health of our businesses in the U.S.?

A - Gustavo Werneck {BIO 20318216 <GO>}

In general for next year, we see the U.S. economy moving strong. We are anticipating GDP growth of about 2% in the U.S.. We haven't seen in terms of new orders any weakening in terms of volumes our backlog of orders that entered in the past few weeks does not indicate any weakening of the businesses where we operate.

In fact, there was a price decline because of discounts published, by the structural profiles industry. But in a way they mitigate the drop in scrap prices. I remember in our last conference call. We talked about scrap and I was telling you that we were seeing a continuous drop along the next months, which indeed materialized. So in terms of both items we were able to maintain a spread, which I mentioned before. Within stable and comfortable levels. But looking towards 2020, we don't see any structural changes in our results or our profitability levels in the long segment.

Now talking about specialty steels. So it has been a more difficult year because there was a very important destocking in that chain. After section 232 there was a destocking in the chain, and there was an outlook of scarcity of raw materials. So but after the 232 there was a better understanding in the market and people then felt there wouldn't be scarcity of materials. In terms of oil and gas in the U.S. there was a decline in terms of what we traditionally sold. But looking forward, we see some recovery in the new segment of specialty, steel specialty vehicles. And one point that is worth mentioning here, and in other opportunities, I talked about that there is a mechanism called surcharge, where you transfer to our contracts any ups and downs in the scrap prices.

So considering that is scrap prices in the U.S. has now reached maybe an all-time low in the U.S. So looking forward we see an increase in scrap prices. And this somehow will help in terms of transferring that to our customers. I would also like to take this opportunity to say that our rationale related to these is that scrap prices have reached the bottom in the U.S. I mean, I can recall spread prices -- price levels that does not motivate people to collect scrap throughout the country. So that's why levels are so low.

Considering, the winter in the U.S. colder climate, which really makes this full more difficult. Everything leads me to believe that very soon we shall see increases in the scrap prices. And in the last few weeks where, we saw announcements of increases in flat steel and with some time this may impact longs. So in general, I see a stable outlook in regards to our businesses in the U.S. in the next coming year.

Q - Timna Tanners {BIO 6766897 <GO>}

Thank you.

Operator

Our next question is from Carlos De Alba from Morgan Stanley.

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

Thank you very much everyone. So first question, so maybe continuing with the outlook for the fourth quarter in Brazil. Gustavo you mentioned that the company has seen now some recovery in civil construction. Could you maybe elaborate as to whether or not you expect to see the performance of the business unit already reflecting this improved demand conditions, or if it is something that you will probably see really only materialize in the numbers in the first quarter. Also, what is the capacity utilization right now in Brazil? And how has it moved in the last few weeks or months. Do you expect to shut down any electric Furnaces? or how do you see the your operations running.

And then my second question has to do with working capital which obviously did extremely well in the third quarter. But as we close the year, how do you see the current levels of receivables and inventories, which declined significantly in the last quarter. Did you see them remaining stable as of September 31 relative to September 31? Or you see scope for further improvement. Thank you.

A - Harley Scardoelli {BIO 7283603 <GO>}

Thank you, Carlos. So, I will answer his first question related to all of the impacts in terms of cost utilization of installed capacity and in the next coming months with the demand growth coming from residential and commercial construction. So as I said before, the long segment accounts for 25% of our business or one-fourth of our business, and it has an important impact in our results. But once again, we also notice that we are being more selective in our businesses related to exports, so we always have our experts portfolios huddled three months in advance. So today, we already have shipments scheduled for November, December and January and is allows us to work with a capacity of about 70%, Carlos.

And our production concentration will be very strong in our auto Branco mill. The refurbishing of the Blast Furnaces. And the advantage, we have with our own ore production close to the mills. Once we increase volumes in Ouro Branco, we will be able to capture important cost gains in our main mill. The decision whether to maintain this capacity around 70 or maybe slightly before -- slightly lower than that will depend on what will happen after February. So, before we make any decisions, we will take a closer look of our capacity. So as to maximize our results vis-a-vis the reduction in export prices.

Our decision will be very strong. A view of the profitability that this will bring to our business. I will now give the floor to Werneck we'll elaborate more on that.

A - Gustavo Werneck {BIO 20318216 <GO>}

I mean, Carlos ask about what we see, in the quarter working capital or whether that situation would be maintained. There was an increase, a significant increase in working capital earlier this year and that was much related to the refurbishing of our Blast Furnace, one of which led our working capital levels to be higher than expected. And we've been seeing that in the last quarters, which was below 80 days. That reversal, that we were able to do in the third quarter should be maintained. Traditionally, we try to optimize working capital by year end. So in the fourth quarter, we see a very positive trend in terms of our working capital looking towards the end of the year.

For 2020 there is a slight change of reversal. But again, our idea is to maintain our average cycle levels below 80. So for the fourth quarter the trend is positive and we will also reduce working capital and we will maintain on average is below 80 days.

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

Thank you.

A - Gustavo Werneck {BIO 20318216 <GO>}

Thank you, Carlos.

Operator

Our next question is from Thiago Lofiego from Bredesco BBI.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Thank you, and good afternoon. Well I got two questions. The first is whether you can comment a bit on the competitive environment for longs in Brazil in the short-term? And now thinking in terms of the mid-range whether you see any possibility of, further consolidation in this very fragmented market. The second question relates to the ramp up of Ouro Bronco after the end of the downtime. How should we see costs evolving in auto Branco both for the first quarter as well as throughout 2020. What would be an optimum point, when would you reach an optimum point of costs?

A - Harley Scardoelli {BIO 7283603 <GO>}

Thiago. Let me just answer both of your questions. The competitive environment is stable. We are not seeing any major changes to the competitive environment. In this quarter, when compared to the previous one. So last time we talked, we refer to larger competition in terms of profiles, but we are seeing a certain stability. Now in regards to consolidation, this is always a topic that we monitor closely. But I would say, that it's not anything simple in terms of competition, organizations and I couldn't be able to say whether there is any possibility in the shorter or mid-term for further consolidation in Brazil.

The Ouro Bronco furnace, we estimated a 60-day downtime and it resumed operation within schedule, and the performance is extremely good. Now the Blast Furnaces that would have been totally refurbished in full conditions to capture all cost opportunities that we see looking forward. So as I told Carlos, our stratergy for next year is to work at full capacity in Ouro Branco because this is a platform where we can get a good cost performance. But we also have to take into account how prices will evolve particularly, coal prices because when it comes to ore we have our own production and we use that alternative up to the limit. So I think the price of coal is what will dictate how competitive we can be in that operation.

I think now I would say that we went through a moment when Ouro Bronco production decline because of the downtime coupled with increases in coal prices. Will impact inventories in the second and third quarters, but we reached a peak and the trend now is to find a more comfortable and stable level. Therefore, I believe that the outlook is very positive in terms of costs and competitiveness in Ouro Branco. We just have to take a closer look at exports looking at all the opportunities we have not only with Ouro Bronco, but also in terms of our mini mills and scrap. A major we have to adjust the export levels to what we need.

Q - Thiago Lofiego {BIO 16359318 <GO>}

I just want to go back to what you said, you talked about stable. Is still challenging or the environment is more balanced. And now going back to the second question. Can you quantify what you expect in terms of average cost improvements in 2020 when compared to the average of this year or the third quarter? If you could give us some number? Numbers, I would appreciate it.

A - Gustavo Werneck {BIO 20318216 <GO>}

Thiago, this competitive environment. In a way, it's very stable and despite the slow demand profitability in the domestic market is very adequate and very stable. So in a moment of low demand, we've been able to navigate in longs with export premium today of around 4%. And I believe that as the market recovers as it is happening now, we see good possibilities of expanding our profitability in the domestic market.

In the flat steel market, I see more competition when compared to longs. For a series of reasons including the impact of coal in this segment. But also I see a concrete possibility for early next year but we will stop working with premium of negative exports and so today we have a 4% negative. So I see a good possibility of these premiums reverting next year. So I think, for 2020 we will have positive premiums in the area of flats as well. Well, in regards to costs in Ouro Branco. It's difficult to anticipate what the performance will be. It's about 2020 because we will then -- we will have to buy coal and it's difficult to tell whether the drop in prices will be more sudden. But in general referring to ore, I will say, that we can be competitive this year. There will be a dilution in fixed costs, which will be stronger than this year because both Blast Furnaces will be working at full capacity. And the main issue is the behavior of coal prices.

Q - Thiago Lofiego {BIO 16359318 <GO>}

That's great., thank you.

Operator

Our next question is from Caio Ribeiro from Credit Suisse.

Q - Caio Ribeiro {BIO 18420483 <GO>}

Good afternoon, everyone and thank you. My first question relates to the sales mix in Brazil. This quarter you had higher sales in the domestic market when compared to the foreign market and I think this impacts the revenue per tonne in the third quarter. But in the fourth quarter, do you anticipate any special rebound that could change the mix effect? Or you still see stronger exports than sales in the domestic market.

And my second question has to do with steel import tariffs and a possible reduction that may come up in the government's agenda, that more recently came up. So how are the conversations with the government evolving so that and then What is your expectation?

A - Harley Scardoelli {BIO 7283603 <GO>}

Caio, well, we are just facing a typical seasonality for this time of the year, even though indicators of new launches of residential and commercial construction, points to a very positive trend in terms of sales of longs. And this is a typical seasonality. So for the fourth quarter, we shouldn't expect different shipment numbers when compared, I mean any different than what we had in previous years, but the positive outlook is that as soon as this sales analogy season is over we will see new levels of demand.

In exports as well, we are being more selective in our choices. We don't expect to replace non-production in the domestic market, replacing it with exports. A Large part of the business is we see a $360 is good. They do not leave positive margins. That's why we have to be very selective in our choices. And in December, we will stock production. Last year, we had prices that allowed us to work with stronger capacity in the fourth quarter.

Now in regards to the so-called commercial opening and export tariffs, I think we are very comfortable with the way this will take place in Brazil. We are not anticipating any major short-term changes. And we communicate with the government through the institutions that we belong to one of them is institute to ASO Brazil. And as such they're -- they have a very strong relationship with the ministry of economics and secretaries of the ministry. And I think there is a general consensus that the commercial opening in Brazil has to take place once we increase competition.

I'll give you a typical example an in-house example, the impact of the freight table introduced in Brazil since the trucker strike in May of last year would bring a direct impact our business of around BRL 200 million. But we seek for all of the possible alternatives things that we didn't even think about doing before we venture into predictive platforms, digital technologies, et cetera, et cetera. We did everything we could to mitigate the risks out of that BRL 200 million that -- BRL 300 million did not, make part of our books because we found out alternative solutions. Imagine in the industry as a whole, so I would say that the government is very sensitive to this issue. And they have deep knowledge that and they believe firmly that the commercial opening in Brazil will happen once the competitiveness the competitive bottlenecks are solved things related to tax issues, et cetera, et cetera. So we are comfortable with the way things will evolve in Brazil.

Q - Caio Ribeiro {BIO 18420483 <GO>}

Perfect. Thank you very much for that.

Operator

Our next question from Matthew Fraddy, JP Morgan.

Q - Analyst

Thank you. I think most of my questions have been answered. I just have a follow-on question. Werneck I think you said that the parity of imports today is slightly positive. I just want to understand what is the prospects for price increases at the end of the year or whether for any price parity for any other given reason?

A - Gustavo Werneck {BIO 20318216 <GO>}

Let me give you more details about the premiums. In the long segment, in early October, the premium was 3% positive. With this round of price increases in longs, which is taking place right now. We hope that in early November premium will be around 6% to 7%. We believe that in the next few months this will be the level that we will work with.

Now in regards to flat steel in early October there was a negative premium of 3% and the at the end of the month I think, the same level we will. We believe that in by December or the end of this year. This level will still maintain with a possibility of leaving this negative position and going towards a more positive position after the seasonality season is finished. Thank you.

Operator

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

A - Gustavo Werneck {BIO 20318216 <GO>}

Well, I would like to say that as always it's been a pleasure to talk to you. On my behalf and on behalf of Scardoelli. Thank you very much for participating. Thank you for your questions that always help us to become a better company. And I would like to invite you all to join us again in our next conference call, which will take place on February 19, 2020, and I would like to put all of ourselves available to answer any further questions so that we can straighten our ties. Good afternoon and I wish you a very good week. Thank you very much.

Operator

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