Q2 2017 Earnings Call

Company Participants

- Fábio Schvartsman, Chief Executive Officer
- Gerd Peter Poppinga, Executive Director-Ferrous Minerals and Coal
- Jennifer Anne Maki, Executive Director-Base Metals & Chief Executive Officer of Vale in Canada
- Luciano Siani Pires, Chief Financial Officer

Other Participants

- Alexander Hacking, Analyst
- Amos Fletcher, Analyst
- Andreas Bokkenheuser, Analyst
- Carlos F. De Alba, Analyst
- Daniel Lurch, Analyst
- John C. Tumazos, Analyst
- Jonathan Brandt, Analyst
- Marcos Assumpção, Analyst
- Thiago Lofiego, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. Welcome to Vale's Conference Call to discuss the Second Quarter of 2017 Results. At this time, all participants are in a listen-only mode. Later we will conduct the question-and-answer session and instructions will be given at that time. As a reminder, this conference is being recorded and the recording will be available on the company's website at vale.com at the Investors link. The replay of this conference call will be available by phone until August 2, 2017, on 55 11-3193-1012 or 2820-4012, access code 977-5487#. This conference call and the slide presentation are being transmitted via Internet as well, also through the company's website.

Before proceeding, let me mention that forward-looking statements are being made under the safe harbor of the Securities Litigation Reform Act of 1996. Actual performance could differ materially from that anticipated in any forward-looking comment as a result of macroeconomic conditions, market risks and other factors.

With us today are Mr. Fábio Schvartsman, President and CEO; Mr. Clovis Torres, Executive Officer and General Counsel; Ms. Jennifer Maki, Executive Director of Base Metals; Mr. Luciano Siani Pires, CFO; Mr. Luiz Eduardo Osorio, Sustainability and Institutional Relations; Mr. Peter Poppinga, Executive Director, Ferrous Minerals and Coal; and Mr. Juarez Saliba (2:02), Director of Strategy, Exploration, New Business and Technology.

First, Mr. Fábio Schvartsman will proceed with the presentation. And after that, we will open for questions and answers.

It's now my pleasure to turn the call over to Mr. Fábio Schvartsman. Sir, you may now begin.

Fábio Schvartsman

Thank you. Good morning to all. It's a pleasure to have this opportunity of presenting my first conference call of Vale for the second quarter of 2017. As this is my first time, I will make it slightly different than normal. Instead of starting discussing the results, I will comment on the points that I know that many of you are interested in understanding how these are moving forward in general since I joined the company.

Well, let's start with this very recent diagnosis that was made, we call it internally, a 60-day diagnosis. It was just delivered. I received it this week. It was far expecting my expectations, faster - I'm sorry, better than my expectation. We have a lot more detailed vision of what to do with Vale. But it is important to understand how the sequence, which - or in other words, which will be scheduled for delivering information on the diagnosis.

First, we are going to present this diagnosis to the board of directors of this company, and this presentation will be made in the next board meeting in one month time. That means that just after that, and if this diagnosis gets approved by the board, we are going to start delivering to the market the information that could be delivered that are not confidential regarding the diagnosis that was made. Nevertheless, I would like to mention a few points that I can, because we are not in a conflict with anything that requires approval.

First, in iron ore, we have a very strong diagnosis towards cost efficiency, cost reduction, sustainability and so forth. And here, we have the work of Professor Falconi just starting. He was just hired. And he is going to make a simple case out of the pellets division. And if successful, it's going to rollout for the rest of the division. The benefit expected from this work will be up to $1.50 per ton once all the division is covered.

And certainly (5:29), these are very rough estimate, because - and basic taking the estimate that was made in the pellets division and I'm rolling out on average for the rest of the division. So, I must say, this is most likely a very conservative scenario of how much we can address costs in the company.

Another very important aspect that was already announced in Vale Day of last year is the center of integrated operation through which we are trying to integrate everything, all the systems, all the railroads and ports and ships in order to optimize the global operation of Vale, and therefore bringing cost down and efficiency up.

But the most important thing that was clearly made through this diagnosis is the issue regarding base metals. Base metals in the last few years was heavily concentrated in the idea that prices of nickel will be very high in the future. And with this in mind, the investments are always possible and the return would be there if the prices went up. Unfortunately, the prices kept low and we have changed entirely the behavior of these metals now towards trying to get the most of the existing scenario, not believing only in a future scenario that will be very favorable.

Now, the objective is to make money in the existing situation, instead of using money for building an uncertain future, much on the contrary to start to be profitable in return on investment in the model that we have today. You know that we have several different sites where we produce nickel, and it's very clear that the biggest problem is Nouvelle-Calédonie, where Vale has invested billions of dollars in the last several years. And we've had very poor results and actually our costs there are still much higher than the price of nickel as of today.

So here, the issue is much more complicated. And we are looking to find a way of having an operation where Vale can have a sustainable model without having to put more money to work in this business. Let's make it very clear. Our main goal is to find a sustainable model. Obviously, if we cannot find it, then we have to face the possibility of shutting down this mill. But this is the sequence. The sequence is we are going to queue the end of the possibilities of finding alternatives of having a sustainable business model for you.

Regarding the team and the group of executives of the company, I'm very pleased to let you know that we have the new group of officers – executive officers that is almost complete. We have just announced our internal promotion as of yesterday for our new position in the executive committee. So now, we have a very strong mixture of officers that are already in the company, plus a small number that came from outside, plus some internal promotions. Now, we have a group that is almost ready to start to work from now on for building the future of Vale.

It's important to make a quick remark on the issue of the new headquarters of Vale. We just announced that we are going to move everybody to the same building here in Rio de Janeiro, in order to have a better integration among everybody that works for this company. This building is in the north of Fogo (10:31) and it is in the landmark building that was built by the last project of the late Oscar Niemeyer, probably the greatest Brazilian architect.

One word about Samarco. It's very important that you understand that we – together with Samarco and together with BHP, we're doing everything that we can to restart the operation of this company. Nevertheless, the truth is that this is not totally under our control, because depends on approvals and licenses and permits and that are very hard to get after the accident that we had there. So, the only reason why Samarco didn't start so far is because we didn't get this permit. And it's impossible to say when we are going to get it.

The only thing that I'm pretty sure that we are going to get it. We are going to get them, and then the company will restart. And the problem is we shouldn't promise when it's going to happen because we certainly don't know.

I want to make a quick comment as well in this capital restructuring of Vale. The operation is coming to a very important phase that ends in August 11, the conversion of shares from PN shares to ON shares. And it is my pleasure to tell to the market that the results so far are far beyond our best expectations. We are getting a lot of traction with retail that we were not expecting. And we are getting indication from the Index Funds that they will convert. So, it means that most likely we will have a very good scenario when it comes to August 11, because besides these people, the vast majority of the market was supporting the operation.

So, it's important to say that we expect a heavy concentration of liquidity of our stock in the ON shares after this conversion period. And it will represent a very important step forward in the direction of preparing this company to become a true corporation with better governance and less government interference, that's the aim of all of that. Another issue that is important to emphasize is the issue of the royalty. That was recently raised by the Brazilian government as recent as this week.

Vale is clearly not satisfied with this increase in royalty, not only because it represents further costs for the company, but even worst it brings a lot of legal uncertainties because this royalty was now extended to freights of the iron ore and to the operation of pellets that is clearly an industry operation, not a mineral operation. As a consequence, the legal uncertainty is growing and this is the worst possible situation, because nobody knows which is the real impact of these measures that were announced.

Now, finally, a very quick comment on the result of the second quarter. It is clear from my understanding that it was a weaker result than expected for everybody. Nevertheless, the main factor for this weak result was the lower iron ore price during this quarter. But we had some factors that were internally caused. As for instance, we had more production than sales because we've been building inventories in China for the purpose of blending. And this, as a consequence, translated into lower sales than expected. And we had still a tail of sales of low-quality iron ore with high silica content that - this affected our net realized price and this affect negatively our result as well. On top of that, we had a number of one-offs issues that affected the results.

The good news that we have is that now we're facing for the next quarter a completely different situation. First, the price scenario is higher prices and more stable that we had in the last quarter. Second, we are reducing, in a very meaningful amount, the production of low-grade iron ore or high silica content iron.

Finally, we are not going to have the one-offs that we had in this year. And we are not going to build further inventories, because we are almost at the level that we wanted to be. The consequences by any means, the results of the next quarter should be more meaningful than the results that we had in the last quarter. Well, this is probably lucky of a hookey that I'm very proud of having this kind of lucky right now.

Finally, one - we had though one good thing in this last quarter is the very strong cash generation of the company that allow Vale to pay large dividends, to pay for the put option that we had to pay and reduce debt altogether in this quarter. This clearly indicates that the trend of reducing debt is here for staying and we are going to see an acceleration in the reduction of leverage of the company in the next quarters, putting behind Vale the issue of high indebtedness.

So, this was basically what I had to present to you. And now, I'm going to convey to Luciano that will give a more detailed explanations on the results of the second quarter. Thank you.

Luciano Siani Pires {BIO 15951848 <GO>}

Good morning, everyone. So, my goal here is to just highlight a few specifics on the results. So starting by the free cash flow. Remarking to you that capital expenditures were the lowest for the quarter since the third quarter of 2006, and looking forward, we see the strength to continue. We are almost at the end of spending money with S11D. In this regard, we are even ahead of schedule. We should conclude the works on the logistics by the end of 2018 instead of going through 2019, as we expected before.

Some large expenditures on, for example, in Canada, in the Atmospheric Emissions Reduction program, they're coming to an end as well. And because of the review of the Base Metals business, it is likely that some of the capital to be spent will be deferred. So in the end, capital expenditures continue to trend down and cash flows will continue to trend up. And even in an environment of lower prices, we are spending today in a quarter what we used to spend two years ago in a single month in capital expenditure. So, it makes a big difference.

Other offenders of the cash flows they have gone. For example, the hedge cash expenditures that we had very intensely last year, they're gone. And opportunities are in the short term. For example, pre-operational expenses are bound to decline. One example of this is that Long Harbour, the Long Harbour refinery, for example, June, we had no pre-operating expenditures. The refinery has reached 60% of capacity. And S11D expenditures are supposed to decline as well in the future. So very good perspectives for cash flows.

In terms of the composition of EBITDA, no news here. Still highly concentrated on iron ore. However, I would like to remark the performance of coal. As you saw, we generated $157 million of EBITDA, of which $182 million was generated in the Nacala Corridor and there was a loss in the other inefficient corridor beta, which is not the long-term future of the company because we will manage our exposure to beta after the end of the contract.

The costs - the total operating costs continue to decline. We have reached $74 per ton, and we are bound to be below $60 per ton in the very near future. There was, yes, an increase in the absolute cost because of the entrance of Mitsui in the quarter. There is now a $15 tariff. But just to remark that of this additional $15, $13 come back to Vale through the repayment of loans granted to the Corridor. And this goes into the financial income in the balance sheet.

In terms of - now going to iron ore, in terms of costs, you saw that the breakeven landed-in-China is now $34.7, a big increase we expect to the end of the year with dilution of fixed costs and other measures to be back towards $32 to $33. As you saw as well, the freight rates - the spot freight rates in the market, they have declined, but there is a lag because of the length of the journey between Brazil and China. So, we haven't captured yet this recent decline in freight rates, but we should in the next coming quarters. So, we're going to be back likely to the range of $32 to $33. And because of all the cost reduction initiatives that we announced in Vale Day and now this iconic (22:17) program that Fábio has remarked, we strongly believe we'll be back down lower than $30 per ton in the near future.

In terms of iron ore price realization, just to call your attention to one phenomena that we were impacted in terms of EBITDA this quarter because of the adjustments on prices from the past quarter, because we've recorded at $78 per ton the outstanding sales with provisional pricing in the first quarter and these sales realize at lower prices.

On the next quarter, this effect will reverse because we have recorded the provisional pricing sales for this quarter at $62 per ton and now we're almost at the end of July and the prices are higher than that. So, not only the average prices for the quarter will be higher, but also we'll have a kicker from these price adjustments carrying from the second to the third quarter. I'm certain that we will talk a lot about these inventories build up and this correlation between production and sales. So, I'll leave it to the Q&A.

On Base Metals, we had a good performance on costs. They've improved from the first quarter. So offsetting a little bit the decline in, especially, nickel prices and cost performance tends to continue to be good in the following quarters, especially in the third, because we're going to have two furnaces operating in Sudbury. And as I mentioned, Long Harbour is in very good shape to continue to reduce costs.

On the divestitures, we just received news yesterday that on the project finance in Nacala, ECIC, the ECA from South Africa, has approved the project so joining now AfDB, we expect JBIC and NEXI approvals for September and disbursement shortly thereafter. On the fertilizer sale, we are now awaiting for the final decision by the anti-trust authority from Brazil, should come soon. And we are also fulfilling the other precedent conditions. So therefore, we expect closing by the month of November and proceeds to come still in the fourth quarter.

The sale of Vale Cubatão is progressing. Potential buyers are doing due diligence right now. And we expect to receive additional proceeds from the sale of two ships in August and another two ships in October, therefore completing the divestiture program.

On the debt, you saw we had still, on the first quarter, very high gross debt. It has declined in the second quarter. We have started to repurchase part of our debt and that should accelerate. We aim at reducing financial expenses going forward. So, doesn't make sense to pile up cash. We will accelerate the repurchasing of debt.

So in the end, as you can see, we are very much de-risking the Vale equity story and being ready to ride this future journey under the leadership of Mr. Schvartsman.

Now, we open for Q&A.

Q&A

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. Our first question comes from Mr. Carlos De Alba with Morgan Stanley.

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

Good afternoon. Good morning, gentlemen, and Jennifer. And first question has to do with the discrepancies or the gap between iron ore shipments and iron ore production. What can we expect going forward on these metrics? I understand from the release there is around 5 million tons, which seems a little bit short relative to the gap that we saw in the numbers. But if you can help us understand how these gap will evolve in the next few quarters and maybe next year, that will be really useful. And the second question, we saw news announced by a smaller producer that Vale sold a couple of autoclaves to them for around $7 million. My question is, does this have anything to do with maybe what Vale would do at VNC? Does this mean that the company will – I mean, these autoclaves VNCs equipment or not? Thank you.

A - Gerd Peter Poppinga {BIO 17245689 <GO>}

So, Carlos, this is Peter speaking. Thanks for the question. Yeah, this gap between shipments and sales happened the last quarters and is now at its – in my opinion, at its peak in Q2. You know the reason for that. We have a blending strategy, which is not only Malaysia and Oman, but also other offshore localities, mainly China. This is CapEx avoidance and it's about price realization and it's about sales distribution of new sales channels. So, all this comes into this positive strategy. But this year the blending in Malaysia will be around 25 million tons and the blending elsewhere, including China, will be 45 million tons, and we will have a 70 million tons blended.

So, stocks are building up. And probably what I can tell you is that in 2018, what we'll see is a conversion of the shipments and the sales volumes. That can be one or two quarters up and down again. Actually, the trend towards the end of the year is to slightly reduce the stocks we have today. But I would say that during the year of 2018, we will have very much a conversion – a very narrow correlation and narrow gap, if any, between sales and shipments. Thank you.

A - Jennifer Anne Maki {BIO 16392645 <GO>}

Thanks, Carlos. Those autoclaves in question that were sold relate back to our Vermelho project, which we had in Brazil a few years ago, which we didn't proceed with. So, it's unrelated to Vale New Caledonia.

A - Luciano Siani Pires {BIO 15951848 <GO>}

We are coming full circle. If you imagine this was a project approved at the board of directors of Vale in November 2005, and here we are 12 years later putting a lid on it, selling two autoclaves for $6 million.

Operator

Our next question comes from Jon Brandt with HSBC.

Q - Jonathan Brandt {BIO 17988091 <GO>}

Hi. Good afternoon. So, two questions for me. I mean, first, on the overall strategy. So, I understand that you want to continue focusing on deleveraging. I noticed that there wasn't really a mention of the $15 billion to $17 billion net debt target, like you've mentioned previously, and instead using the language that you want to be in a more comfortable leverage situation by the end of the year. Have you moved away from this $15 billion to $17 billion target? And then, I guess, sort of related to that, once you reach what you deem is comfortable, should we continue to expect the rest of the free cash flow to be paid out in dividends? And then, my second question relates to VNC. Fábio, I know you want to take some time and have this be more of a sustainable project. I'm wondering how much time you're willing to give this, and if you've analyzed potential shutdown costs if you have to go that route? Thank you.

A - Fábio Schvartsman

Well, Jon, thank you for questions. First, in the initial leverage. Well, we can say that we are reducing the target. Actually, we want to have less than $15 billion to $17 billion debt. And my reasoning here is very simple. Vale is too much dependent upon one single commodity, iron ore. And this is a very volatile commodity, doesn't go well with any kind of debt. So, in my point of view, Vale has to have the lowest possible debt. And we are moving in this direction. By doing that, we'll be improving and making our balance sheet stronger and this will be one of the measures that we are looking for, besides improving performance, besides improving governance, besides improving execution.

If you can put everything here together, it will probably represent an improving in the perceptional value of the company. And therefore, we will be able to use, in a more broader way, the stock of the company. That's my goal here. Actually, I don't want to use that to look to the future in this company based upon that. I think it doesn't work to follow this road. Therefore, we are going to keep – keeping dividends and we are going to keep the leverage in the company. As a note, even in my former job in execution of the largest product of the entire life of the companies I worked for, we've been growing dividend throughout the construction of that big investment there. So, it gives you an idea how do I feel about dividends.

Second, regarding VNC, well, I said exactly what I meant. We are clearly looking, in a deep way, how and if we can transform it in a sustainable business. And then, and only then, if it's not the case, we are going to look into shutting it down. As a consequence, we are analyzing and evaluating all the scenarios. Calculations are being made, but I have no idea which is the results – which are going to be the results of this calculation, because the priority is to find a sustainable solution. Closing is the last resort. Imagine, after investing billions of dollars there, I just cannot go there and close it without take into consideration all the efforts, all the jobs that we have, everything that is there.

Only if in the end we cannot continue. One point is clear, we are not going to put more money to work there. So, we have to find a solution without putting more money there. And we are focusing on that.

Operator

Our next question comes from Amos Fletcher with Barclays.

Q - Amos Fletcher {BIO 4728914 <GO>}

Yeah. Morning, gents. Just congratulations on the stunning free cash flow generation in the quarter. In particular, you had a very strong $1.4 billion receivables inflow, can you explain what was behind that? And then, secondly, on iron ore, you mentioned on the Portuguese call that you're going to produce 400 million tons next year. Could you clarify when you envisage reaching the 400 million ton level? Thank you.

A - Luciano Siani Pires {BIO 15951848 <GO>}

Amos, Luciano. I understood from the first question – the line was a little creepy – that you want some comments on the free cash flow on – the highlights for the free cash flow, is that it?

Q - Amos Fletcher {BIO 4728914 <GO>}

Yeah. Just to clarify there was a $1.4 billion receivable inflow, just explain what was behind that? And whether there was anything receivables (34:58) within that going forward as well? Thank you.

A - Luciano Siani Pires {BIO 15951848 <GO>}

Okay. So, part of that reduction is a natural consequence of the declining prices. So, you collect sales at the beginning of the quarter at higher prices and then you record sales at the end of the quarter at lower prices. So, that explains a little bit of the disconnect between EBITDA and cash flows, which goes through the – usually, the accounts receivable reducing.

The second topic is because of the very steep increase in iron ore prices at the end of the fourth quarter and going through the first quarter, there were lots of outstanding invoices of the provisional price adjustments, who weren't immediately collected because of the sheer volume of those. So, there was some inefficiency in the collection of provisional price adjustment invoices, and we've resolved that so that explained a little bit also the reduction of accounts receivable. But we believe now we are at a more normalized level of accounts receivable. So, going forward, only eventual price streams will explain the up and downs.

A - Gerd Peter Poppinga {BIO 17245689 <GO>}

I guess, Amos, regarding the 400 million tons annual production question, we have stated repeatedly that although we have a 450 million tons capacity, it doesn't mean that we are going to use it. It depends on market conditions and, more importantly, on our margin maximization, optimization efforts. If you take our recent ramp-up schedule, which was revised last Vale Day instead of two years ramping up in four years, mainly concerning the Logistic Corridor, then you reach the full ramp up of the S11D at 2020.

It may be, if market conditions are right and if we are maximizing our margins, that means that we are reaching, in 2019 or in 2020, our goal, our target of 400 million tons. It will not mean that we'll go beyond that. And again, like we said, we are – this is our optimum level of operations, and we think it fits well into the mid-term market. And so, to answer your question, reaching probably to 400 million tons either in 2019 or in 2020.

Operator

The next question comes from Andreas Bokkenheuser with UBS.

Q - Andreas Bokkenheuser {BIO 7182883 <GO>}

Yeah. Thank you very much for taking my question. Two questions actually. The first one is that there's been some talk this year, and I think you reiterated some of that this morning, that management may be looking to diversify out of iron ore towards other commodities over time, not to be so dependent on a single commodity. How do you think about that in terms of a comfort level? Would that be, for example, iron ore shouldn't account for more than 50% of EBITDA? Is that the way to think about it? So, if you could give us some clarity there, that would be great. And the second question is, potentially, financing this diversification. Given that you're also trying to delever the balance sheet, would you consider potentially selling some of your iron ore assets to effectively refinance and move into other commodities? So, that would be my second question.

A - Fábio Schvartsman

Andreas, thank you for your questions. First of all, the idea of diversifying the commodities (39:14), and we reiterated our intention of diversifying the company to become less dependent of this – on one commodity that we have today. But in our way of seeing things, we are going to do it in a very cautious way. The first step being trying to get the most of what we already have, especially to make unique operation profitable and in a meaningful part of our portfolio.

Today, we are not getting much of this huge investment that was made there. So for starters, we have to stress the case that we have in hands. Second – sorry, about the guidance, 50%, there is no magic number. We are not looking for numbers. But we really want to have very good and competitive situation in anything that we get involve to. Regarding financing. If there is no chance whatsoever, in any case, that Vale will sell in any of its iron ore assets to do anything, other than iron ore.

Look, what we are going to do, we are going to use – as I'm saying time and time again that we are going to use our only tool that is for real for this. This is the stock of the company. If we are going to move forward and when we are going to move forward depends upon the capacity of using in a negative way shares of this company. So, this is the only financing tool because, Andreas, we know by experience that diversifying is a very difficult thing. And if you do it in any other fashion than using your own stock, you are just adding risk to the process. And we are not going to do that.

Operator

The next question comes from Daniel Lurch with BNP.

Q - Daniel Lurch {BIO 17122284 <GO>}

Hi. Thanks very much for taking my questions. Just a couple of questions on strategy and then iron ore. And first of all, on your – maybe a follow-up on my colleague's question on your organic growth option or on your strategy to potentially diversify the business. Is there still a focus on allocating some CapEx on any organic growth projects? One thing I'm thinking about here is, for example, Salobo III, which is exposure to copper and currently going very well?

My second question is quickly on iron ore. On S11D, you mentioned the progress there. Can you give us a bit more detail on how the operation is running at the moment and how much you are planning to produce this year? And on iron ore cost, lastly, you were highlighting that you expect costs to go down to BRL 46 million to BRL 47 million in the second half. Can you explain how quickly you expect this to happen? This is a more gradual process or is it towards the end of the year? Thank you.

A - Fábio Schvartsman

Thank you for your questions about organic growth. Yes. Obviously, organic growth is part of the strategy of any company, that's no different in Vale. The issue here is that we have to be very careful not to spend capacity to put money to work in markets that are already oversupplied. But having said that, there are some commodities and assets where Vale has already a position, like copper, where we can continue to invest in organic way, because the market can absorb it easily. So, the decision here will be very simple. The assets that can be profitable in areas where clearly there are no evidence of oversupply, Vale will invest organically. Now, to Peter to answer about S11D.

A - Gerd Peter Poppinga {BIO 17245689 <GO>}

Daniel, thanks for the question. So, on S11D, a little more detail, if you want. So, you saw that we are already, in the mine, at 99% physical progress and 90% overall in the growth project. We have not encountered any major problem in terms of commissioning, but we are – now, of course, we are producing and commissioning at the same time. Where are we – where is the (44:18). It's in the mine, where we actually – we couldn't test the (44:26) total capacity of the truckless, because we are producing and commissioning at the same time, like I said. The long-term conveyor is going well, was tested. The mobile crushers were tested. Some small issues in locomotion. A pleasant problem that actually a capacity of the MSRs are actually exceeding our expectations. But all this means interference, no major problem. That's why in the second half of this year we expect to focus more on production and then the commissioning will be less and less. The nominal capacity, as you know, is 90 million tons. We have already produced around 10 million tons this year and we expect to – for the whole year, we expect to have a 25% of nominal capacity, and probably being in the pace of 40% to 50% at the end of the year. Now, that's for S11D.

On the iron ore cost, yes, you saw the increase in cost, mainly there was the merch increase and that was related to the maintenance of the Pier I and PDM. We are changing the big belt conveyor there. And since Pier IV is still not ready yet, it's still being tested, we couldn't compensate there. So, also we had some railway problems in the Vitória-Minas Railway, which also increased the merch cost. That are one-offs events, which will not repeat. We had a increase in our freight costs because we were caught by surprise in some of our Contracts of Affreightment running out and, at the same time, we had to go to the stock market, which was high. This will be overcome in the midterm by our second and third generation ships, Valemax being delivered.

And all the focus on the cost reduction is more and more on the integrated supply chain management, not only in terms of efficiency, but in terms of price regulations. That's where the biggest cost advantages and cost reductions will happen in the future. Thank you.

Operator

The next question comes from Alex Hacking with Citi.

Q - Alexander Hacking {BIO 6599419 <GO>}

Hi. Good morning and thank you for the question. My first question is a follow up to Peter. You mentioned earlier that Vale's annual capacity will be 450 million tons. My question is, does that include the 50 million tons of high silica capacity that's been closed and is in the process of closing, being the 30 million tons that was closed last year and 19 million tons that's closing in the second half of this year? And then, my second question is on the cost structure of the coal business. Can you remind us how much coal are you shipping through Beira today versus Nacala? What is your contractual obligation to ship through Beira? And once that contractual obligation is over, should we assume that you will ship 100% of the merchant coal through Nacala? Thank you.

A - Gerd Peter Poppinga {BIO 17245689 <GO>}

Alex, thank for the question. At 450 million, that capacity is when you add all the four ports together, right. And it includes the domestic markets. It doesn't mean export, okay. It includes the domestic market where you have around 30 million to 40 million tons capital market. So, the 450 million tons is when you add all the export and deduct the domestic market. And the Southern System have some high silica, but also some normal silica, normal quality iron ore. So closing down almost 20 million tons of this is not only related to the Southern System, it's also related to the Southeastern System. So, you will have – all over the place, you will have in the mines, not closing the mines, but you will have product flows being rationalized and eliminated, and by that, you're reducing production on the 20 million tons in the South and Southeast on a annual basis.

But since we are today at, let's say, 365 million tons production this year and we, probably, will go to 400 million tons in the midterm. And I just said to your colleague that I'm not sure if it's 2019 or 2020, when the margins are good and when the market is permitting. So, that means that we are going to compensate – more than compensate the 20 million tons, which will be eliminated in the Southern System and Southeastern System. The flows will be compensated by more production in the Northern System, S11D and Carajás.

A - Luciano Siani Pires {BIO 15951848 <GO>}

On the cost structure for coal, the cash costs through beta is around $125 per ton. So very difficult to make money in this quarter. We still have transportation obligations of around 200,000 tons per month. Those obligations, they extend until the end of this year and they go a little bit into next year. Overall, the way to think about it is that there is an 18 million ton capacity through Nacala and another 4 million tons capacity through beta, which leads us to the 22 million tons, which was the original design for the two process plants for coal.

So, if you want to run the mines at the full capacity, you will need to increase capacity in the Nacala Corridor, which means adding a little bit of rolling stock and seeing if the car dumper can run at very high availability to try to reach the 22 million tons just on Nacala. But the key message here is that beta is not on the plans or the longer term and, therefore, this is an upside for the cost structure of the whole of Mozambique.

Operator

The next question comes from John Tumazos with John Tumazos Very Independent Research.

Q - John C. Tumazos {BIO 1504406 <GO>}

Could you explain a little bit the Sumic transaction? It might be in your footnotes, but there's a lot of press releases this morning. And second, could you explain the political process in restarting Samarco permits? Those of us that are far away might not understand all the issues after a couple of years. I visited BHP in Melbourne this month and I was very pleased with how supportive and complete agreement they were with you?

A - Jennifer Anne Maki {BIO 16392645 <GO>}

John, the Sumic transaction, it relates to prior year transaction when they left the Goro project and, essentially, the payment of that was happened in this past quarter.

A - Fábio Schvartsman

On Samarco, there are basically two environmental permits that need to be obtained. One is for the – on exhausted pit, which will receive the tailings on the short on the first few years of the restart. And the other one is the so-called Corrective License because the whole operating license of Samarco was suspended. And both of the license, the permits are in negotiations with the relevant authorities and they depend on several smaller issues. No fundamental structural issue, but several smaller issues.

Also on the legal front, there is a preliminary agreement established with the public prosecutors, which leads us to until October 30. They may be part of the larger framework agreement established in the beginning of 2016 with federal and state authorities, therefore providing legal stability for the restart of Samarco, which is also very important. So, these are the three main challenge; the obtaining of the two permits, which are on the state authority and the final negotiation with the prosecutors expected for October. And the restructuring of the debt, which again is also going with the banks and bondholders.

Operator

The next question comes from (54:50).

Hi, guys. Thank you for the opportunity for asking my question. I have two questions related to CapEx. First, Siani, could you please compare the levels of maintenance CapEx we saw in the first half of the year to the Vale Day guidance that we saw at the end of last year? And second, still on maintenance CapEx, I would like to hear a little bit from you about the reasons for the lower maintenance CapEx in the second Q, if any of these reasons are the same as the reasons which you said – which you cited the intend to maintain in lower looking forward? So, how should I look at CapEx looking forward concerning these two points? Thank you.

A - Luciano Siani Pires {BIO 15951848 <GO>}

So, the guidance of Vale Day was the $4.5 billion total CapEx for the year. When we announced the sale of the fertilizer business, we removed $300 million, which was the capital for fertilizer from this number so we are talking above $4.2 billion. We should be very sharply close to this number this year. But as you saw, we had some higher number in the first quarter. And now we have a small number in the second quarter.

We should have smaller numbers for capital - investments in capital on the third and fourth quarter, but higher number for sustaining. So, all in all, we should reach the $4.2 billion. The reason being because I wouldn't give much weight on the sustaining capital variations quarter-over-quarter, they depend on a wide number of factors, but they tend to accelerate towards the end of the year.

The way to think about sustaining iron ore is basically we've been going around the magic number of $3 per ton. So, this is a good rule of thumb going forward. On nickel, there is a more longer-term trend towards reduction, given that all the single furnace transition, the AER, Atmospheric Emissions Reduction program, they are all charged into sustaining capital. So, you should expect sustaining capital for nickel to reduce going forward. So, our hopes of declining capital expenditures going forward, they're mostly driven by the reduction of expenditures in S11D and the reduction of sustaining capital in nickel.

Operator

The next question comes from Thiago Lofiego with Bradesco BBI.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Hi. Thank you. Just a follow-up question to Peter. Peter, could you give us your view on the swing production. So with iron ore prices at $70 per ton and even when iron ore prices were at lower levels than, again, the $70 per ton, we were seeing some more volumes from domestic concentrates in China and more volumes from some exotic procedures. So, I just want to understand your view on whether your $70 per ton iron ore price estimate for this year really holds? Whether you think that we should see more fleet production coming back to the market? Thank you.

A - Gerd Peter Poppinga {BIO 17245689 <GO>}

Thiago, thanks for the question. I will give you exactly my numbers we are working with. So, in 2016, we - now, I'm talking on a net basis. We had a 85 million tons of additional seaborne. It was 120 million tons coming in and 35 million tons coming out. Now, what we are working with is coming in 60 million tons, this is mainly Vale and others this year, right, others in Brazil. Broyhill (58:58), as you know, is around 15-plus million tons coming in. India came in increasing with 15 million tons and some others. So, 60 million tons coming in. But seaborne is also coming out. You see Atlas, some South African and other exotics.

And then China, China surprised us actually, it is a fairly inelastic behavior because it's underground mines, it's environmental problems, there is a security problem. So, we thought the Chinese - and we are reluctant to jump in again. So we thought they would come over. But in our focus, there is only 5 million tons to 10 million tons coming. So, that's what I'm saying, at 50 million tons, if you add all this together, seaborne in 60 million tons, seaborne out 15 million tons and China in, maybe increasing little bit 5 million tons to 10 million tons, we will reach 50 million tons. And 50 million tons iron ore equals roughly to 20 million tons to 30 million tons of steel, and that's exactly the steel increase we are having this year, the steel production and increase revenues of steel (1:00:17).

So that's why I'm saying, the market is fairly balanced and it shouldn't be different from the price levels we are seeing today. Of course, you can have ups and downs according to sentiments. But in whole year, the fundamentals are what they are. So $70, and also remind that the breakeven of some concentrates in the Chinese marginal suppliers are around $70 a ton. So, I don't see the market holding for several months below $70. So, it's my model behind that and I hope you see that the market is fairly balanced this year.

Operator

The next question comes from Marcos Assumpção with Itaú BBA.

Q - Marcos Assumpção

Hi. Good afternoon, everyone. My first question is regarding S11D. When do you expect the S11D to start reducing Vale's average cost? And also, on the pre-operating expenses, when do you expect that to finish for S11D? And on the coal business, the second question, if you could provide us a little bit of more details on the run rate of what is the (1:01:45) production and also cost performance in the late this month. You mentioned that production has been ramping up and the cost has been going down. So, if you could provide more updated numbers, it will be useful. Thank you very much.

A - Gerd Peter Poppinga {BIO 17245689 <GO>}

Marcos, I will try to answer the first question, and leave the others for my colleagues, if they can check those numbers. But S11D, for sure, this year will be a higher cost still than – because we are not at nameplate capacity. Although, we are putting some of the costs as pre-operating expense, of course. And so, I would guess that it's going to happen towards the end of next year that we are going to see a real cost reduction on the S11D. On the coal business, I am just stepping in. I'm not so familiar with it now (1:02:44).

A - Luciano Siani Pires {BIO 15951848 <GO>}

Yes, Marcos. We overcome 1 million tons for the first time this quarter per month and now we are heading towards 1.2 million tons, 1.3 million tons. This is the next target to stabilize production at that level. And I don't have the June numbers top of my head, but again I wouldn't place too much emphasis on those monthly numbers. So, what we should see, incremental cost reductions going into the third quarter, for sure.

Operator

This concludes today's question-and-answer session. Mr. Fábio Schvartsman, at this time, you may proceed with your closing statement, sir.

A - Fábio Schvartsman

Thank you. Again, I appreciate very much everyone on this call. It was a pleasure to deliver my first conference of result. And I hope you'll be able to join us for the next one. Thank you and have a good day, all of you. Thank you. Bye-bye.

Operator

That does conclude Vale's conference call for today. Thank you very much for your participation. You may now disconnect.