Q1 2017 Earnings Call

Company Participants

- André Bier Gerdau Johannpeter, President, Chief Executive Officer & Director
- Harley Lorentz Scardoelli, Chief Financial Officer & Vice President

Other Participants

- Bruno Giardino, Analyst
- Carlos F. De Alba, Analyst
- Ivano Westin, Analyst
- Leonardo Correa, Analyst
- Marcos Assumpção, Analyst
- Roy Yackulic, Analyst
- Thiago Lofiego, Analyst
- Thiago Ojea, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon, and welcome to Gerdau's Conference Call about the Results of the First Quarter of 2017. At this time, all participants will be on listen-only mode during the company's presentation, and later on, we will initiate the Q&A session.

We would like to emphasize that any forward-looking statement that might be made during this conference call related to Gerdau's business outlook, projections and financial and operating goals are mere assumptions based on management's expectations related to the future of the company. Even though Gerdau believes that its comments are based on reasonable assumptions, there is no guarantee that future events will not affect this evaluation.

Here today are Mr. André Gerdau Johannpeter, Director, President and CEO; and Mr. Harley Scardoelli, Vice President and CFO.

With no further ado, I'd like to give the floor to Mr. André Gerdau Johannpeter. You may proceed, sir.

André Bier Gerdau Johannpeter

Thank you. Good afternoon, everyone, and welcome to Gerdau's conference call to discuss the results of the first quarter of 2017, where we initiate by looking at the world scenario of the steel industry, followed Gerdau's performance in the quarter. And after that, Scardoelli will refer to Gerdau's financial performance. Right after that, we'll be available to take your questions.

For those of you who are following us on the Web, on page 2, I talk about the general steel landscape starting with the World Steel Association that in April revealed the outlook for steel consumption for 2017, and the forecast of growth that went from 0.5% to 1.3% in 2017. Therefore, it's anticipated that by year-end, steel consumption worldwide should be 1.5 billion tonnes. For the year, more particularly, the highlights for the recovery of South America and Asia and with that, we should see a 4% increase in consumption in 2017 coming from these regions.

Now, if we exclude China, the estimate in China is that steel should – steel consumption should be in keeping with the growth of last year, of 1.3%. Therefore, we are still concerned with the industry, not only due to unfair trade in many countries, but also due to excess of installed capacity, which is a cause of concern for many in the sector.

In terms of Brazil, we believe in a gradual evolution, mainly starting in the second half of 2017 and mainly in a more consistent way after 2018. We hope that interest reductions and reductions in inflation with the new structural reforms in Brazil – social security, labor, and tax reform should boost the economy in the country and, as a consequence, increase in steel consumption.

The expectation from the Instituto Aço Brasil is that the consumption of (03:32) and steel did grow 2.9% this year. And this, just to give you an idea, corresponds to the same levels we had a decade ago, which really reflects the current political and economic scenario.

In North America, the forecast for 2017 is that we should see the growth in demand for non-residential construction, and the recovery of the industrial sector. The announced measures or the deployment by the Trump Administration fuelled by unfair (04:03) trade reductions and tax deregulation, investment in infrastructure should boost the demand for steel in the U.S.

In 2017, the forecast of growth in steel consumption in the U.S. is 3%. Moreover, there is an expectation that the U.S. Department of Commerce will finally approve the charge of the anti-dumping tariff related to investigation of rebar imports coming from Turkey, Japan and Taiwan, and also countervailing measures to be applied for rebars coming from Turkey. There is another new anti-dumping case for wire ore in long steels and this will also merit another verification involving 10 countries that import into the U.S. We believe that once these measures are approved, we should see positive results in the region.

Still speaking about North America, we are concerned with our imports of long steel because they are coming in large volumes and that represents an important part of consumption in the U.S. because it's an important material and that generates competition, especially in wire rod and rebars.

In South America, the economy of market-certified (05:26) should present different levels of growth, especially related to GDP growth; 3.5% positive in Peru; in Colombia 2.3%; Argentina 2.2%; and Chile 1.7%. These positive growth numbers should also be reflective of the increases in steel consumption. In the quarter, we see an improvement of specialty steels in the automotive sector in Brazil especially due to exports. In India, the market remained bullish; and in the U.S., we should see stability in the automotive industry and an upturn in the segment of oil and gas.

Now, I would like to talk about the large (06:08) figures of Gerdau on page 3. Starting with consolidated shipment. We shipped 3.6 million tonnes, a reduction of 7% vis-à-vis the first quarter of 2016, influenced by Brazil due to seasonality of lower demand in the initial months of the year which was accentuated with the effect of the economic crisis. In addition, there was a reduction in export volumes coming from Brazil due to lower opportunities in the international market.

Now net sales came up to BRL 8.5 billion in the first quarter of 2017, down by 16% vis-à-vis the same period of the previous year due to the foreign exchange effect in the period as well as the sale of the units in Spain.

Gerdau's result in the first quarter of 2017 was influenced by a non-recurring event related to the reversal of a contingency provision related to the exclusion of ICMS tax from the tax base for contributions to PIS and COFINS accrued from 2009 to 2016.

This reversal was based on a ruling by the Federal Supreme Court stating that the inclusion of the ICMS on this contribution was unconstitutional, and this decision is supported by the position of the Company's legal counsel that the probability of loss in the pending lawsuit became remote in light of the court's decision. Therefore, the net effect from this reversal and other provisions to the Gerdau's result in the quarter amounted to BRL 858 million.

However, I would like to clarify that there is still the possibility that the Supreme Court finds it necessary to apply the modulation mechanism to this decision which is used to determine the effect in time of a ruling of unconstitutionality. In case the Supreme Court applies this modulation mechanism, limiting the effects of the decision in time, it may be necessary to reassess the risk of loss associated with the above-mentioned lawsuit which consequently may require the approval of new provisions related to this matter in the future.

Due to that non-recurring event, we are presenting the adjusted net income and EBITDA. Adjusted EBITDA was BRL 853 million, down by 8% vis-à-vis the first quarter of the year before, stemming from lower growth profits partially offset by the reduction of BRL 205 million with SG&A expenses. I would also like to mention that EBITDA from North America operation in the period was strongly impacted by the inflow of significant volumes of imported steel went through the region.

However, when we compare that to the fourth quarter of 2016, consolidated adjusted EBITDA grew 19% especially due to a growth of 47%, coming from the Brazil operation which is a reflex of a better product mix offered to the market amongst other factors.

Now, consolidated net income amounted to BRL 824 million. However, not considering the non-recurring event already mentioned, Gerdau had an adjusted consolidated net loss of BRL 34 million due to lower EBITDA in the period under analysis.

Moving on with the presentation on page 4. We will talk about our asset optimization and what we did so far in 2017. We continue pursuing our strategy to focus on the most profitable assets and during the year, divestment and the joint venture amounted to BRL 421 million. In March, Gerdau signed a contract for a joint venture selling 50% of Gerdau's stake in Colombia with a public capital management which is already a partner in the Dominican Republic.

The economic value of the transaction was BRL 523 million and the part that refers to the 50% stake of Gerdau amounted to BRL 162 million. The transaction has not yet concluded. That's why Gerdau Diaco is still reported as a controlled entity in the balance sheet of the first quarter. Moreover, we sold four downstream units of specialty steels and five mills producing goods (11:12) construction in the U.S. with an economic value of BRL 179 million.

Now, I'd like to talk about investments on page 5. Our investment in PP&E totaled BRL 237 million from January to March of this year. Now, for the rest of 2017, we intend to outlay CapEx amounting to BRL 1.3 billion in keeping with 2016. The focus of the investment is to improve maintenance and productivity of the operation.

With that, I conclude this part of my presentation and I give the floor to Harley to continue the presentation.

Harley Lorentz Scardoelli {BIO 7283603 <GO>}

Thank you, André, and good afternoon to you all. Now, I would like to talk about the results and performance of each of our operation in the first quarter of 2017, starting with Brazil in 2017 and the first quarter of 2017 vis-à-vis the first quarter of 2016.

Shipments were down mainly due to lower export (12:17). Looking at the EBITDA and the margins in the first quarter of 2017, they were up due to higher net sales per tonne and also a better market mix, higher proportion of sales in the mix in addition to SG&A expenses. In North America, sales were up when we compare the first quarter of this year to the first quarter of 2016 due to improvements in the non-residential construction market and in the industry. Vis-à-vis the fourth quarter of 2016, there was improvement due to seasonality in the period under comparison and also due to the commercial strategy of the company to recover market share of imported products. EBITDA in the first quarter of this year was down when compared to the first quarter of 2016 and due to higher costs of raw materials that were not totally followed by higher prices of steel.

Now, in terms of the fourth quarter of 2016, the improvement in EBITDA and EBITDA margin happened due to higher volumes sold or better net sales per tonne and as a consequence, higher dilution of fixed cost. In South America, shipments in the first quarter of 2017 were down when compared to the first quarter of the previous year, mainly due to heavy rains in Peru which damaged the distribution of products.

EBITDA and EBITDA margin in the first quarter of 2017 were down when compared to the first period the year before due to higher levels of reduction of net sales vis-à-vis cost of goods sold, particularly in Peru and Argentina. On the other hand, the reduction in SG&A expenses offset the drop in EBITDA and EBITDA margin.

And lastly, related to specialty steel, sales in the first quarter of this year were down by 30.2% vis-à-vis the first quarter of 2016, due to the sale of the units in Spain which occurred during last year. Improvements in EBITDA and EBITDA margins in the first quarter of 2017 when compared to the same period of the year before happened due to the sale of the units in Spain that had lower margins, in addition to higher profitability coming from the specialty steel units in the United States.

Now, moving on to slide 8, I will talk about consolidated EBITDA. This adjusted EBITDA and consolidated reached BRL 853 million in the first quarter of 2017, 8% lower when compared to the first quarter of 2016. If we look at the bridge chart on the higher part of the slide, we can see that the reduction in adjusted EBITDA occurred due to lower shipments and lower net sales per tonne, partially offset by the optimization of costs and operating expenses, mainly SG&A expenses.

Now, in relation to the fourth quarter of 2016, EBITDA and the EBITDA-adjusted margins presented an increase, mainly due to the best performance of the BD Brazil. In the bridge chart in the lower part of the slide, you can see that we went from an adjusted net income of BRL 14 million in the first quarter of 2016 to an adjusted net loss of BRL 34 million in the first quarter of 2017 due to lower EBITDA in the period.

Just as André mentioned during his presentation, I would like to highlight that in the first quarter of this year, we also had the reversal of contingency provisions related to the exclusion of ICMS taxes from the tax base of contributions to PIS and COFINS. Those reversal is also detailed in all of the reports issued by the company, but I would like to emphasize that in terms of net results stemming from this reversal and the recognition of other accounting provisions for the period ending March 31, the company posted BRL 930 million in the line of reversal of contingency liabilities, net and BRL 370 million in the line of reversal of updated contingent liabilities, also net in the part related to financial results of its consolidated income statement.

Income tax and social contributions on this reversal amounted to BRL 442 million with the net effect, excluding this amount, totaling BRL 858 million, being considered non-recurring event in the company's consolidated results. Also there, we would like to emphasize that there is yet the possibility that the Supreme Court may understand that the application of the modulation mechanism may be necessary to be applied, which is used to determine the effect in time of a decision to declare unconstitutionality. If the court applies the modulation mechanism, limiting the effects of the decision in time, it may be necessary to reassess the risk of loss associated with the said lawsuits, which, as a consequence, may require the accrual of new provisions related to the matter in question in the future.

In terms of dividend, consolidated net income in the first quarter of 2017 was BRL 824 million and it was impacted by the non-recurring event already mentioned related to the reversal of the provision for contingencies amounting to BRL 858 million. Considering the possibility that the Federal Supreme Court may prospectively apply the modulation mechanism to its decision to declare unconstitutionality and thus limiting its effects on taxpayers, the company is not considering at this time the payout of dividends in advance of minimum mandatory dividends, and will continue to monitor the matter until the court's final decision is made.

Moving to the next slide, page 9, I will talk about debt and liquidity positions of the company. Gross debt as of March 31 of this year amounted to BRL 19.7 billion, down by 4.3% vis-à-vis December of 2016 and 17% vis-à-vis March 2016, basically due to amortization of working capital loans and the effects from exchange variation. The weighted average cost of the debt was 7.1% a year with an average tenure of amortization of 5.6 years.

On March 31, 2017, approximately 21% of gross debt was short term. Bear in mind that from the BRL 4.2 billion of debt with short-term maturity, BRL 2.5 billion refer to the 2017 bond due in October, and the remaining refers to the working capital lines that are renewed on a frequent basis. Cash equivalents and the credit facilities of the company are more than enough to honor this commitment. Furthermore, the company has the option to refinance the debt in full or in part.

The reduction of the net debt over EBITDA indicator of 4.1 times in March 2016 to 3.5 times in March of this year, and despite a lower EBITDA in the periods compared was the result of debt amortizations brought about by cash generation in the period in addition to the positive effect from the exchange variation.

Finally, still talking about the debt, I would like to mention the company's strategy referring to the capital structure of the Metalúrgica Gerdau holding company. On March 7, 2017, Metalúrgica signed a contract for the exchange of shares with Banco BTG Pactual whereby 34,209,552 common shares held by BTG will be exchanged by 32.3 million preferred shares held by Metalúrgica anticipated in the negotiation of an obligation maturing in December of 2017.

In addition, in view of the increased interest of Metalúrgica Gerdau in the common stock of the company is resulting from the exchange and in compliance with CVM Instruction 361 Metalúrgica Gerdau filed at the CVM an application for registering a public tender offer due to the increase in the interest in compliance with the formal procedures necessary to put that into effect.

Now, next slide, I will talk about working capital. In March 2017, the cash conversion cycle was up vis-à-vis December 27, 2016 due to increases of 5.3% in the working capital when compared to a reduction of 1.9% in net revenue. Increases in working capital stem from the re-adjustment in our inventories in the BDs, Brazil and North America reflecting the seasonality of this indicator. From March 2016 to March 2017, we were able to reduce by BRL 1.8 billion our working capital, and the company remains very much focused on managing this indicator.

And finally, in concluding my part of the presentation on slide 11, we talk about the free cash flow of the company. In the last 12 months, the company generated positive free cash flow due to some activity in our spending in CapEx and we did all the necessary efforts to manage working capital.

Looking at the bridge chart in the lower part of the slide, EBITDA was enough to honor all of these CapEx commitments and income tax and interest. However, with the consumption of BRL 457 million in working capital stemming from inventory adjustments, our free cash flow was negative by BRL 256 million reflecting, as we mentioned before, the seasonality in the period (22:53).

Now, I will give the floor back to André for his final remarks.

André Bier Gerdau Johannpeter

Thank you, Ms. Scardoelli. To conclude, I would like to highlight that our performance in the first quarter, excluding that non-recurring event, reflects the very challenging moment faced by the world steel industry, and also I would like to highlight the excess installed capacity and overtime (23:21) practice that's coming from some companies in the global market.

In Brazil, we believe that we will see a gradual evolution, mainly in the second half of 2017 and 2018. As the domestic market is still gradually moving, it's very important to be competitive, and extra dollar exports range about 35% or even 40% in terms of our production in Brazil.

But in order to do that, we have to increase the tax rate of Reintegra, which is now 2% and should go to 5%. Reintegra (24:01) the downstream industry. And Reintegra, for those of you who are not familiar with it, is the tax mechanism to – tax restitution to get restitution from non-recoverable taxes already paid in the consumption by the different length of the productive chain. With that increase, we will be able to inject more than BRL 45 billion in the Brazilian economy and generate more than 400,000 new jobs, considering the entire downstream industry.

In North America, the market continues to grow, and the expectation for the year is very positive, considering the deployment of new measures by the current Trump administration, as I said before, and this will increase steel consumption. I would also like to emphasize our joint venture in Colombia, and also the divestments adding up to BRL 421 million this year – BRL 441 million.

To conclude, I would like to say that for 2017, we will focus on generating – on improving productivity and improving our operating performance and financial performance, and also we will continue to focus on the most profitable operation.

I would now be available to take your questions. Thank you very much.

Q&A

Operator

Ladies and gentlemen, we will now initiate our Q&A session. Our first question comes from Mr. Ivano from Credit Suisse.

Q - Ivano Westin {BIO 17552393 <GO>}

Good afternoon, André and Harley, and thank you for questions. I would like to start with BD Brazil and the outlook for the year. You had a significant margin in the first quarter and I just want to understand whether you can make further improvement and what is your outlook in terms of volumes and prices, and whether we should be able to see some price increases coming into the results for the second quarter. And also, if you can help a little bit about parity.

Now referring to North America, I think the units is in a different momentum when compared to Brazil. Could you please comment on the challenges and what should be expected throughout the year? You said that in this current Trump administration, you anticipate a positive outlook, but then you have antitrust coming in, whether that would impact their (26:41) consumption. And what is your expectation vis-à-vis volumes throughout the year? How do you see the increases in pricing in metal spread?

And one more thing, when I look at production and sales in the first quarter, you had significant increase of plus 10% in your sales volumes, and then minus 2%. So, I want you to comment on that, please, if you can.

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

Good afternoon, Iva. This is Harley. Let me refer to Brazil. In terms of pricing, we do not make any comments on that because it also – it depends on parity, volatility and the appreciation or depreciation of the dollar. Very recently, the premium was very low, close to zero. That's why we have to take a close look at that in terms of volumes and higher production vis-à-vis deliveries. This, in a way, has to do with our inventory adjustments and, therefore, production had a mismatch. And then, we have to work harder on readjusting our inventories. This is also due to seasonality effects. So, throughout the year, this should be mitigated.

A - André Bier Gerdau Johannpeter

Good afternoon. André. Speaking about the U.S. market, I mean demand remains strong in the non-residential construction area. There has been recovery in the automotive area. We see good figures. We have record numbers, and they have – they will continue to remain as such. So, our challenge refers to significant volume of imported goods and also competition coming from domestic producers. So, the major challenge in the U.S. and Canada and also in Mexico has to do with resuming margins.

We had a slight recovery from the fourth quarter to the first quarter, and we expect to continue that trend throughout the year with some rebound coming from metals price. We don't know precisely when that will happen, but we anticipate some margin recovery throughout the year. And, once again, there is good volume, but there is a very fierce competition coming from domestic producers. There is an anti-dumping case that can happen (29:54), but we never know what their final decision will be, but once again, the outlook on the demand side is very good.

Q - Ivano Westin {BIO 17552393 <GO>}

Thank you, Harley and André. I would just like to go back to the previous point. Can you quantify what kind of volume increases you can anticipate year-on-year? And whether you can say anything about the drop in flat and longs.

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

We would rather not give you this market guidance. We've been closely monitoring all of the KPIs. It's a moment of recovery like André said about North America. The outlook is quite positive in Brazil. In terms of margin recovery, we have to work hard to try to improve the performance. But in terms of volume, it's difficult to tell you anything about that.

Q - Ivano Westin {BIO 17552393 <GO>}

Thank you. That's clear.

Operator

Our next question comes from Thiago Lofiego from Bradesco BBI.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Thank you, and good afternoon. André, could you comment on the divestment? You talked about a target of BRL 1.5 billion between this year and next. Do you still have the same target? Could we probably expect further divestments or – beyond that figure and in what regions could we see further divestments? And about ICMS, in case you win the case and the court favors you, that amount that is in an escrow account, will that be totally reverted to your cash and will that reduce your net debt automatically or is there any other accounting measure which is associated to that?

A - André Bier Gerdau Johannpeter

This is André. About our strategy to optimize asset. Year-to-date, we had a lot of results. We had a joint venture. We don't have any specific figures, Thiago. We are working in several business (32:28) and in several different alternatives, as we've been mentioning in the past two years.

And whenever something happens, we make the announcement. So, we would rather not announce anything very specific. I can still tell you that we have some negotiations underway, which could become a joint venture, a partial sale, or a total sale as we have been telling you throughout the quarter. So, what is important to know is that we are constantly seeking for further asset optimization, aiming at better profit.

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

This is Harley answering the second part of your question related to the ICMS case. We are very cautious in terms of any possible outcome of the case, but considering your hypothesis and if, indeed, the Court favors us and the modulation allows us to have access to that cash, the cash will return to the Company and it will help in our leveraging. Therefore, it's not considered in the calculations yet.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Thank you, Harley and André. Thank you.

Operator

Our next question comes from Leonardo Correa from BTG Pactual.

Q - Leonardo Correa {BIO 16441222 <GO>}

Hello, good afternoon, everyone, and thank you. My first question refers to imports. We've seen some pressure in the return of imports. So when we look at the monthly evolution in the past month, I would just like to learn your expectation for longs. I know that the pressure is not as high as with flat (34:22), but what have you seen amongst other distributors and competition from imported goods in Brazil?

And the second question refers to CapEx and, Harley, maybe you could help me with that. When we look at the BRL 1.3 billion current level, I think the market is currently discussing especially when you look at the depreciation level of the dollar which is about BRL 2.5 billion, we are – I mean, the market is questioning the sustainability of such low CapEx.

I know that your operating level is very reduced. Other players in the industry have a different level of CapEx more distant from the deprecation than you. So, maybe you can help us understand, for how long you can run with such suppressed levels of CapEx and about metal spreads, we see some movement of price increases in the U.S. and what about your metal spread in the U.S. – in that part of the world?

A - André Bier Gerdau Johannpeter

Hi. This is André. Speaking about imports, longs more specifically, we have to be careful because there are also rails in that figure. But if you remove that, the number changes. In our product line, we haven't experienced growth. It's been stable in the past month, and the reason is very simple. That's because the Brazilian market, looking at prices domestically compared to prices abroad, the cost of import and selling here is not very attractive.

Our run-of-the-mill is based on the growth of internal demand so that we can optimize the operation. So, import is not our major concern because, here, it's slow (36:16) and also due to domestic prices, there is not much profitability to those that export to Brazil.

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

Hi. This is Harley. Now, to answer your question about CapEx and depreciation; we've been very careful to maintain our growth at a level where we run no risk in our operation.

We are only working to maintain our CapEx, and we are being very careful and very attentive. A good level on average in our operations and also considering that part of that CapEx today relates to investment in equipment, that also – I mean, maintenance is not proportional to the level of investments, therefore, we are very comfortable that in a period of time, we will maintain investments at these levels BRL 1.3 billion. So, this is what we expect now for the year 2017.

Operator

Our next question is from Thiago Ojea from Citibank.

Q - Thiago Ojea {BIO 17363756 <GO>}

Good morning. Good afternoon, and thank you for the question. First of all, I would like to ask Harley something about working capital. We just saw an increase in working capital and inventory adjustments and replenishment. What is your idea about working capital in the next quarters of the year?

And the second question refers to imports. André just said that imports in the line of products are still okay, but have you felt from your customers, any increase in imports of their products that have compromised – I mean, do you feel that your customer is suffering more and that's why there should be – this should impact demand in Brazil?

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

Good afternoon, Thiago. This is Harley. Referring to working capital, this effect on the first quarter, for us, is very normal and seasonal. We had some readjustment in our inventory and throughout the year, the numbers – or the situation should be normalized.

But the trend in the last few years and the last quarter has always been that of readjusting our levels of working capital to be more in line with our activity. That's why we've been able to maintain our cash conversion cycle between 70 days and 85 days in the inventory and the trend is to work with working capital below 80 days. This is our intent. This is not our guidance. So our intent is to migrate towards these levels throughout the year. Once again, we should revert this trend from the first quarter, but that should occur probably in the second half of the year, you know, the reversion on working capital in the second half of the year.

Thiago, I will talk again about import and you ask about what our customers saw, but there may be something in infrastructure and probably machinery, but we haven't noticed anything unusual when compared to the last few months. The major challenge in the entire industry has to do with a rebound in demand. The longs market which has seen better years, I mean, around 9.5 million tonnes and 10 million tonnes is now around 6 million tonnes and 6.5 million tonnes. So this is the major problem and we see good opportunities for recovery. So more particularly, this will occur in the second half of the year and in 2018. Thank you.

Operator

Next question from Bruno Giardino from Santander.

Q - Bruno Giardino {BIO 15974970 <GO>}

Thank you. My first question relates to cost, particularly in the Brazil BD. So what do you expect in terms of cost pressure particularly from coal and SG&A now I saw a significant reduction in the first quarter when compared to the first quarter of the year before. Do you see that your steel has further gains in that line further on or whether – what should we expect from the company from now on?

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

Hi. Bruno, this is Harley. Talking about coal, our coal purchases have been scaled amongst the different contracts, that's why we see that volatility is in the short term for coal. Coal represents about 80%, but the impact of this recent increase in coal was very much offset because of our long-term contracts that can mitigate that effect. There is an impact, but I would say that the most relevant impact comes from our Brazil cost as a whole.

So the second aspect of your question related to SG&A. This is an area where we've been focusing for quite some time and we are reaching levels that can be maintained throughout time. The trends that we see now should lead us to maintain further stability, as we saw the numbers on an year-on-year comparison.

Q - Bruno Giardino {BIO 15974970 <GO>}

Thank you.

Operator

Next question from Marcos Assumpção from Itaú BBA.

Q - Marcos Assumpção

Good afternoon, everyone. My first question is about the rebar business. Could you elaborate on how do you see the possibility of new entrants to this business today and also the recent attempts to increase prices, whether this attempt has been successful or not?

The second question is, whether you could talk about the performance of iron ore in the quarter and how much that impacted the Brazil BD.

A - André Bier Gerdau Johannpeter

Hi, Marcos. This is André. About rebars, we do not have access to the cost or how things work because the new entrants are still closely held companies, and they don't publish their results. What we've seen is that in terms of volume and market sales and production is that many of them are increasing their volumes currently.

And – well, the new entrants are already here to stay, so the market is still trying to find ways to work out its demand. They already occupy an important space in the (45:05) and I think the trend going forward is that this will be sustained in terms of the rebar market. Once again, we just wait for a rebound in demand, and once that happens, this will change the dynamics not only for rebars, but for other products as well, but mainly rebars. This is one of the areas that is struggling the most because it has to do with the civil construction industry where rebar is important.

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

Hi, Marcos. This is Harley. About iron ore, we do not separate or follow the results of iron ore because we have a separate cost line. The volume of our sales go to our own units, and that is about 70% to 75% that goes to our own units, which is important. We have to supply this raw material at an adequate cost. We are not separating the results because the result is already incorporated in the Brazil BD. A great part of that iron ore is geared towards our domestic operation. Thank you.

Operator

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

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

Thank you and good afternoon. My first question has to do with the recovery in Brazil. Have you seen any tangible evidence that demand is picking up or will improve in the second half of the year? We're already in early May and also what end market do you think will recover first in Brazil in the local market?

And then the second question is, similarly, with North America, what is your outlook for volumes? Could you give us some numbers guidance, or at least qualitative guidance in terms of volumes and EBITDA in North America which continues to be the lowest in terms of EBITDA generation – EBITDA margin rather in – across the portfolio. Thank you.

A - André Bier Gerdau Johannpeter

The first question – Carlos's first question was about Brazil's recovery, whether we've seen any concrete signs of recovery or what is the outlook of a rebound in demand in Brazil. The signs are too weak. We've seen one-off signs here and there, but once again, our idea is that there should be a stronger rebound in the second half of the year and mainly in 2018.

So considering some important initiatives we've seen, like the reforms and the labor outsourcing, there have been drops in interest rate, there is also the release of the severance pay of BRL 34 million, we see (48:36) private and public partnerships, we recently saw that in four airports, so we hear some good and positive news here and there, but it takes some time until this has any impact in the steel consumption. That's why we anticipate improvements in the second half of the year than in 2018.

And also, the agribusiness in Brazil is doing well, so that's not a major segment to Gerdau, but once agribusiness is doing well, there is an increase in wealth and that is good for us. We already saw some improvement in the numbers. The forecast is about 0.5% of rebound in the industry, in general, part exports and part domestically, and the most difficult segment is that of civil construction, and that industry takes longer to recover, but I think that probably, it will start recovering later this year and in early 2018. This is the outlook we see today, a gradual recovery occurring in the second half of the year and early next year.

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

To answer Mr. De Alba's – other part of his question, he talks about the market in the U.S. In that regard and I think that we go back to something that André talked about, that the forecast or expectation for 2017 has to do with the growth and demand especially in nonresidential construction in industrial areas. So some of the measures that have been implemented by the current administration like no tax reduction, investments in infrastructure which is something that we know it takes some time until we see any impacts, but all of these measures can certainly impact the U.S. demand. Our own operation is going through a market share recovery and we saw improvements in volumes because of the market share that we worked on, and the forecast for the U.S. in 2017 for the entire country, anticipate an average steel consumption of about 3% growth. There has been some recovery of market share on our part. That's why we may see some improvements in our own performance. But it should be close to the market growth as a whole.

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

Thank you.

Operator

Our next question, also in English, is from Roy Yackulic from Bank of America, Merrill Lynch.

Q - Roy Yackulic {BIO 4201939 <GO>}

Hi. Thank you. I noticed that this quarter free cash flow was negative, driven by higher working capital and in last year and in the fourth quarter, we saw positive free cash flow in the fourth quarter particularly because of working capital gains or reduced working capital. So now that we see perhaps the market (52:05) and having turned in the U.S. and higher working capital demand, how do you expect that to balance going forward in terms of the magnitude of increasing working capital, how this will impact free cash flow and I also noted that in the first quarter, you didn't pay any dividends. And now, I think you have to balance increasing working capital and can you pay dividends to maintain positive free cash flow and deleverage?

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

His question has to do with cash generation in the quarter and the forecast for the year especially related to working capital. In terms of increase in working capital and the negative effect on cash generation in the quarter has more to do with inventory readjustments due to the seasonal effects rather than increase in volume for demand recovery and this also answers part of your question. We consider that this seasonality will be reverted throughout the year due to our history on that indicator, and cash generation will be positive this year as well. Our policy vis-à-vis dividends last year certainly had a lot to do with our lower results and also in terms of cash adjustments.

And that's why...

Q - Roy Yackulic {BIO 4201939 <GO>}

Can I...

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

...we did not pay out dividends. In this quarter, we are being very cautious. We have the positive results, but we are deferring dividend payout for another later date once we have a final ruling from the Supreme Court. With the reversal or the end of that case, we should see changes in our working capital, but once again, due to seasonality things, we resume as they did in the past, looking at our history.

Q - Roy Yackulic {BIO 4201939 <GO>}

Can I just ask a further question on that? And that would be that in 2016, working capital was reduced to about BRL 2.6 billion, from 2015. Are you saying that you can maintain this low level of working capital going forward, or is it just that the market is going to recover so slow that it won't increase that fast?

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

The question is whether we can maintain this level of working capital with the market and recovery. In fact, things are proportional. If there is growing demand, that will require a higher working capital, but as a consequence, we will also improve our cash generation coming from a better EBITDA. So I think this is the rationale.

So, as a consequence, if the situation is reversed, we will not generate EBITDA. The reduction in EBITDA we had in the past two years was just to adjust working capital with a lower EBITDA generation. So we expect that once the recovery occurs, we will have the two indicators moving further and we will work hard so that we will end up by having a positive cash flow, free cash flow.

Q - Roy Yackulic {BIO 4201939 <GO>}

Thank you.

Operator

We now conclude the Q&A portion of today's call. I would like to give the floor back to Mr. André Bier Gerdau Johannpeter for his final remarks.

A - André Bier Gerdau Johannpeter

Thank you all very much for participating in the conference call. On my behalf, and on behalf of Scardoelli, then I would like to invite you to be with us again on August 9 for the results of the second quarter of 2017. If you still have some questions remaining, please see our IR department to answer your questions. Thank you, and have a good day.

Operator

Gerdau's conference call is now concluded. I would like to thank you very much for participating, and have a very good afternoon.