Y 2018 Earnings Call

Company Participants

- Gustavo Werneck Da Cunha, Chief Executive Officer
- Harley Lorentz Scardoelli, Executive Vice President, Chief Financial Officer & Investor Relations

Other Participants

- Carlos De Alba, Analyst
- Gustavo Allevato, Analyst
- Jonathan L. Brandt, Analyst
- Leonardo Correa, Analyst
- Marcos Assumpcao, Analyst
- Milton Sullyvan, Analyst
- Petr Grishchenk, Analyst
- Rafael Cunha, Analyst
- Thiago Augusto Ojea, Analyst
- Thiago Lofiego, Analyst
- Timna Beth Tanners, Analyst

Presentation

Operator

Good afternoon, and welcome to Gerdau's conference call to discuss the results for the fourth quarter of 2018. At this time all participants will be in listen only mode. And later on we'll initiate the Q&A session. (Operator Instructions)

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

With no further ado, I'd like to give the floor to Mr. Gustavo Werneck. You may proceed, sir.

Gustavo Werneck Da Cunha {BIO 20318216 <GO>}

Good afternoon, everyone. I would like to begin by saying that it's a pleasure to be here with you once again. And again, I would like to welcome you to Gerdau's conference call on the results of the last 12 months of 2018. I will talk about our results for the year, and then Scardoelli will elaborate more on the performance of our operations and he will also talk about our debt position. After that, I will talk about the outlook for the markets where we operate and investments looking forward. At the end, we will be available to answer your questions.

So let's move to Slide 2 to talk about the main highlights of the year. 2018 ended with important achievements in the goals and priorities that the company set forth for the year. We posted the best annual EBITDA and net income since 2008. And we also had improvements in the profitability of almost all of our operations.

Our main consolidated figures were positively impacted by three factors; higher shipments in the Brazilian domestic market, more profitable exports, and lastly, the positive effect of the exchange rate when converting sales generated abroad into BRL.

Also, Gerdau's divestment plan was concluded successfully, reaching more than BRL7 billion in the last four years. And we significantly reduced our net debt to 1.7 times EBITDA. Moreover, we generated the highest volume of free cash flow of the last few years of BRL2.600 billion. We also managed to achieve the lowest historical level of SG&A equivalent to 3.6% of net sales.

Well, I would also like to stress that there was significant progress in the EBITDA margin of the North America operation, a market that remains extremely relevant to us.

As a result of our team's dedication and the evolution of the markets in 2018, we are paying out higher dividends to our shareholders, much higher levels when compared to previous years. I also want to emphasize that these achievements demonstrate that the efforts from our teams to transform Gerdau into a more innovative and open organization is beginning to bear fruits.

Throughout 2018, we worked on something very important to our future, and that was the definition and the global launching of Gerdau's purpose. In other words, we reached for the true reason of being of our company, building up our purpose, which is to empower people who build the future is one more step towards the cultural transformation, we've been going through in the last few years. In practice, this transformation is translated into more independence and openness for people, less hierarchy, more flexibility and an agility to help us adapt to a fast-changing world in an increasingly competitive global steel market. Therefore, our purpose will not only guide us in our day-to-day operation, but will also guide our decisions and business strategies in the years to come.

Now I'll give the floor to Scardoelli, right next to me, and then I will get back to you soon.

Harley Lorentz Scardoelli {BIO 7283603 <GO>}

Thank you very much, Gustavo, and good afternoon to you all. For those of you following us over the web, I will start with Slide number 4, and I'll talk about the results and performance in the fourth quarter of 2018.

In consolidated terms, adjusted EBITDA was BRL1.4 billion in the fourth quarter of 2018, being the best result for this quarter in 10 years. Looking at the chart on the upper part of the slide, if we compare to the fourth quarter 2017, we see the evolution of adjusted EBITDA and the margin that went from 12% to 12.9%, and from BRL1.18 billion to BRL1.4 billion in absolute value. This increase was mainly due to the improved performance of the North America BO caused by improvements in metallic spread and supported by the economic growth that favored the construction and industrial sectors.

In relation to the Special Steel's BO, it is important to mention the adverse effects in the second half of 2018 caused by a slowdown in the economic activity of Argentina, an important customer of our Special Steel's operation in Brazil with implications to the Brazilian automotive industry. And with regards to cost pressure, cyclical price increases for superior scrap, electrodes and metallic alloys, all important cost components of this operation and all of these factors affected the margins of the operation. With the results of this last quarter at the end of 2018, as mentioned by Gustavo, we posted the best EBITDA and net income of the last 10 years. There was a significant reduction of our debt and we paid out much higher dividends, we reduced the profile of our debt and the payout of much higher dividends was also in keeping with the betterment of our results. And we will talk about these topics in the next slides.

Now moving to the Slide number 4. We will talk about the pro forma and the divestments that took place throughout 2018. With the conclusion of the divestment of assets in India and the rebar assets in the US, Gerdau concluded its divestment program and is now focusing on the more profitable operations in the Americas. The economic value of all divestments carried out by the company since 2014 was over BRL7 billion, thus, to demonstrate the results of the business operations, net of the effects of the divestment program, this slide shows the pro forma results for 2018. We see that the consolidated EBITDA margin of Gerdau goes from 14.4% to 16% in 2018, once we disregard the results of the companies and assets that were sold throughout the year. To clarify, in North America, the wire rod assets of [ph]Vermont until March and the rebar assets until October. In South America, the Chile assets are included in the results until June. And the Special Steel operation assets, the assets in India include the results that were posted until September 2018.

Now moving to Slide 6 and adding to the previous slides. The bridge chart shows EBITDA evolution from Q4 '17 to Q4 '18. And the growth in net sales per tonne sold that more than compensated for the increase in cost per tonne sold and lower shipments in the period stemming from the deconsolidation of the assets divested during 2018. This is due to improvements in the worldsteel environment throughout the year and also better average international prices throughout the year, all combined with cost management efforts, commercial policy, and the simplification of the company's organizational structure in line with the new governance introduced in the company in 2018.

The charts on the lower part of the slide show the evolution in dividend payout throughout 2018 compared to the previous year, both for Gerdau S.A. and the holding Metalurgica Gerdau S.A., reflecting the growth of net income in both companies as a result of EBITDA improvement and lower financial expenses. These results allow the company's maintaining the minimum payout of today's 30% of the adjusted net income, allowed us to post a much higher flow of dividends when compared to 2017. The fourth quarter 2018, in the fourth quarter, the company allocated BRL170 million in dividend payout for the shareholders of Gerdau S.A. BRL0.10 per share and BRL49 million to the shareholders of Metalurgica Gerdau S.A. BRL0.5 per share. And the payment for both companies will be on March 18.

In 2018, Gerdau S.A. allocated BRL765 million, BRL0.45 per share for the payment of dividends, the equivalent of more than five times the amount paid out during the entire year of 2017. In the same period, Metalurgica Gerdau S.A. allocated BRL244 million per share, BRL0.25 per share for dividend payout, equivalent to 12 times the amount paid throughout 2017.

Now we move to Slide 7, when we'll talk about the company's debt position and liquidity. Gross debt on December 31, 2018, was BRL14.9 billion. The reduction of BRL1.6 billion, vis-a-vis December 2017, was mainly due to debt amortization in the period, even considering the negative impact from BRL depreciation of 17% during the period. When compared to September 30, 2018, the reduction was BRL3 billion. The strong reduction in the net debt over EBITDA ratio of three times in December 2017 to 1.7 times in December 2018 was a consequence of continuous EBITDA improvement and the proceeds from the divestment program, focusing on financial deleveraging and optimization of the company's asset portfolio. It is also worth mentioning that in the fourth quarter '18, there was the issuance of the 15th debenture -- issuance of the 15th debenture of Gerdau S.A. in the amount of BRL1.5 billion and the buyback of USD1 billion in bonus distributed between bonds with maturities in 2020, 2021, '23 and '24, with the purpose of reducing the gross debt restructuring and balancing the debt maturity schedule in addition to reducing its exposure to US dollars. Another very important point is the fact is that the Board of the company, the Board of Gerdau S.A., defined as the financial policy of the company the achievement in maintenance of the following parameters in the mid and long range. Maximum net financial debt over EBITDA or leverage maximum should be between 1 to 1.5 times, the average term of the debt above six years, maximum gross financial debt of BRL12 billion.

These guidelines allow the company to work towards an adequate balance situation while at the same time, it will be able to execute its investment plan in order to fulfill the demands of the market and cope with the challenges of the business.

Now moving to Slide 8, which is the last one in my presentation, where we'll talk about the company's free cash flow in this quarter, which amounted to BRL2 billion. This amount comes from adjusted EBITDA that was more than enough to honor our CapEx commitments, income tax interest in addition to a strong

release of working capital. 2018 as a whole, the -- in 2018, the equivalent amount was BRL2.6 billion, the best result in terms of free cash flow in the last three years. It's also important to mention that a well-defined and flexible investment program for the next three years that Gustavo will detail later on, combined with the leveraging parameters and a debt position defined by the board, enable the company to pursue further positive free cash flow for the next coming years, which is something extremely important to an industry of capital-intensive and significant exposure to international prices of its main products and inputs.

Before concluding my presentation, I must say that in financial terms, 2018 was a very good year. The company working all fronts, strengthening its balance structure. We were able to reduce our debt position. We improved our assets and improved our working capital position. So thank you very much. And I'll give the floor back to Gustavo.

Gustavo Werneck Da Cunha {BIO 20318216 <GO>}

Thank you, Scardoelli. Well, now, I would like you to move to Slide number 9, and we can talk about the outlook for 2019. Up to now, we are optimistic about the outlook for our main markets, Brazil and the US, which could generate consistent results in 2019. According to statistics from the World Steel Association for this year, global demand for steel should grow 1.4% over 2018, growing to 1.680 billion tonnes, boosted by the rebound in investments in developed countries and also by the improved performance in emerging economies, despite the current landscape of trade tension.

In Brazil, we believe that a positive economic cycle is about to begin, which should lead to a rebound of the domestic market. According to data from Instituto Aco Brasil, it is estimated that the apparent consumption of steel in the country should grow 6.2%, reaching 22.5 million tonnes, influenced by the continuous growth of the industry and the recovery of the civil construction sector.

Speaking about civil construction, Sinduscon, Sao Paulo estimates that the sector's GDP should grow approximately 2% if the estimated growth of 2.5% of the Brazilian economy is materialized. To this end, we are fully prepared to serve the growth in Brazilian demand. And as I told you before in previous meetings, we have plants from Cerro Chato [ph], Rio Grande do Sul. And some of them are still operating at idle capacity. However, Brazil's sustainable growth depends on the country solving its tax crisis. And it all starts with the pension reform. Gerdau and the steel industry and other economic agents in the country supports the necessary review of the pension rules. And we remain confident that the National Congress will approve the theme. Brazil urgently needs this pension reform.

In regards to our operation in North America, we believe that the economy of the United States will remain strong. And according to the IMF, GDP should grow 2.5%, whereas consumption of long steel should grow between 2% to 3% a year according to our projections.

One of the figures we watch closely in the US is the ISM Manufacturing Index that is showing a good short to mid-term tranche for the industry sector, one of the main segments that use steel from Gerdau. In January, ISM Manufacturing was above 50 points, in keeping with the levels of the last 29 months. In the construction market, an indicator called CPIP in our construction put in place nonresidential projects a 2.4% growth for 2019 and reinforces our expectation for higher demand in the construction

market. We also believe that Section 232 will remain in effect in 2019.

With this backdrop, early this year, metal spread in North America reached a record level when compared to previous years of almost $500 per short tonne, influenced by higher prices in the region and also, the high utilization of installed capacity. This good performance was also due to a strong demand from the industry and the construction sector, in addition to the significant reduction in steel imports in the United States.

Now looking at the Special Steel's operations in Brazil. We believe that the automotive industry, our main market of operation, will grow in 2019. More recently, ANFAVEA reported that vehicle production should be up by 9% this year. That is higher than in 2018, when it grew approximately 7%. In terms of the North American market, demand for Special Steel should remain high, in line with last year. Production of heavy trucks, for instance, should reach record levels and agricultural machinery and yellow line should follow suit. On the other hand, the oil and gas industry should also post some reduction, vis-a-vis the growth achieved in 2018, which will probably influence the distribution segment that is currently facing high levels of inventory.

As for the other countries in South America, we anticipate economic growth for the region, particularly for Peru and Colombia, both with estimate of GDP growth above 3% for 2019. Like in 2018, the economy of Argentina must still be looked into carefully, as their perspectives points to an economic slowdown this year, according to market figures and the IMF itself.

Well, let's move now to Slide number 10 to talk about investments. In 2018, we invested BRL1.200 billion in keeping with what we had announced earlier this year. So precisely a year ago. This amount was basically used to improve performance and maintenance of our operations. As our result of our governance process, we will detail our CapEx schedule for the next three years, meaning 2019, 2020 and '21. At the moment, we anticipate investing BRL7.1 billion until 2021. In order to facilitate the understanding about our investments, we will classify them into three categories; one, general maintenance; second, maintenance of the Ouro Branco Mill, our largest mill; and thirdly, technological expansion and updating. Investments in general maintenance, this first item, refer to recurring initiatives to improve operating excellence of our existing assets, which is basically what we've been doing in the last few years. Investments in maintenance of Ouro Branco involve a series of initiatives related to a scheduled downtime to modernize the mill to take place in 2022.

In 2019, there will be a scheduled maintenance of the Blast Furnace 1 for 60 days around June and in the following years 2020 and 2021, we will initiate a gradual remodeling of the unit to be prepared for 2022. In regards to the downtime of Blast Furnace 1 this year, we are already building up inventory to ensure regular supply to our customers. We believe that the maintenance downtime of Blast Furnace 1 is happening at the right moment, when the domestic market is in its early stages of recovery. This equipment is approximately 20 years old, with an installed capacity of 3 million tonnes a year. And when Blast Furnace 1 resumes operation after 60 days of downtime, we will gain efficiency. And by the end of 2019, our production volume should be similar to that of 2018.

Investments in expansion and technological updating, both in Brazil and abroad, involve in a ramp up, an increase in installed capacity and innovation in the lines of products or processes with higher profitability potential. These investments will be more flexible in terms of execution as they will be done as soon as the market growth expectations are materialized and there is free cash flow generation in the period, always in compliance with Gerdau's net financial -- new financial policy of maintaining a net debt over EBITDA ratio between 1 and 1.5 times.

The main investments in expansion relate to the increase of installed capacity of rolled products by 530,000 tonnes in several mills in Canada and in the United States, amounting to BRL456 million. The ramp up of the production capacity of Special Steel's in Pindamonhangaba in the state of Sao Paulo and also, in our Monroe mill in Michigan, totaling BRL798 million. And the production increase of coil hot roll strips in Ouro Branco in Minas Gerais by 230,000 tonnes of plant investment of BRL380 million.

Well, as for the mining activities, well, firstly, I would like to express our solidarity and respect to the families and friends of the victims of Brumadinho. Our companies has a strong footprint in Minas Gerais and a large portion of our employees, as you well know, work in that state, producing steel or and also by a reducer. In terms of our dams, I want to reinstate our commitment to the highest safety levels of people and the environment.

In addition, we are constantly looking around the world for state-of-the-art technologies to improve our mining practices even further. Therefore, part of the CapEx to be invested into 2021 will be spent in deploying the best technologies in the world, both in environment and the safety of people. As for our steel production activities in North America, I would like to highlight that these new investments reinforce the importance of this market to Gerdau. Moreover, we will remain leaders in the production of structural logs, commercial profiles and special steels in North America.

To conclude, and now moving to the next slide, Slide 11, I would like to stress that our top priority is always with people, particularly regarding their safety in our operations. This is a nonnegotiable value for Gerdau, and it dates back from the early days of our company.

I would also like to talk about our commitment to our thousands of customers throughout Brazil and abroad, where we'll continue to work every day to generate value to both sides, working diligently to strengthen the relationship and improve the experience of those who buy Gerdau products. This is crucial to become a leading company in profitability in the market where we operate.

At the same time, we will be even more rigorous when it comes to topics such as the company's debt position and the positive free cash flow generation. And the digital transformation process, so important to improve our competitiveness and efficiency in the last few years, will continue to move at full speed. I would also like to say that a few years ago, Gerdau celebrated its 118th anniversary, when we joyously celebrated the profound cultural and business transformation of the last few years that currently allows us to work with the energy and determination of a startup. In addition, in next month, we will celebrate 20 years since our listing in the New York exchange.

And to conclude, I want to extend a particular thank you to our employees, for their dedication, restlessness and resilience. And also, to our customers and shareholders for their confidence.

So now, with that, I finish our presentation. And now, we move to the Q&A session, when Scardoelli and myself will be pleased to answer your questions. Thank you.

Questions And Answers

Operator

Ladies and gentlemen, we will now initiate the Q&A session. (Operator Instructions) Our first question comes from Thiago Ojea from Goldman Sachs.

Q - Thiago Augusto Ojea {BIO 17363756 <GO>}

Good afternoon and thank you very much for taking my question. My first question refers to the dams. With this new E&M measure, the dams have to be decommissioned, especially the upstream mining dams. How are you dealing with that situation? And how would you transition from the iron ore production, vis-a-vis the change in the mining dam? So if you could give me some idea of timing, and what do you think in terms of the CapEx you just announced? What would be the cause of the change in relation to the dams? And the second question refers to the domestic market. Are you noticing any improvement in the domestic market? Is there any room to increase prices in the short term? Or any changes in the civil construction industry that could be more significant? Thank you.

A - Gustavo Werneck Da Cunha {BIO 20318216 <GO>}

Hi, Thiago, thank you for questions. I would start with the dams. I would like to remind you that half of Gerdau's steel production in Brazil, it's based on metallic scrap -- recycling of the metallic scrap. The other part is iron ore and the bulk of the production is then through dry processing. Only 15% of iron ore processing requires the use of dams. We have two tailings dam from -- of iron ore located in Ouro Branco in Minas Gerais. One of them is inactive, and it has been inactive since 2011. It is totally dried. And in February, we just received a report de-characterizing the dam. The second dam is currently in operation. It's monitored and audited and is considered stable. And we rigorously follow all of the federal and state legislation. We will invest approximately BRL300 million by 2021 to deactivate this dam and to deploy another solution of dry dams. We are constantly seeking for the best possible technologies around the world in order to improve our practices in all of our mining activities. Moreover, as I said before, we are committed to the highest possible safety levels, because safety, as I said before, is a nonnegotiable value to all of us at Gerdau. Now in relation to the domestic market, Thiago. As I said before, I also want to say that mid to long-term sustainable growth involves the pension reform. The society, as a whole, and the business community, they need to get together to enforce the approval or to force the approval of the pension reform. In the domestic market, the industry is resuming a recovery that was initiated last quarter. We will see a moderate growth in the construction segment in 2019, boosted by what was initiated last year and continues this year. In terms of civil construction retail, it wasn't stagnated before, and it will continue to move forward in 2019. Infrastructure investments, we don't believe that there will be major infrastructure events in 2019, but probably in 2020. So all-in-all, the growth of the domestic market, according to our estimates, is between 6% to 7%. As for prices, you know that traditionally, we do not comment on our commercial policy or price increases. But it is good to remember that this strong price increase that we notice from the beginning of the year onwards, we continue to have import premium close to zero. In some cases, even negative. So this import premium, we believe that it should evolve going back to historical levels.

Q - Thiago Augusto Ojea {BIO 17363756 <GO>}

Thank you, Werneck. I just want to get a better understanding. Out of the BRL300 million in the dams, can you probably tell me how much of that relates to the adoption of the new technology for dry piling up and the deactivation of the dam? When you talk about your investment policy, you said that even with this increase in CapEx, you are not going to change your guidance of 1 to 1.5 times net debt over EBITDA ratio, right?

A - Gustavo Werneck Da Cunha {BIO 20318216 <GO>}

We estimate that 50% of the BRL300 million, 50 -- it will be a 50-50 split. Now related to our CapEx for the next three years, we have investments in new technologies and ramp up of capacity. The investments will occur once the market proves that it will be able to improve and generate free cash flow. So most importantly is to follow our policy. Well, the investment in Ouro Branco is important because it will help us maintain all of the operations. But this bulk of the investment -- I mean, out of the BRL7 million, that amount for Ouro Branco is BRL2.4 million, but as Scardoelli can elaborate more on that.

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

Thiago, I just have something else to comment. I think, we have to look at our CapEx program with a view in the long run. If we take the last three years from 2016 to 2018, our CapEx was much lower, mainly because of all of our efforts to reduce our cash position -- I mean, towards that position. In the previous years from 2013 to 2016, the company's EBITDA was below BRL5 billion. And back then, on average, we were investing something similar to what we are expecting to invest now BRL2.3 billion to BRL2.4 billion a year. And even then, we generated positive free cash flow all these years. So our plan is to execute on our CapEx plan to reach new leverage indicators with free cash flow generation. And as Gustavo said, we are flexible to use the CapEx that will allow us to reach our goals. Another important aspect that I must mention is that in 2018, our EBITDA was much higher than in previous years. But with the improvement in the business landscape, better volumes in most part of our operations, great part of that free cash flow generation is also geared towards increasing working capital if you look forward and if market conditions remain the same. So this is only in theory. So theoretically, there will -- there should be no further consumption of working capital. In order for that to happen, things would have to be better. And that will mean also improved EBITDA. So we are prepared both to fulfill our leverage goals as well as to fulfill our CapEx program with a good degree of flexibility.

Q - Thiago Augusto Ojea {BIO 17363756 <GO>}

That's very clear. Thank you very much to both of you.

Operator

Next question is from Thiago Lofiego from Bradesco BBI.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Good afternoon. My question starts with your investment plan, particularly the ramp-up. If you could recap, please, what kind of expansion, and what is the capacity that you have in mind? And if you could repeat the numbers? And what is the expected return from the capacity increase? And again, what benefit do you expect to have with cost reductions in the maintenance of Ouro Branco? And the second question relates to the US market. How do you see the supply of longs in the US with all of these ongoing debates about tariffs and capacity reduction in that geography?

A - Gustavo Werneck Da Cunha {BIO 20318216 <GO>}

Hi Thiago, your question -- we couldn't hear your question very well. But I think your first question was about our investments to increase capacity and to do a technological update. The investments will be done on a different asset base compared to what we had before. I mean, we've made some strategic choices in the last few years. And so now, we are focusing on assets with greater profitability. And this is an important point because we will invest in the assets that, in the future will increase our profit margins when compared to investments done in the past. So when we talk about investments to increase capacity and to update technologies, we understand that there is room to improve the performance of our operations by conducting a technological update, especially in the mills that produce structural profiles. We believe that we will be able to improve performance and to grow capacity of 530,000 tonnes in the assets in North America. And there is another investment that, I think, we mentioned in previous occasions at the end of last year, which is the preparation of our Special Steel mills to cater to the automobile industry, who is going through great transformations because they are using lighter steels, cleaner steels and more resistant steels. Therefore, we are investing in the improvement of our melting shops in the two main Special Steel plants we have in the world, one in Pindamonhangaba in Sao Paulo and the other one in Monroe in the US. Investments in these two plants amount to approximately BRL800 million. And in Brazil, we see also a significant growth in terms of the expansion of our coil hot rolled strips in Ouro Branco. This investment amounts to BRL380 million, where we intend to add 230,000 tonnes in the production of coil hot rolled strips in Ouro Branco. In terms of your second question related to some possible impacts of cost reduction with that scheduled maintenance in Ouro Branco, this blast furnace has a capacity of 3 million tonnes. So it's very significant, vis-a-vis our overall production. I mean, this plant has been in operation for over 20 years. And so probably, throughout this period, many new technologies came around in the steel industry. So now after 20 years, we will invest in state-of-the-art technology in blast furnace. This will also allow us to produce at higher capacity when compared to today. And we are also focusing on reducing our fixed cost because new technologies can certainly boost the performance of the equipment for the next cycle of 20 years. In relation to the North American market, demand remains very strong. There was some seasonality at the end of last year, which is very typical of that market. And currently, we see some one-off difficulties in some of the mills located in the North of the US and in Canada because of the very severe winter weather. But demand remains strong. And it reflects in a very consistent portfolio looking forward. We do believe that in the US and in Canada, this year, the market will remain very consistent. And as Gerdau, with the assets that remain with us, the volume should be higher than those of last year.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Thank you. Thank you very much.

Operator

Next question is from Leonardo Correa from BTG Pactual.

Q - Leonardo Correa {BIO 16441222 <GO>}

Good afternoon, everyone, and thank you. My first question relates to Special Steel's BO. There may -- maybe it came as a surprise the drop in margin of almost 5 percentage points in the quarter. I would just like to hear from you what led to that? And what is the outlook looking forward for that business, which is very important to the company? We've seen some slowdown in Brazil, especially in Sao Paulo. There was recently the shutdown of a truck plant from Ford. So -- but you said that the outlook for the business seems to be good. So I'd just like to hear something about the margin evolution for that unit. And what should we expect looking forward? The second point in relation to the US. We saw the improvement in your performance. And I know that you are now reaping the benefits of some of the processes that you introduced through your business. But I just want to understand the new road map for the US. And what's still missing? What is -- what should happen? Because I know that they already made capacity adjustments, and then you divested from assets of lower margins. But what is still missing? Or what could be expected in the US? And what still remains a challenge that could lead to further improvements. And then I also have a one-off question. Because you talked about Ouro Branco and you were very clear during your presentation. But my question is with that 60-day downtime, I understand that you are building up inventory to be able to supply to your customers. But my question relates to volume and cost performance. Can you hold cost at a stable level? And what kind of profitability you expect considering the downtime of 60 days?

A - Gustavo Werneck Da Cunha {BIO 20318216 <GO>}

Thank you for your questions. Well, I will answer that in three parts. First, in relation to Special Steel's. I think, we should -- temporary, what happened in Brazil and in the US, in that regard, even though the phenomenon were similar, but there are some particularities that apply to Brazil that are different in the US. In 2018, we saw a very strong automotive market, very strong in terms of sales in the beginning of the year. But in May, in June, there were two factors that impacted our volumes. The volumes of Special Steel's in Brazil, and that was a truckers' strike in Brazil. And followed by the tax crisis in Argentina.

Argentina has a relevant stake in our volumes of Special Steel in Brazil. As a reminder, Argentina is the third-largest partner of Brazil. In 2018 alone, passenger vehicles accounted for 26% of exports from Argentina to Brazil. When we look at the numbers and compare exports between Brazil and Argentina, there was a drop of 17%. So Argentina also had lower volumes. And then you look at months of May and June, there was a drop in the volume of Special Steel's in Brazil in shipments. There was another phenomena in the US, which was the strong increase in input prices, particularly scrap, alloys and electrodes. When you look at the dynamics of these markets, and we have long-term contracts with our customers. And so the margin recomposition is not as quick as it happens with long. So throughout 2019, we hope that we can revisit the margins, not only by reviewing contracts with our customers, but also through some structural events that occur, both in Brazil and in the US, in regards to scrap prices. Now speaking about the US. After the divestment, our asset portfolio -- the current asset portfolio will bring about higher margins when compared to what we had in the past because we are investing in downstream and rebar. We see the possibility of improving the performance of our operations in the US and Canada, both in terms of investments in technology -- to update our technology. And also to improve the performance of our operations. This has been in place for some time when we restated our management. And ever since we started to reduce cost and improve performance. We have historical spreads -- metallic spreads, about $500,000 per short tonne. And also very consistent volumes. This improves our outlook for results because it's more consistent now than what we had throughout 2018. In terms of the downtime of blast furnace 1, right now, we believe that by year-end, we will reach similar volumes as the ones we had last year. Last year, we had the refurbishing of blast furnace 2. Now blast furnace 2 is much more competitive and operating much better. The downtime of blast furnace 1 will be absorbed by the best performance -- by better performance of blast furnace 2. So we are building up inventory again. So in terms of cost in 2019, we believe that the impact will be very minimum, also because we have the production of our own iron ore.

Q - Leonardo Correa {BIO 16441222 <GO>}

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

Operator

Next question is from Rafael Cunha from Credit Suisse.

Q - Rafael Cunha {BIO 20229675 <GO>}

Good afternoon, everyone, and thank you for taking my question. My question relates to the Brazil BO. What would be -- what should we expect the exports to be considering the domestic market performance? And how do you think that the sales mix will behave? And could you give me a follow-up on the premium aspect, considering a most favorable environment of domestic demand, which has been expected for quite some time. Could we see an export premium at a higher level, higher than 10% to 15%? Or you see that 10% or 15% more normalized once demand picks up more strongly? Do you see that possibility? And what would be a fair level considering a demand that supersedes expectations?

A - Gustavo Werneck Da Cunha {BIO 20318216 <GO>}

Rafael, in relation to your first question, exports in our operation in Brazil. One important aspect to bear in mind is that since the drop in the market in 2014, exports through our Brazil OPO -- Brazil BO, became irrelevant. But it's not enough to look at the situation of the domestic market. But also, we have to look at what happens in the international market. As of June 2018, we have experienced a significant drop in steel prices in the international market. Around June of last year, the billet price in the international market was about $120 per tonne. And in three months it went up to -- I mean, it was much higher and it went down to $320 per tonne. So the current export scenario, considering 30% in Brazil, has an impact in the margin. In the last few months, the billet price has experienced some recovery, from $390, it went back to $450. And 30% of the exports are through Brazil. So this would have a positive impact in the margin. That's why it's important to remember that there is a delay between the raise in prices internationally and margins of our exports. What we are doing today with the billet price in the international market, the deliveries or the shipments will occur in three months. Therefore, there is a gap between price increases internationally and new -- in the margins and the results in Brazil. Now in terms of the domestic market. With the escalation of prices in the international prices, there was a decrease in export premium. In the end of last year, it went over two digits, getting close to 15% and now it's pointing down to zero again. So traditionally, we don't work with premium export. We believe that in the next few months, there is a possibility that we will resume the old export prices of around 10% to 15%.

Q - Rafael Cunha {BIO 20229675 <GO>}

Okay, thank you.

Operator

Next question is from Marcos Assumpcao from Itau BBA.

Q - Marcos Assumpcao {BIO 7474402 <GO>}

Good afternoon, everyone. My first question relates to your mining business and whether you see some room to increase the production of iron ore to make up for the short-term price recovery, whether there is still room in your operation to do that? And now looking on the side of the risk of shutting down operations because of lack of licenses or certification, could you elaborate on the certification process of your dams? And what would be the next steps? And whether there is risk of shutting down the operation unexpectedly as it happened in some cases in Brazil? Now changing gear and talking about cost. Werneck, could you please elaborate a bit on scrap? We've heard that there was a significant drop in scrap prices earlier this year, impacted by maybe demand. So could you please confirm the information? And tell me whether -- what was the price in the market and what it is now? And finally, I know that you talked a lot about free cash flow -- hardly talked about the company's cash flow. Could you comment on the dividend payout expectation for 2019? We saw what happened in 2018. And Harley said that even if you expect a stable EBITDA, maybe this year, you won't be -- you won't use a lot of working capital. So in that case, what would be the position of dividend payout in this case?

A - Gustavo Werneck Da Cunha {BIO 20318216 <GO>}

Marcos, about mining, I would like to recall there that our -- ore production is basically for our own use. And only 15% of our ore production requires the use of dams. That's why we don't see any further room for increase in the mining production. Well, we will remain focus on our production for internal use. We have one tailings dam, which is currently in operation. This dam is constantly monitored and audited. And we strictly follow the legislation, the state and federal standards. And if at any point there is any change in the norms, and they tell -- somebody tells us that we can no longer operate with these dams, we will follow and comply with the legislation in force. In regards to scrap, the scrap price in Brazilian market has been falling. So as of December, because of seasonality, scrap prices are coming down. And even now, it's still dropping. Prices are still dropping. I will give the floor now to Scardoelli that can -- who can elaborate more and answer your third question.

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

Marcos, about your question on free cash flow and dividend payout. I think, this is quite an interesting question because considering what we said that we have a long-term CapEx schedule and more precise investment and our financial policy is still conservative, even considering all of that, our view is that we will continue to generate very interesting positive cash flow. And with that, we will reduce the debt, reduce the financial expense. And the dividend payout outlook is that we will continue to pay good dividend and consistent with the operation. Today, we maintain our policy of paying out 30% of dividends. But even with that policy, the outlook is that once we reduce leverage in interest rates, so it's a good outlook that the dividend policy will remain untouched.

Q - Marcos Assumpcao {BIO 7474402 <GO>}

Thank you, Harley.

Operator

Next question is from Gustavo Allevato from Santander.

Q - Gustavo Allevato {BIO 18933135 <GO>}

Good afternoon, everyone. I have two follow-up questions. The first has to do with the Brazil BO. I just want to understand the export mix? And whether in the first quarter, given the rebound of the economy in Brazil, whether it should be similar to the fourth quarter, or the improvement should come more in the domestic market? And I also want to understand something related to Special Steel's and whether the EBITDA margin of the fourth quarter will go through a recovery in the first quarter? Or this will come maybe in the second half of the year or next year?

A - Gustavo Werneck Da Cunha {BIO 20318216 <GO>}

Gustavo, referring to the Brazil BO. Last year, 28% of our total volume was exported. There were -- we had higher margins than the ones that we have now. We always make our business decisions. So with the current margins, we are deciding whether we should or should not export. We have to look at what will be the percentage of exports until the end of the year. But we believe that throughout the year, with the recovery of the domestic market, I mean, in 6%, 7% growth, then we will reduce exports and make shipments to the domestic market. We also believe that in terms of domestic demand, it goes through natural seasonality in the end of the year. And sometimes, in January and February, and the margins become more consistent as of March. The margins for Special Steels, to answer your second question, when you compare the margin we had in the fourth quarter of last year, follows a similar logic. Therefore, there is a rebound in the vehicle production after the year was over. And we will see a reduction in scrap prices, both in the US and Brazil because with lower scrap prices, we reduced the average cost of our inventories. And this also reflects in higher margins.

Q - Gustavo Allevato {BIO 18933135 <GO>}

That's very clear. Thank you very much.

Operator

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

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

Thank you very much. Good afternoon. Maybe the question I have is maybe at a high level, but -- so the company has gone through a lot in the last say three, four years. A tremendous improvement in the share price, driven by recovering global markets, but also by a lot of efforts in the company in divesting assets, improving the balance sheet and all the expectations on a Brazil recovery. So fast forward, Gerdau is leaner, stronger, better positioned company. What is the next phase? How would you describe the next phase for Gerdau? Do you expect this company to be a growth company, a cash flow payment company? Where would you like to -- how would you like to describe the new Gerdau or the Gerdau in the next phase? And also, are there any initiatives perhaps now that all these improvements have been made to move the company to Novo Mercado? Or to change the dividend policy and put it more related to cash flow generation than net income? And also, if you could explain what is the rationale maybe Harley, what is the rationale for the 1 to 1.5 net debt-to-EBITDA leverage, which seems if that is for across the cycle, it seems a little bit low. But not necessarily bad but just a little bit low. Thank you.

A - Gustavo Werneck Da Cunha {BIO 20318216 <GO>}

Thank you, Carlos. Your question was very broad. And your question was about we had better performance, better balance sheet, what is the focus looking forward, whether we will be a company focused on growth and cash flow, what is the outlook and whether we intend to enter into Novo Mercado and what is the rationale behind that net debt-to-EBITDA ratio 1 to 1.5 times. I would say that what we were able to accomplish in the -- more recently is that now we are a company that is much more prepared. Our industry is very cyclical and it's capital-intensive. That's why we remain with that view that our leverage should remain as the one reported, to 1 and 1.5 times net debt-to-EBITDA ratio, which is adequate, considering the cyclical nature of our industry. And this will be adequate because there were some very strong structural changes in the market. Therefore, I believe that this leverage level is adequate. And it's not inconsistent to our policy that will give us a good return on equity. Also, if we look at the return of employed capital that came down significantly after the low cycle after 2012, it goes back to its cost of capital. And this will determine the adequate profitability to all of our stakeholders, shareholders. It will allow us to pay the interest on equity, interest on our debt. And so, I think, we are getting close to these levels with the reduction of our debt position. Whether Gerdau is going to be a company focused on this or that area, we will focus on profitability. We will guide our growth. And we will focus on niche markets that we are also looking at new initiatives. But in terms of size, size is not the focus. Size is not the focus. We want to be profitable with adequate growth and a more balanced position or P&L. The last part of your question, I think, relates to our equity structure. We believe that Gerdau is very well positioned in terms of governance. And we consider our dividend policy. And also considering the fact that we're 100% tagalong, our structure is very adequate. And we are very much focused on the profitability of the company. We know that the company still has some years ahead of itself to focus on results. And Novo Mercado is not something that is in our pipeline.

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

Thank you very much Werneck.

Operator

Next question in English from Timna Tanners from Bank of America.

Q - Timna Beth Tanners {BIO 6766897 <GO>}

Hey. good afternoon, Just two quick ones for me, if you would. One was just a follow-up on the scrap question. It looks like the scrap price is starting to go up in some global markets the US is up maybe 10, 20 in early days for March, partly a function of the higher pig iron prices with iron ore also rising. So I wanted to get your thoughts on that, and how that would play out for timing of your Q1 versus Q2? Then the second question is just on the beam market in the US. And how you're seeing that and any thoughts on prospects for fabricated beam prosecution given the pending trade cases there? Thank you.

A - Gustavo Werneck Da Cunha {BIO 20318216 <GO>}

Tina, thank you for question. I would just repeat the first part of the question about the increase of scrap prices in the global market and the possible impact that this price increase will have in the next few months, vis-a-vis the results of Q1 and Q2. I would like to begin by saying that it's important that we understand that the scrap markets in the geographies we operate have some differences in Brazil, we are flexible enough to increase production in our integrated industries. We have our own ore production, we have a very distinguished and competitive scrap base. Therefore, the increase in scrap prices in the global market does not have a very direct impact when we look at our cost in the Brazil BO. Our North America BO is more closely impacted by differences in prices. There was a drop in January and February. And we are still looking at how prices will evolve in February and early March. But as our scrap inventories, both in Brazil and the US are well formed. These possible swings up and down in scrap prices may -- will be translated in production costs as our inventories are reduced. We -- there is some price reductions in November and December. And there are some price increases -- those early price increases will only have an impact in the second quarter. Tina, now when you talk about the structural prices in the US, our view -- the initial view is that this is very positive to our operation because we are highly exposed to structural profiles in the US. The part of the assets that we divested in the US -- I mean, we remain in the markets that were more attractive to us. And this will benefit local producers and we are amongst them.

Q - Timna Beth Tanners {BIO 6766897 <GO>}

Okay, thank you.

Operator

Next question in English from Petr Grishchenko from Barclays.

Q - Petr Grishchenk {BIO 19084897 <GO>}

Good afternoon and thanks for taking my questions. I wanted to follow-up on your commentary and expectations regarding the auto sector in Brazil. Just today, it seems that most domestic steel producers are fairly bullish on the auto sector. But then, I hear -- I keep hearing comments from Ford shutting production, and GM management considering shutting some facilities in Brazil. And I guess, simply the fact that the reported car production decline is roughly 10% year-over-year in January. So I guess, could you please help me reconcile the steel industry's views with those of its customers? So that's number one. And then two, can you also provide little more clarity on your net leverage target of 1 to 1.5. It wasn't clear to me if this includes any additional asset sales, or do you think you'll achieve this through just free cash flow generation over time in any time frame, it would be really helpful. Thank you.

A - Gustavo Werneck Da Cunha {BIO 20318216 <GO>}

Petr, thank you for your question. Petr's first question was about the auto market in Brazil. The production growth of vehicles in Brazil was around 7% in 2018 when we compare it to 2017. There is a natural seasonality, which is every year-end and the beginning of the year, we estimate that the auto production in Brazil should be around 10%. When we look at the growth of orders -- the portfolio of orders to be shipped as of March. This portfolio indicates to a 10% growth and this is beginning to be materialized. Therefore, we are very optimistic because we believe that this year's growth will be in keeping with our projections. We have some difficulties, as I said, in Argentina. So in relation to exporting volumes, this year, I think, our volume will be lower when compared to last year. But since June of last year, we are looking for other export alternatives into other countries, rather than Argentina, to compensate for that drop in volume to Argentina. So we believe that volumes -- we're very optimistic about shipments. And even though there was a drop in January, the projection is positive. And we see now a more consistent flow of orders starting in March. Now the second part of Petr's question refers to our leverage objective of 1% to 1.5% or times whether they are dependent on additional investments, our investments are concluded? We concluded in 2018. And this objective of 1 to 1.5 times should be reached through free cash flow generation. And as I said, we will anticipate more positive levels looking forward, also in face of the investments that we mentioned. At the end of the year, we had that level of leverage.

Operator

Next question in English from Jon Brandt from HSBC.

Q - Jonathan L. Brandt {BIO 17988091 <GO>}

Hi, good afternoon. You mentioned several times your focus on profitable growth and profitability. Could you, perhaps, just touch on what your expected returns are in some of the US and Brazilian projects that you're undertaking over the next few years? And if you're not comfortable with that, perhaps what the hurdle rate is for these projects or for any project in the US and Brazil? And secondly, we've been hearing a while back about the potential cut in import tariffs into Brazil. I'm wondering if you can comment a little bit on that? If you can give us an update. Is that something that we should be concerned about? If the 12% import tariff could be cut or eliminated? Thank you.

A - Gustavo Werneck Da Cunha {BIO 20318216 <GO>}

The first part of Jon's question relates to our profitable growth. And what is our hurdle rate in the projects, whether we anticipate and when we should anticipate some returns. The question is -- oh yes, we do. Our cost of capital -- the average cost of capital at Gerdau is around 11% to 12%. And as I said, our return on employed capital is also very close to that level. Our hurdle rate was higher than that number because we use a minimum hurdle rate of 15% for the approval of investments. And more and more, we are even more stringent when it comes to approving investments because we want to ensure that the profitability of the projects will be guaranteed. So the profitability falls into the levels that I mentioned before. Jon's second question is about import tariffs in Brazil and the possible decrease or drop of the tariffs. We are constantly in conversation with the Ministry of Economy via Instituto Aco Brasil in the second meeting that took place a few weeks ago and reported by the press. And in the last meeting, once again, the Ministry of Treasure said that the import tariffs will change if there is good competitive landscape for Brazilian companies. Therefore, we believe that what the minister was committed to, vis-a-vis the steel industry, becomes a reality, all the commitments become a reality.

Q - Jonathan L. Brandt {BIO 17988091 <GO>}

Okay. Thank you. Very clear.

Operator

Next question from Mr. Milton Sullyvan from XP Assets.

Q - Milton Sullyvan {BIO 19085202 <GO>}

Thank you for taking my question. I would like to get a better understanding about your CapEx for increase for your technological capacity. You said that the hardwares you use are in markets with the higher added value, where Gerdau has a different -- a competitive edge in the BQ market, maybe BQ is a product with lower added value? Maybe -- that's maybe only one of the categories where you have an idle capacity, which is very large. I just want to understand what is the rationale behind that BQ capacity?

A - Gustavo Werneck Da Cunha {BIO 20318216 <GO>}

Milton, thank you for your question. In terms of the production of coil hot rolled strips in Brazil, we started with that a few years ago. And we're very pleased with our entry in flat steels. We -- our capacity is operating at full speed, catering to the Brazilian market. We -- our quality is very differentiated, vis-a-vis the rest of the competition in the market. And I'm sure that we will be very pleased with our coil hot rolled strips production.

Q - Milton Sullyvan {BIO 19085202 <GO>}

Could you also be more specific and talk about expenses in the Brazil BO? I don't know whether my calculation is right, but it seems to me that expenses went up, not particularly only SG&A, but also in that line of other expenses. In consolidated terms, that line was up substantially, especially in Brazil. So I just want to understand what caused that.

A - Gustavo Werneck Da Cunha {BIO 20318216 <GO>}

Milton, these originally referred to nonrecurring items. So without getting into a lot of details about this quarter, there is no reason for concern. So in terms of cost of operations in Brazil, this could be modeled further on.

Q - Milton Sullyvan {BIO 19085202 <GO>}

Okay, thank you. Thank you both of you.

Operator

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

A - Gustavo Werneck Da Cunha {BIO 20318216 <GO>}

I would like to thank you very much for participating. And it's always a pleasure to talk to you. Also, I would like to invite you to join us again in our next earnings release related to the first quarter of 2019 on May 8. So once again, on my behalf, on behalf of Scardoelli and the entire Gerdau team, I would like to thank you for this opportunity. And once again, I wish you all a very good year of 2019. All the best.

Operator

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