Q3 2015 Earnings Call

Company Participants

- Andre B. Gerdau Johannpeter, President and Chief Executive Officer
- Harley Lorentz Scardoelli, Chief Financial Officer

Other Participants

- Alan Glezer, Analyst
- Carlos de Alba, Analyst
- Ivano Westin, Analyst
- Karel Luketic, Analyst
- Leonardo Correa, Analyst
- Leonardo Shinohara, Analyst
- Marcos Assumpcao, Analyst
- Unidentified Participant

Presentation

Operator

Good afternoon and welcome to Gerdau's Conference Call about the Results for the Third Quarter of 2015. At this time, all participants will be in listen-only mode during the company's presentation, and later on, we will initiate the question-and-answer session. (Operator Instructions)

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

Here today are Mr. Andre Gerdau Johannpeter, Director, President and CEO; and Harley Scardoelli, Executive Vice President. With no further ado, I would like to give the floor to Mr. Johannpeter. You may begin, sir.

Andre B. Gerdau Johannpeter

Thank you. Good morning and good afternoon everyone and welcome to our conference call on the results of Gerdau. We will now like to begin our analysis by giving an overview of the world steel industry; right after that we'll comment on Gerdau's performance on the third quarter of the year; and next we will elaborate on all of the investments in that period and the capital increase done by Gerdau SA.

It is also important to note that we will analyze the performance of the consolidated results of the third quarter of 2015, vis-a-vis the same period of the year before. After that Harley Scardoelli will elaborate on the Gerdau's financial performance. And finally, we'll be available to take your questions.

For those of you who are following us, right now, we are on page two, and I'll talk about the steel world industry, which is still operating a very challenging moment as we've mentioned in previous quarters. According to Worldsteel Association, the estimate is that this year the apparent world consumption worldwide should be down by 1.7%. This is due by the global excess in installed capacity of approximately 700 million tons; the economic slowdown in China; low level of world investments; turbulences in the financial markets; slower demand from emerging countries, Russia and Brazil particularly; and some geopolitical conflict. All of these factors kind of influence the behavior of consumption in the next few years. For 2016, the growth outlook for the sector is 0.7% still according to the Worldsteel Association.

Other factors that still impacting the market in where Gerdau operate is the entry of imported steel in North and Latin America. Alliances of steel associations both in North America and Latin America are making government more sensitive to the need of setting up measure to fight unfair trade, particularly from China. Some anti-dumping measures have been recently taken for instance in China, Colombia and Mexico and India.

They set up minimum price and tariff level for imports of some steel launched products trying to reduce the -- trying to avoid the reduction of the industrial activity and job cuts. In Brazil, this economic slowdown is still impacting the demand from the main segment that consume steel like the industries, several construction, automotive industry as we have been following, and also posting weak performance.

In North America, their civil construction especially non-residential construction has been posting a consistent growth in 2015. However, the prices of longs are still feeling the pressure coming from the entry of imported goods in the region. As for specialty steel, the segment of specialty steel in the North American market is facing a different reality. In the automobile industry, we're seeing some growth where there is a significant reduction in the segment of oil & gas. In Europe, we see a gradual recovery of the automotive market, whereas in India, the sales of light and heavy vehicles are still strong. In Brazil, production and sales of vehicles are continuing to drop.

On page three now, we will talk about this current environment in this quarter. Our scenario was impacted by non-recurring items, especially because of the write-offs and goodwill amounting to R$2.2 billion with no cash impact, well that will represent EBITDA and the adjusted net income. So as to reflect to the performance of the company and the internal works that we are doing to manage all of our operations. Starting with consolidated shipments, we shipped 4.7 million tonnes which represent a 2% increase when compared to the third quarter of the year before, mainly due to a growth in exports that surpassed a 180% [ph] exports on Brazil.

Now our net sale; net sale was of R$11.9 billion in the quarter which was an evolution of 11% vis-a-vis the same year period of last year. This expansion was due to the positive effect coming from exchange rate variation and conversion into reals of our revenue in dollars and also growing exports from Brazil.

Now SG&A, our efforts can be clearly seen through the reduction of 6% in SG&A in the first nine-months of 2015, when compared to the same period of the year before. Now in the third quarter, the reduction was 4.5%, vis-a-vis the same period of the year before. However, if we exclude the effect of exchange variation, the reduction was even stronger, 17%.

Now EBITDA; the adjusted EBITDA was R$1.3 billion, meaning 4% higher when compared to the third quarter of 2014, mainly due to lower expenses with SG&A. Now speaking about the adjusted consolidated net income, it amounted to R$193 million and also considering non-recurring items, the negative accounting income was R$2 billion or R$1.9 billion.

On page four, now we talk about our investment. In the third quarter, CapEx amounted to R$509 million. The main highlights are the continuity of the installation of the heavy plate rolling mill at the Ouro Branco Mill in Minas Gerais and the construction of the melt shop in Argentina. Both investments are predicted to a start up in the second half of 2016. During that period, there was a reduction of 21% in CapEx expenditure vis-a-vis the second quarter of 2015. Year-to-date investments totaled R$1.8 billion.

Now, we will refer to the offering from Metalurgica Gerdau. Metalurgica Gerdau one of the listed companies in Brazil will hold the public offering of common and preferred shares. The transaction will involve 500 million shares to amortize the indebtedness of the company. So, it is to improve the company's liquidity position. There are different stages of this transaction like you can see in the chart. Pricing will be on November 17, and it should be concluded by November 24.

With that, I conclude this part of my presentation, and I give the floor to Scardoelli. I will come back after his presentation.

Harley Lorentz Scardoelli {BIO 7283603 <GO>}

Thank you, Andre, and good afternoon everyone. Now I will talk about the results and the performance of each one of our business operations in the third quarter of 2015. We are on slide number seven of the presentation. And after that I will give you more details about our consolidated figures. And in conclusion, I will talk about some of the extraordinary events in the quarter.

I would like to emphasize that the comments that will follow already contemplate the new business segmentation for Brazil, North America, South America in specialty steel with the iron ore operation now reporting together with the Brazil BO and the Mexico BO as part of the North America business operations. In terms of Brazil, the uncertainties and the economic environment has caused a lower levels of demand, which has affected our business. Sales of steel in the domestic market in the third quarter of 2015 were down when compared to the same period of 2014.

On the other hand, exports increase in this quarter vis-a-vis the same quarter of 2014, especially due to opportunities in the international market coupled with a favorable exchange rate. Looking at the EBITDA for this third quarter, the absolute value was down by 21% vis-a-vis the third quarter of 2014 due to mix in the market and a lower net sales per tonne. These effects also affected our EBITDA margin, which went from 16.3% in the third quarter to 12.6% in the third quarter of 2015.

In North America, the economic environment continues to be positive. Therefore, however, the growing pressure from imported products resulted in reductions in shipments of 3.5% when compared to the third quarter of 2014. EBITDA in the third quarter of 2015 was the highest ever since 2008 and it was 519 million when compared to 355 million in the third quarter of 2014 which is an increase of 46%. This improvement is mainly due to the effects of the exchange rate variation in the period coupled with better EBITDA margin, which went from 9.3% in the third quarter of 2014 to 10.7% in the third quarter of 2015, due to a lower costs [ph] per tonne.

So in dollar terms, and lower operating expenses.

Speaking about South America; the South America BO, you know shipments in the third quarter represented an increase vis-a-vis the third quarter of 2014 with different behaviors in the countries where Gerdau operates. The high levels of imports in the region starts to be dealt with measures of anti-dumping such as what have been done in Colombia and in Chile. The increase in shipments and the reduction of operating expenses brought about an increase in EBITDA margin which went from 8.1% in the third quarter of 2014 to 9.1% in the third quarter of 2015. So, there was an increase in the EBITDA margin going from, as I said, 8.1% in the third quarter of 2014 to 9.1 in this quarter of 2015.

Specialty steel; specialty steel shipments in the quarter posted a reduction of 13% vis-a-vis the third quarter of 2014 due to a strong flop in demand in the automotive industry in Brazil and at a lower degree changes in the Oil & Gas performance of the market in the US. The reduction in EBITDA for specialty steels in the third quarter of 2015, vis-a-vis the same period of '14 occurred due to a lower dilution of fixed cost and a worse geographic mix. With that the EBITDA margins went from 11% on Q3 '14 to 10.2% in Q3 2015.

Now, I'll talk about the consolidated numbers on the next slide. In consolidated terms, the adjusted EBITDA was R$1.3 billion in Q3 of 2015, an increase of 4% vis-a-vis Q3 of 2014. If you look at the bridge chart, on the upper part of the slide, we can see that this EBITDA, this adjusted EBITDA increase occur due to increases in the volume served, and higher net sales per ton which offset at a higher cost of sales in addition to lower expenses with SG&A.

And the bridge chart in the lower part of the slide, we can see that the consolidated net income in the Q3 of 2015 was down in relation to Q2 [ph] of 2014 basically due to lower depreciation and higher financial expenses impacted by the exchange rate effect. In terms of dividends, based on the adjusted net income from Q3 of 2015, we will pay out dividends of R$67.5 million to Gerdau SA shareholders equivalent to $0.04 per share.

Despite all of the extraordinary events that impacted our results, this dividend will be paid out due to pre-existing income reserves and based on our liquidity position that contemplates the generation of a positive cash in the quarter. These proceeds will be paid on November 19 based on the position of that date.

Now on page nine, we look at the indebtedness of the company, which is under control, even despite the impact of the exchange rate variation. The gross debt on September 30 of 2015, was R$27.6 billion higher when compared to June of 2015 due to the effect of the exchange variation. The weighted average cost of the debt was 6.8% a year with our average amortization tenure of 6.6 years.

The net EBITDA -- the net debt over EBITDA ratio was 3.8 times in September 2015 due to exchange rate variation. In September 2015, the company concluded the process of eliminating the financial covenants, maintaining the net debt over EBITDA in all contracts with commercial banks. With that the company can maintain the focus towards reducing its leverage without running the risk of breaching these covenants in moments of volatility and cyclicality that are inherit to the business.

Another important item that must be mentioned, and the company has already signed a new line for $1 billion higher than the amount we had before to ensure working capital has access to liquidity and so on with operations. We would also like to highlight that the company still maintains its investment grade with the three major rating agencies, even with the lowering of Brazil's investment grade. We are still maintaining our investment grade, allowing the company to access capital markets with a more competitive cost.

Now going to the slide 10, I would like to refer to working capital. In September 2015, the cash conversion cycle of the company was down by 6 days, had a reduction of 6 days when compared to June, 6 days in one quarter. That was due to the fact that nominal increase of 3.9% of our working capital accounts was offset by an increase of 10.8% in our net sales. I would like also to highlight that this increase in working capital of 426 million from June to September also contemplate an exchange variation in the companies abroad. Excluding this variation, there was a reduction of R$1.3 billion from June to September, which clearly demonstrates all other companies' efforts to optimize its working capital and as a consequence to generate cash.

Now, moving on to slide 11. This slide shows something very important that speaks about Gerdau's operating performance this year and more particularly in this quarter. The first nine months of 2015, the company generated 1.8 billion of free cash flow. And this is due to an EBITDA of 3.6 billion, which was up by R$595 million vis-a-vis in relation to all of the commitments of the company in terms of CapEx, income tax and interest. And in addition to the release of R$1.2 billion of working capital, this free cash flow, this positive free cash flow is in keeping with the company's strategy to pursue a capital discipline as it has been the case in 2013 and 2014, despite a very challenging environment faced by to steel industry.

Now concluding my part of the presentation, we go on to slide 12, where we refer to extraordinary events during the period. Gerdau presents its financial statements in compliance with the international standard of IFRS. And the standard determines that we were on -- on an annual basis, tests for goodwill, recoverability and other long-term assets of the company.

These calculations for the recoverable amount involve calculations for [ph] business segment based on the methodology of discounted cash flow. Due to the changes in the business, segments of the company and also the deterioration of some markets where the company operates, the company decided to anticipate as a goodwill recoverability test for this third quarter of 2015. In these tests, we recover impairments of R$1.9 billion.

In addition, the results of the write-off of some tax credit from differed income tax that presented no hope of ever being utilized amounting to R$1.9 billion as you can see on the chart in the slide. I would like also to highlight that these extraordinary events affected the results of Gerdau. However, they did not produce any cash effect.

And now, I'll give the floor back to Andre for his final comments.

Andre B. Gerdau Johannpeter

Thank you Scardoelli for your presentation. But once again, I would like to emphasize the Gerdau's results in this quarter with strongly influenced by non-recurring items with no cash impact. Once we exclude these items, the net income and the growth of EBITDA already reflects all of the work that our teams have been doing to increase competitiveness and efficiency and other operations. And all that is part of our initiatives of Gerdau Project 2022. The project also involves the simplification of operations and internal structures, the modernization of the business culture and the reassessment of the profitability potential of our assets following a long-term strategy view. Our managerial efforts are also reflecting, for example in the reduction as SG&A, the optimization of working capital, and also a significant free cash generation amounting to R$1.6 billion in the third quarter of 2015. We were also able to maintain our investment grade in the main rating agencies and also we were able to negotiate the removal of some covenants which allows us to have a better management of the debt, focusing on long-term.

I would also in addition like to reinstate, our offerings of shares which is an important initiative to amortize the debt level of the company and in turn to improve our liquidity position. This is a very challenging moment for the steel industry in the world and also in Brazil due to the economic slowdown. Our teams are working very diligently to operate in different fronts to make the company even more profitable and more competitive.

And with that, I conclude our presentation. And Harley and I are now available to take your questions. Thank you very much.

Questions And Answers

Operator

Ladies and gentlemen, now we would like to initiate our Q&A session. (Operator Instructions) Our first question comes from Ivano Westin from Credit Suisse.

Q - Ivano Westin {BIO 17552393 <GO>}

Good afternoon, everyone and thank you for the presentation. I would like you to elaborate a bit on the Brazil deal and what can be expected in terms of pricing for the end of the year and early next year. How do you see prices going through and what would be the shipment expectation for next year, and what would be the quality of that exported products?

And the second point is, whether you could comment on North America. The operating result was quite robust. Do you believe that the margin reported can be sustainable or whether you think that with the evolution of the metal spread, what could be expected for 2013 -- 2016, pardon me?

A - Andre B. Gerdau Johannpeter

Hello, this is Andre. I will answer the first part of your question about Brazil. Your question was about market volume mix, et cetera. It is very difficult to anticipate anything about Brazil, of course, given the current environment and what we see, I mean, the first quarter was better in comparison, and in the second quarter there was about an 18% reduction in the domestic market. And part of that volume was offset with exports. This is a landscape that will probably be maintained from now on. The export level in the third quarter was a bit higher, maybe it will not be as high in the fourth quarter, but we will continue to maintain a robust export policy given the slowdown in the domestic market.

The margins of export despite the fact that there was -- depreciation of the real, there is still low margins, but the margins are low because since the depreciation of the real, there is also, in addition to the depreciation of the real, we also experience a lower, -- we experience lower prices in the international markets.

About prices in Brazil, I have no comments because we do not make any comments about that. And once again, apparently I think that the market will continue to perform at the same levels of the third quarter. This is my view.

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

Good afternoon. Ivano, this is Harley. Now speaking about North America, which is the second part of your question. In North America, we've seen at lease well in the market. In general, we see a recovery in consumption levels. This is something very clear. This recovery has been very apparent in various segments.

But, one thing that has happened and we see a clear trend at stores imports. The levels went back to pre-crisis level, so there has been an increase of imports and this is a trend that we may anticipate for a short term. Even yesterday, we heard that possibly interest rates in South America may go up even before what the market expected. So, I don't think that we will see a major change when it comes to imports.

But now speaking about exports, the metal spread has been stable, have been at very good level, I would say. And at the same time, maybe one positive aspect for the future having a mid and long-term view is that we may be able to see some recovery in the infrastructure areas. The infrastructure industry is very important to us, and once the situation become stronger, a great part of this consumption will then go back to local producers, because infrastructure products backed up by the government. I mean of course the steel consumption will be reduced. This is an important aspect and something to be mentioned about North America. There is also a traditional seasonality factor, traditionally the market face the seasonality in terms of volume because we are approaching winter in North America.

Q - Ivano Westin {BIO 17552393 <GO>}

Thank you, Harley and Andre. I would just like to link the outlook of Brazil and North America, your two main businesses. Harley, could you say something about your indebtedness level, your net debt over EBITDA ratio was 3.8 times and you negotiated the covenants. So, what is your confident level concerning this debt level and how far you want to go?

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

In terms of our indebtedness, one important thing about the negotiation of the covenants is that, we wanted to eliminate any short-term pressure regarding the net debt over EBITDA ratio. But the trend is that this leverage goes up once the real depreciated. But, with time the trend is reduced [ph] to go down, because we see negotiations denominated in dollars. So, we see pressures coming from the US and that part of the specialty steel is that it is also in the North America, and some economies that have prices linked to the dollar will lead us to a decrease in that trend.

So, in medium to long-term, those leverage will be resumed. This short-term trend we saw -- a higher net debt over EBITDA ratio may be seen in the near future. But we know for sure that, we will not have any problems with our debt.

Operator

Thank you very much. Next question in English is from Carlos de Alba from Morgan Stanley.

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

Thank you very much. I would like to talk very quickly about the view for cash flow generation in the fourth quarter and next year. Clearly, third quarter had a very positive performance. So if you can comment as to what the CapEx level that you expect for the remaining of this year and next year as well as working capital efforts (inaudible) finally switching in the year?

And then, there were some comments about potential flood in the European assets in specialty steel division. So, if you could elaborate on that? And finally, situation doesn't remains clearly quite difficult. But, could you comment as to have you seen any stabilization at all in your order book and what are the expectations for the next year. Thank you.

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

Okay. Summarizing Carlos de Alba's question. The first point refer to CapEx and working capital trends. And the second question was about our specialty steel operations in Spain and what will be the general outlook for the Brazil operation.

Now concerning CapEx and working capital, one important point to highlight is that the company is focusing heavily on the optimization of our working capital and the efforts will materialize in this quarter, in particularly. So, now we have adequate working capital, adequate to our operations level, and this is lower this year. So the trend is that, we will have a consistent working capital in consistent with the level of operations. So in moments where the market is down, we were able to optimize our working capital. So, there was a significant reduction and we want to continue with that trend.

Likewise with CapEx was then very disciplined in terms of our CapEx expenditures. This R$1.8 billion which is year-to-date amount also reflects an exchange aspect that occurred throughout the year, which leads to that amount. At the same time, it is important to highlight that our CapEx trend, I mean, in this quarter and the quarter before had a drop of 21%, administered R$448 million in the second quarter and we've spent a bit over R$500 billion, R$509 billion and normalized [ph] in this quarter which stems from the consistent effort by the company to pursue a very strong discipline in terms of CapEx.

A - Andre B. Gerdau Johannpeter

Mr. de Alba, this is Andre. And I'll talk about the other part of your question about -- about specialty steels and the order book. So speaking about the specialty steels, we do not have any previous sales decision, I mean any decision to sell assets. But what we have reported is that, for all of our operations around the world, we are constantly evaluating opportunities to generate book value in our portfolio and this is part of our long term strategy. And this is part of our event of the new operation.

Now concerning the order book, and I think that you were referring to the order book. Right. So, I will go back to what I said before. In the first quarter, we had a drop of 7% to 8%, and then in the second and third quarters in Brazil, we experienced an average of 18% decline vis-a-vis the previous year. So we see a certain stability at this low level. The fourth quarter usually comes with more seasonality in Brazil.

So, it is difficult to make a comparison, but for next year, it's very difficult to anticipate what will happen due to the overall economic environment in Brazil. So, it is very difficult to give any guidance, but what we've seen is a certain stability, stability at a much lower level when compared to previous quarters.

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

Thank you very much, Harley and Andre.

Operator

Next question is from Thiago Lofiego from Merrill Lynch.

Q - Karel Luketic {BIO 16467278 <GO>}

Good afternoon. This is Karel. My first question is about demand in Brazil. Today, we saw (inaudible) announcing the readjustment in their output. But after you announced the closing in sort of (inaudible) demand continues with the zero rate. Do you have any initiative or any plan towards adjusting your production again, considering the current demand levels? This is my first question.

My second question is whether you can give me the -- what is the current level of the metal spreads today and about SG&A? We saw a very good performance of SG&A, which was very stable in the quarter, and with a drop of 5% year-on-year. My question is whether you still some room to make improvements along this line or whether great part of the benefit have been already contemplated?

A - Andre B. Gerdau Johannpeter

Good afternoon. This is Andre. We've been making adjustments to our assets as of November of -- December of last year, when we revisited some operations, we took operations to the mining route, focusing on a more integrated work and giving more flexibility to our scrap operation. And throughout the year we also made other necessary adjustments to cope with the current demand. But currently we do not know what the next step will be, but it'll certainly depend again on the demand because the demand -- as the demand goes down further, we will have to reassess, but we are operating at about 70%. And that we are also ready to reassess anytime.

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

Good afternoon, Karel. About the metal spread in North America, I cannot give you the exact figures, but it has been stable. It has been very resilient and it is currently at good levels or adequate levels to our operation. In terms of our SG&A effort, I must say that this is a continuous effort. We've been focusing on that in the past years and so the trend is for us to maintain however reductions that have been captured those spot.

I would like to remind you and this is something Andre already mentioned that the 6% of drop that we have here today is in real, especially in our North America operation, there is a very strong exchange rate variation. And once you exclude that exchange effect, it would be -- the number would be 17% in terms of SG&A year-on-year.

Q - Karel Luketic {BIO 16467278 <GO>}

Okay. Thank you very much.

Operator

Our next question is from (inaudible) from BTG Pactual.

Q - Unidentified Participant

Good afternoon, everyone, and thank you for this opportunity. My first question refers to the turned scrap pricing landscape in Brazil. And how do you see the price evolution in Brazil and the short-term trends considering the prices we've seen in the international scrap prices? And secondly, can you comment on the anti-dumping investigation that are being conducted in the US?

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

Good afternoon. This is Harley. To answer the first part of your question about scrap, yeah, the numbers are quite volatile in the market. But, we've been also monitoring, what has been happening to iron ore in different markets. They counterbalance each other. The consumption there is according to the price of ore, large ore producer are replacing this scrap consumption by other products based on ore, when price of iron ore is lower. We haven't seen any significant drop recently, but you have to monitor the market due to its volatility. And also look at what is happening with iron ore.

Now referring to anti-dumping, this is also another thing that is closely monitored by the company. We've seen a trend in countries like Chile and Colombia, and more recently, we didn't think that there would be any reaction. So this is something that shows that countries are more concerned with the excess capacity, and as a consequence, a higher volume of imports that are entering several countries. The United States have been closely monitored for obvious reasons, but thus far we do not know of any new things concerning cases in that country.

Q - Unidentified Participant

Thank you very much.

Operator

Next question is from Leonardo Shinohara from HSBC.

Q - Leonardo Shinohara {BIO 18788974 <GO>}

Good afternoon and thank you all very much. My question refers to projects, and also the installation of your heavy plate rolling mill. And we see some companies with some difficulties in the flat market. How do you see that as a new entrant? And in terms of the melt shop in Argentina, in your view, this will be good to supply that local market in Argentina or you have other things in mind?

A - Andre B. Gerdau Johannpeter

Hi. This is Andre. About the heavy plate project in Ouro Branco in Minas Gerais, it's still according to plan. It should start up in the second half of 2016. And our expectation is that, as it will start up in the second half of the year, in the first year, it's still in the initial phase of the learning curve. We will then be better prepared to supply the market after maybe 2018. And then we will probably see some rebound of the market in Brazil by then.

This is a very differentiated project because we will introduce a very modern state-of-the-art of rolling mill that will cater to all different demand segments in Brazil. And so we know for sure that even though, this is a very difficult economic environment, we will be able to provide rolling products of high quality. Now about the melt shop in Argentina which should start up in the second half of 2016 and the focus is to supply the local market with good levels. You know that we will be able to access without the dollars set we sent to Argentina, so the focus is very domestic.

Q - Leonardo Shinohara {BIO 18788974 <GO>}

Thank you very much.

Operator

Next question is in English from (inaudible) from Merrill Lynch.

Q - Unidentified Participant

Hi. Could you give a more detail about the covenants, I guess -- just remind me, I think what the covenant was and they get temporarily raised or what exactly are the circumstances? Thank you.

A - Andre B. Gerdau Johannpeter

The question is about the covenants and whether the wave was only temporary. The covenants we had was four times net debt over EBITDA, but the removal of the covenants is our permanent nature. From now on all of our contracts with commercial banks related to the debt, will no longer contemplate any leverage covenants as we had in the past.

Q - Unidentified Participant

Can I ask a follow-up, if -- and I don't think, it's likely are going to happen. If the dollars to lose investment grade then the covenants will not (Technical Difficulty) --

Operator

Christina, your line is now open.

Q - Unidentified Participant

Thank you. It went quite for a while there. I just want to ask some questions, if you don't mind on the working capital cash benefit that you realized in the third quarter. I know it is for the third quarter, you had a inventory working capital benefit and cash flow of R$1 billion. And to add to that, the net of purchasing and profit of trading securities was a working capital benefit of R$583 in the quarter. (inaudible) understand that and if you go back to the inventory question, I mean that you had a R$1 billion directly in working capital inflow. Actual inventory balance sheet increase, I wasn't sure, how you can increase inventory in the balance sheet. You have a cash inflow that is our working capital. Just help me understand that better as well as the (inaudible) purchase and profit trading securities? Thank you. And we may have a bad connection.

A - Andre B. Gerdau Johannpeter

I would like to ask you, please you repeat the first part of your question. Our line is a bit noisy and I couldn't really understand. Can you please repeat the first part of your question slower, please.

Q - Unidentified Participant

Sure. The third quarter saw a cash benefit from inventory of R$1 billion, but the balance sheet of inventory increased in the third quarter compared to the second quarter. I wanted to better understand how can inventory increase, if you have a cash flow benefit of R$1 billion? Thank you.

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

Your question was about working capital. We have a cash generation through working capital issued in reals. It seems like there was an increase in working capital. But, to answer your (inaudible) question indeed. In fact, the cash effect occurs when we look at our working capital, current operation and according to the currency of this denomination.

Looking in North America and it was denominated in dollar terms. So, there was a reduction in inventory than a reduction in working capital. And this was reverted into a generation of cash which entered our banking accounts in North America. But now, when we look at the balance sheet, it's translated into reals and considering the depreciation of the currency shows a nominal growth. But once we eliminate it, we eliminate the exchange factor. We see a reduction in working capital in a positive entry in our cash flow. So there was -- in reals, a reduction in our working capital.

Q - Unidentified Participant

Thank you. Can you discuss about the trading securities benefit? What -- is that consistent?

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

I think, the question relates to accounts receivable in our working capital. These numbers also reflects a major effort on the part of the company to maximize, and in this particular case to shorten the receivable term from our clients. This has a very strong impact on the working capital of the quarter.

Operator

Our next question is from Marcos Assumpcao from Itau BBA.

Q - Marcos Assumpcao {BIO 7474402 <GO>}

Good afternoon, everyone. My first question refers to the Latin America operation. Despite the drop international prices and an increase in imports, the EBITDA margin is at a very reasonable level in the quarter. Do you believe that these levels could represent a new level for the operation. We see that the margins in South America, around 89% has been more consistent in the last quarters. Can we consider this new level as a new normalized level for the business?

The second question is on specialty steel. I saw with a big surprise, the fact that the margin was up in the quarter even though this was a lower quarter, particularly in Europe. So once again, is that possible to maintain the margins for specialty steels or you think that the margins will go up in view of the newer volumes or the recovery of volumes in Europe in particular?

Operator

Ladies and gentlemen, please wait. We will resume this conference call in a few moments. Thank you. Please hold, ladies and gentlemen. Please hold for a few more seconds. Ladies and gentlemen, please bear with us for a few more moment -- for a few more seconds. Please hold, this conference call will be resumed momentarily. You may proceed.

A - Andre B. Gerdau Johannpeter

Marcos, we would like to apologize. There was a technical problem here in our office. But we heard you very well, and your question was about the margins for the specialty steel operations and also Latin America. So starting with Latin America, the margin levels were different, especially if you compare to the margins we posted about a year ago, because now they are almost half of what they were before. And I think that the level -- the currents levels of 8 and/or 9, they are still sustainable -- they are sustainable levels. This is the way we see the operation today.

But we must also look at the countries where we operate in Latin America, because they were also benefited from the exchange rate. Some countries have prices more factor the dollar. And so of course, the imports also impacted volumes, but I believe that we can say that there is a certain stability in Latin America. Now referring to specialty steels, a positive aspect when you look forward to the margins. This has certainly something to do with diversification. We mentioned before that India went from a cash generation that was negative to a more stable cash generation close to breakeven. And this is very good. When we saw a slowdown in the automotive industry in Brazil, and in North America this industry is performing well. But the oil and gas industry is still struggling. Therefore, it's difficult for us now to have a good visibility. But these are markets that are still struggling with seasonality in the last quarter, especially when it comes to reinstating their inventories in the network. So we may see some readjustment by the end of the year due to seasonality.

Q - Marcos Assumpcao {BIO 7474402 <GO>}

Now I have a follow-up if possible referring to working capital. Working capital improved in the quarter. Do you have a target? That was posted at the end of last year. And you said that you wanted to get closer to 75 days of cash conversion cycle. Do you think that this target is too feasible?

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

Marcos, thank you for your question. In fact, we are pursuing more optimized working capital levels, due to the current environment and also in an attempt to preserve liquidity. So therefore, we will continue to pursue lower cash conversion cycles. It is difficult to say when we will reach these levels, but this is a continuous effort on our part. But, it will depend on the predictability of delivery.

Most part of our working capital is inventory and the optimization of inventory depends on the accuracy of our sales production [ph]. If the production is good, we can reduce it. So as to adjust the inventory levels to a more adequate levels. So this involves a continuous work and our focus has been very strong in that area. We will strictly pursue lower cash conversion target. I cannot just tell you now when this will happen.

Q - Marcos Assumpcao {BIO 7474402 <GO>}

Thank you very much.

Operator

Next question comes from Leonardo Correa from BTG.

Q - Leonardo Correa {BIO 16441222 <GO>}

Good afternoon, everyone and thank you. I know that, we are approaching the end of this call. So, if it is necessary, you can shorten your answer. But my question is addressed to Andre first of all, because I want to know about your demand chain, we've seen and we've been looking at the numbers and think some resilience in the market (inaudible) was facing a different environment. But I'm referring to that small spread around market. How are you seeing the post offers new market. Are you already seeing a worsening of that demand worse than -- when compared to other industries or you already see a differentiation in the demand? This is my first question.

And I have two other questions to Harley. Could you please briefly talk about CapEx? Some competitors are already talking about a different CapEx level, assuming a more complicated landscape in the near future. They are even referring to a lower CapEx, lower than -- when compared to a sustainable level. Do you think that, even if we have recession next year, you will have higher CapEx in considering all of the assets and the competitiveness having a dollar denominated CapEx including the inflation, everything.

What would be your opinion about a good CapEx level that is workable, despite the difficulty we find in the economy. About leverage, maybe -- net debt to EBITDA is 3.8. I know that you negotiated all the covenant. But Harley, we also know that historically all have been very conservative in terms of the net debt over EBITDA ratio. What ratio would be ideal at this moment of the cycle? Before you start thinking about paying out dividends in a more aggressively way, to what level that leverage should fall to allow you to pay more dividends to your shareholders?

A - Andre B. Gerdau Johannpeter

Leonardo, this is Andre. I will answer your first question about the business segments, and to the decrease, and you also talked about very pulverized market that -- market the pulverized market did not experience such a significant drop or decrease as it was experienced by the construction industry. I mean, it wasn't even close to that 18% experienced by the larger segments in this -- only one digit. And now it's difficult to say whether things will remain the same next year because you have to look at the level of employment. But this is a good market and we've been monitoring that market closely. If you look at construction materials, finishing markets, these areas have experienced, some slowdown, but not as significant and this is also an important market to our industry.

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

This is Harley, Leonardo. Now to answer your question about CapEx. Today, we have a very strong discipline concerning CapEx. We are only focusing on the investment in our Detroit [ph] maintenance. We only have two large project that is still underway as Andre mentioned before. One is our heavy plate project in Ouro Branco and also the new melt shop in Argentina. So, we saw a downwards trend in our CapEx slightly. And we used to make a more encompassing review of our CapEx close to the end of the year and in a year like this. Maybe, we will wait until the year-end approaches to give you a better guidance. There are only two projects now as part of our CapEx. And all of the remaining expenditure approved is for maintenance.

Now, in regards to the net debt over EBITDA ratio, we will continue to work towards reducing that leverage. As we saw with the covenants, we have to leverage more consistent with our conservative profile. And so, once you keep our investment grade and have a lower net debt over EBITDA ratio.

With the current results and naturally with the passing of time that net debt over EBITDA ratio tends to go down, because we have cash generation coming from our business that are denominated in dollar. So, this leverage is improving. I don't want to give you any guidance. We have to look at our local levels that our in keeping with our investment grade. And if we lower this leverage and maintain the company as we generated a positive cash flow. This is what we want and this is important for a company such as ours.

Q - Leonardo Correa {BIO 16441222 <GO>}

Thank you very much. I just have one thing to add about our dividend policy. Our dividend policy is proportional to our results. Therefore, we want to keep our dividend policy of 38%. The dividends will readjusted to the profitable -- levels of the company.

Operator

Next question comes from Alan Glezer from Bradesco BBI.

Q - Alan Glezer {BIO 17508681 <GO>}

Good afternoon and thank you very much for this opportunity. I have two questions. The first is about the Brazil BO. We saw a significant increase of exports in the first quarter, 60% quarter-on-quarter. Where are the main destinations of your exports and whether you can say something about products that were exported this quarter, the net sale -- net sales per ton was about flat quarter-on-quarter? This is my first question.

My second question is about the North America BO. Do you have any information about scrap? We have seen a drop in scrap exports in the US. So, have you seen an increase in the scrap availability and whether the pressure on prices have increased because of the availability of scrap in the North America? Thank you.

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

Hello, this is Harley. In terms of the destination of our exports, we always look at the opportunities. So when prices are convenient, we look at the convenience of prices and we also look at the aspect related to the depreciation of the Brazilian currency. The export shipments have been directed to Latin America, Asia, Europe and something also to North America. And in terms of the mix, the bulk of the exports are semi-finished goods. Our Mill of Ouro Branco is very competitive in terms of cost. We have on own iron supply and the cost is very competitive. Therefore, we can make a very good use with the opportunity.

Now referring to scrap in North America, the trend is of a recent drop in prices. But, first what is important is the monitoring of the metal spread. Metal spread has been flat or stable in the last quarters.

Q - Alan Glezer {BIO 17508681 <GO>}

Okay. Thank you very much for your answers.

Operator

Now we conclude the Q&A session. I would like to give the floor to Mr. Andre Gerdau Johannpeter for his final remarks.

A - Andre B. Gerdau Johannpeter

Thank you very much, on my behalf and on behalf of Harley for your questions and your interest. If you still have any further questions, our people are available to assist you there. I would like to invite you to join us again on March 1st of 2016 for the results of the fourth quarter. Thank you very much.

Operator

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