Q4 2016 Earnings Call

Company Participants

- Gerd Peter Poppinga, Executive Director-Ferrous Division
- Jennifer Anne Maki, Executive Director-Base Metals Division
- Murilo Pinto de Oliveira Ferreira, Chief Executive Officer
- Roger Allan Downey, Executive Director-Fertilizers & Coal

Other Participants

- Alfonso Salazar, Analyst
- Andreas Bokkenheuser, Analyst
- Carlos F. De Alba, Analyst
- Christian Eric Andre Georges, Analyst
- Daniel Lurch, Analyst
- David Wang, Analyst
- Jamie Eileen Nicholson, Analyst
- Jeremy Sussman, Analyst
- John C. Tumazos, Analyst
- Jonathan Brandt, Analyst
- Marcos Assumpção, Analyst
- Thiago Lofiego, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. Welcome to Vale's Conference Call to discuss the Fourth Quarter of 2016 Results. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions will be given at that time. As a reminder, this conference is being recorded and the recording will be available on the company's website at vale.com at the Investors link.

The replay of this conference call will be available by phone until March 1, 2017, on 55-11-3193-1012 or 2820-4012, access code 4280600#. This conference call and the slide presentation are being transmitted via internet as well, also through the Company's website.

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

With us today are Mr. Murilo Ferreira, Chief Executive Officer, CEO; Mr. Luciano Siani, Executive Officer of Finance and Investor Relations, CFO; Mr. Peter Poppinga, Executive Officer of Ferrous Minerals; Mr. Roger Downey, Executive Officer of Fertilizers and Coal; Mr. Humberto Freitas, Executive Officer of Logistics and Mineral Research; Ms. Jennifer Maki, Executive Officer of Base Metals; and, Mr. Clovis Torres, Executive Director for Human Resources, Sustainability, Compliance, and General Counsel.

First, Mr. Murilo Ferreira will proceed to do the presentation. And after that, we will open for questions and answers. It's now my pleasure to turn the call over to Mr. Murilo Ferreira. Sir, you may now begin.

Murilo Pinto de Oliveira Ferreira {BIO 1921488 <GO>}

Ladies and gentlemen, welcome to our webcast and conference call. Thank you all for joining us to discuss both our 2016 and fourth quarter results.

In 2016, we reached at an important milestone with the startup S11D project, the largest mining complex in our history with a nominal capacity of 90 million tons per year and average ferrous content of 66.7%. The completion of S11D is a landmark in the mining industry as it presents technology with low cost, high productivity operations. Moreover, the complex is a clear statement of Vale's ability to make things happen.

For 2017, we stand firm in our pursuit at significantly lower net debt while we conclude our investment cycle and prepare the foundations for (03:26) strong free cash flow generation from 2017 onwards.

First, our financial and operational performance, I'm proud to report that Vale delivered a sound operational performance in 2016 with annual production records in iron ore, copper, nickel, cobalt, and gold. Our adjusted EBITDA in 2016 amounted $12.200 billion.

In 2016, we achieved for the fourth consecutive year a reduction of $1.8 billion in cost and expenses, with Brazilian real depreciating on average by only 4% in 2016. Costs decreased by 6% our general, sales, and administrative expenses decreased by over 24%.

Our research and development expenses decreased by 28% and our pre-operating and stoppage expenses decreased by roughly 50%. We also regard that decrease in capital expenditures with a big reduction of $2.9 billion in our investments, from $8.4 billion to $5.5 million in 2016. The S11D project started up successfully in December 2016 with deferred shipment in January 2017. In line with our divestment plan, we announced that asset sales of more than $3.8 billion in 2016, including sale part of the Fertilizers business for $2.5 billion, another gold stream transaction for $820 million. This sale of three very large carriers for about $270 million, for capesize vessels for $140 million, and received an additional payment for the sale of Paragominas for $113 million. That amounted $25.1 billion by the end of the year, a decrease of hopefully $900 million when compared with the third quarter of 2016.

The pace of decrease should accelerate as the sales registered in November and December month with higher price are collected in the first quarter of 2017. Our forecast remains only strengthening our balance sheet while maintain our commitment to shareholders return and net debts (06:35). In that regard, we paid out BRL 857 million of shareholder remuneration in 2016, and we'll pay now BRL 4.667 billion, subject to our general shareholders meeting at end of April.

Vale reported a net income of about $4 billion in 2016. This is a great improvement from a net loss of $12.1 billion in 2015, as a result of higher EBITDA, higher gains on foreign exchange, and monetary valuation and lower impairment.

EBITDA from Ferrous Minerals increased 70.8% (07:27) in 2016, reaching almost $10.5 billion, mainly driven by higher prices and gain (07:38).

Our EBITDA breakeven landed in China for iron ore and pellet decreased by five point – $5.07 per ton to $28.9 per ton in 2016, when compared to 2015 leading to the higher EBITDA margin of $30.50 per ton in 2016.

Base Metals adjusted EBITDA amounted $1.8 billion representing an increase of 33% comparing with 2015, mainly due to the lower costs and expenses and higher volumes despite lower base metals prices. Base Metals EBITDA increased by 14% in 2016 when compared to 2013 – 2015, despite the lower nickel and copper price of 36% and 34%.

Salobo's EBITDA was $736 million, an increase of $135 million when compared to 2015, mainly to higher volumes. Salobo achieved a yearly production record of 175,900 tons in 2016, after completing its ramp-up and reaching nominal capacity as of September 2016.

Vale New Caledonia continues to improve despite of its few negative EBITDA of close U$170 million. EBITDA improved by $240 million when compared to the previous year.

With Coal – with Coal, we saw an important improvement. Coal EBITDA improved, increasing by $450 million from negative $508 million in 2015 to negative $54 million in 2016. As a result of the ramp-ups of the Nacala Logistics Corridor and the Moatize II plant and the strong increase in coal prices.

Adjusted EBITDA of coal shipped through the Nacala port reached $110 million in 2016. Production cost per ton of coal shipped through the Nacala port decreased by $21 per ton to $77 per ton in the beginning of this year, compared with the $98 per ton recorded in the latter fourth quarter 2016, as a result of the increasing production and ramp-up of the Nacala Logistics Corridor.

This week, Vale announced a proposal to transform value into two corporations (10:54) with different control and the adoption of the best practices of corporate governance. This is a historic opportunity for Vale, a milestone that may be as important as the company's privatization 20 years ago. We view proposal as a big step towards implementing a world-class governance and creation of value to our shareholders.

Thank you for your attention. And, now, let's open this webcast for your questions.

Q&A

Operator

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

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

Yeah. Good morning. Very strong performance. Congratulations. Just wanted to ask two questions. And Murilo, maybe with the balance sheet in fast repair mode (12:02), surprisingly strong iron ore prices Vale has that you would like to turn into a dividend paying company for all the excess the company might generate?

Right now, there is not really specific dividend policy all around the company law (12:22) required dividend of 25% on net income. Do you think that the company could turn or could come out with a more precise, maybe higher payout ratio and state in a dividend policy going forward?

And my second question, maybe for Peter, is if he could comment as to how the ramp-up of S11D is likely to progress this year and next year, and any particular comments as to how the production ramp-up achieved out of S11D are going, that will be very useful. Thank you.

A - Murilo Pinto de Oliveira Ferreira {BIO 1921488 <GO>}

Carlos, thank you. I think that we have learned in the super (13:08) cycle that just in case, and I am saying about in our long-term, at least the medium- to long-term perspective, we should just involve in world-class projects. Then in case of not having these long-term projects, Vale should be completely devoted to increase dividends policy. But we cannot be precise, because we needed (13:36) to see, in annually basis, what should be done in order to increase the value of the company.

I strongly believe in that Vale will be one of the highest payout in the mining sector in the whole stock exchange, but we think that it's very early to provide some comments. Our priority in 2017, for sure, is to reduce our leverage. Thank you.

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

Carlos, thanks for the question. The ramp-up of Carajás is going well. In the last 30 days or so, we produce or expect around 1 million (14:23) tons. There is no major issues where we have the still stop and go (14:25) operations because we have to do some adjustments, which is normal. As you saw maybe its 85% physical progress, on average, we have 97 million tons (14:38) in the mine and 67 million tons (14:39) in logistics and infrastructure.

No major issues, like I said; trucks is still being commissioned in some parts and the whole system in 2017 will do 175 million tons – I mean, the S11D plus the Northern range. Maybe, we can - depending on how the ramp-up goes, we can reduce a little bit pressure on the Northern range and increase in S11D or vice versa. What we will do is to check what makes best economic sense.

Today, the bottleneck view (15:17) is the logistics. So we have 175 million tons, on total, to ship. And the complete ramp-up, as you may recall, we have – one year ago, we have revised the ramp-up and it was best for – make more economic sense to do it in the ramp-up in four years instead of in two years. And that is still the plan and we will be ready to have a full capacity after four years. Thank you very much.

Operator

Our next question comes from Jon Brandt with HSBC.

Q - Jonathan Brandt {BIO 17988091 <GO>}

Hi. Good morning. Good afternoon. Congratulations on the results and thanks for taking my questions. I first wanted to ask about iron ore prices and the fact that they are much higher than what everybody thought. I'm wondering if that changes your mining plan where before, you were very vocal about only producing – or not producing sort of your less profitable volumes. With iron ore above $90, I'm sure everything that you have is very profitable. So has that strategy changed at all? And I'm thinking more from the South and Southeast systems, are you going to start the producing as much as you can?

And then sort of the second part to that question, have you noticed or are you expecting any restarts from some of the higher cost countries like China and India, and sort of what does that mean for your 2018 supply/demand outlook?

And then secondly, I'm just wondering if there's an update on Samarco, if you're still expecting a potential restart in 2017, or if we should only expect a Samarco restart next year. Thanks.

A - Murilo Pinto de Oliveira Ferreira {BIO 1921488 <GO>}

Thank you, Jon, I will relate with (17:12) Peter. But for sure, what we have in mind permanently in Vale is to maintain to keep our discipline in the supply side. Peter.

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

Thanks, Jon. Regarding the iron ore prices, what we see for 2017, in a nutshell, would be, we see a much higher demand for several reasons than we had in 2016 - steel demand, I mean that translates into iron ore demand, steel prices and everything. What we also see is that there is much less new supply coming into the system than it was the case in 2016.

And finally, we see a completely imbalanced stocks, the ratio between high-grade and low-grade sitting in China is imbalanced, which will probably mean an additional demand pull of equivalent of more than 5% what China imports. So from that perspective, I think we have a very strong 2007 team ahead of us.

We see the - the question you asked me about how - are people coming back. We don't think it's so easy, so immediate, the elasticity is not there so easily. What we have seen is in China, for instance, for environmental reasons and also for quality discounts which translates into cost, the breakeven is, if you add sustaining, is probably higher than $70, $75. That's sort of the floor.

And the same applies to the seaborne supply, the extra supply where you have seen huge discounts in terms of quality, which also translates into higher cost. So the whole cost curve have shifted a little to the right and is now much more steeper than it was in the past. And I don't see - really I don't see average prices below $70, probably more in the 80s in 2017.

Regarding if we change our mine plan, we will not change our mine plan. What we have said is we are committed. We have a new long-term target. We have a capacity of 450 million tons but we have a long-term target of - a base case target, which is 400 million tons, which we expect to achieve the pace (20:04) of 400 million end of 2018.

And it is the fact that if you look into 2018 now and you analyze all the possible supply coming in from the majors, and so you see that actually in 2018, it's 50% coming from Vale. And certainly Vale will not be the one to derail the supply/demand equilibrium. We are looking for maximization of our margins and that's what we believe in. So it is 400 million unchanged and we will closely watch what happens in 2018, since it's more than 50% our ore coming into the market in 2018. Thank you.

A - Murilo Pinto de Oliveira Ferreira {BIO 1921488 <GO>}

Jon, regarding Samarco for sure, (21:00) to get the environment permit, it's out of our control. What we can say that Samarco is doing everything in the right way. We believe that we'd say, they have already (21:15) delivered everything to have the new permit to the Alegria Cave. They need us to get again the same what used to be in the existing facilities. I could say that it's very realist (21:33) to consider Samarco going back to the operations in the third quarter of this year. But for sure, I repeat, it's not something that we can have a nice (21:47) statement, because it's completely out of our control. But what should be done has been done. Thank you.

Operator

The next question comes from Jeremy Sussman with Clarkson.

Q - Jeremy Sussman {BIO 15112588 <GO>}

Yeah. Hi. Thanks very much for taking my question. I just want to talk a little bit about inventories. First - my first question, can you guys give us a sense of sort of where Vale's inventories are across the whole system, maybe compared to this time last year?

And then I think you touched on - second question is, you touched on high-grade inventories being much different than lower grade inventories in China. Again, can you maybe give us a sense of order of magnitude? I think overall inventories at port are probably up 25 million to 30 million tons year-over-year. I'm curious, kind of, where you see high-grade inventories year-over-year. Thank you.

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

Well, thanks, Jeremy. It's Peter speaking. In terms of Vale's products in iron ore, we have reduced our inventories from last year, from 2015 to 2016, by roughly 2 million to 3 million tons. At the same time, our inventories they have shifted downstream. They are less concentrated in the mine now and more in the ports. So we have actually blended – last year, we have blended roughly 40 million (23:29) tons. So in spite of the additional blending last year, we have reduced inventories and inventories have shifted downstream.

Regarding the inventories sitting in Chinese ports is around kind of 20 million tons, and there are several sources, there are several ports. There is analyst reports, we have our own market intelligence and it's a fact that the high-grade ores are very low have very low inventories. The medium grades are a little higher inventories, and the low-grades are really increasing dramatically. So that's a fact.

And this means that you cannot use, if you would use all the inventories into one single – let's say in one single (24:30) you would not be able to make a good quality of steel at all out of it – pig iron out of it. So it must be said that yes, stocks, inventories have increased in China, but part of them are actually so to say sterilized (24:47), they cannot be used and they have to be probably used in a very, very long time down the road. Thank you.

Operator

Our next question comes from Alfonso Salazar with Scotiabank.

Q - Alfonso Salazar {BIO 18358082 <GO>}

Hello, thank you and congratulations on the results for the full year. The question I have is regarding cost. We saw an increase in the quarter, it was in part related to labor, but also there is a stronger Brazilian real today. So I was just wondering if you can give us some guidance on what to expect in terms of costs for 2017? And how the cost is going to be impacted by the S11D ramp-up this year?

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

Yes, Alfonso, thank you for your question. Yes, the cost in the fourth quarter has increased a little bit. In the freight, it was the bunker, you saw that it was exactly the effect of the higher bunker. And in the C1, there is mainly a non-recurrent cost increase where we had some stocks adjustments, but also we have some provisions for variable remuneration and also the deal with the unions for the wages for this year. So, that is mainly the reason why the costs have increased. If you compare the costs in the fourth quarter, the C1, and compare it to last year's fourth quarter, it's in reais, it's more or less in line what we had then.

Looking forward, I don't expect in 2017 to have a big effect of S11D, given that we will still be in ramp-up. But what I can tell you is that we are working on, in the next two to three years, what we will have is, yes, there will be $1 or so less in C1, due to the effect of S11D, I mean, diluted in the whole Vale. You will have another dollar coming from our global recovery. Remember that we are more and more dry processing instead of wet processing, and reducing our strip ratio not because we are leaving ore behind, but because we are actually using former (27:50) waste and now processing it in our (27:54) projects, that's another dollar.

And then you would probably go for $2 or so when the whole supply chain is completely integrated and optimized, which is not the case today, we have the efficiency piece where we can still work on and we have the price realization piece. So we are saying roughly $4 a ton down the road in two or three years, compared to the 2016 costs. Of course, depending a little bit – in the C1 case, depending a little bit on the exchange rate, which is now a little against us, but that's the order of magnitude I would indicate.

Operator

Our next question comes from Christian Georges with SocGén.

Q - Christian Eric Andre Georges {BIO 1557701 <GO>}

Yes, hi, thank you. I just have a couple of questions. One of them is on your coal production in Mozambique, if you could update us on what you're looking at in terms of production at Moatize next year. I think I saw that Moatize II will be in action in this quarter, but I suspect it's only going to be happening perhaps in the second half. So, if you could give us some detail,

And just I'm not sure if I missed in your comment, but you're mentioning that you want net debt to reduce further, do you have any kind of target of where net debt should be ideally in the coming 12 months? Thank you.

A - Roger Allan Downey {BIO 7419641 <GO>}

Good morning. It's Roger here. We are ramping up the Moatize II plant. I think we're going well. We're targeting a 13 million to 14 million ton production this year as we ramp up. We had a very good January, which has boosted our confidence in terms of achieving that goal.

Obviously, there is always a challenge, but all the systems are doing very well, both the mine, the plant, and the Nacala Railway and Port. So, we're on target.

A - Operator

Christian, as regards net debt, we do have a target to reach $15 billion to $17 billion of net debt. This can be achieved over the next 12 months depending on prices, but even in a scenario of lowering prices, we are very confident that we will achieve this in the near term, helped also not only by the increased cash flow of the company, but also by the divestitures of Fertilizers and Coal.

Important to note is that one of the reasons behind the increased cash flow generation of the company is not only higher prices, not only higher volumes, and reduced costs, which are already reflected on the results you're seeing, but also lower investments, that's very important, so freeing up more cash, and lower expenditures with the derivatives.

For example, in 2016, we had a lot to spend on settling open positions in bunker hedge. And also we had a toll (31:25) also because of the appreciation of the Brazilian real on the accounts of the currency hedge. So all of those drags on cash flow they have been cleared. So therefore, even in an environment of very low prices, deleveraging should be a reality going forward very quickly.

The next question comes from Daniel Lurch with BNP Paribas.

Q - Daniel Lurch {BIO 17122284 <GO>}

Hi. Thanks so much for taking my questions. Just two quick questions on Base Metals. The first one is on capital allocation. You were posting obviously very considerable costs (32:04) in iron ore and should, as you mentioned, consider to (32:07) decrease your net debt in 2017?

I understand your focus on balance sheet and shareholder returns but could outline your thinking about (32:16) outside iron ore? I'm thinking, particularly about over three-year. (32:20) It appears this could (32:22-32:26) and in terms of timing, what do you think – when would you start considering this investment?

And the second question with regard to Base Metals, how do you think will cash costs develop in 2017, given the changes you are planning in Sudbury in Canada? Thank you very much.

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

On the unit cash costs, when you look at the Canadian unit cash costs in 2017, it will be slightly increased as 2017 is a year of transition. We go down on March 15 with one of the furnaces that will be rebuilt, and it will be down until we come back up in July. And in June, the whole surface plants in Sudbury are shutdown for the annual maintenance that happens every 18 months. We didn't have that maintenance in 2016, so it's an additional $60 million and a loss of four weeks of productions out of the refinery in Sudbury.

As well as highly necessary this year, because we'll also be doing the tie-ins for our Atmospheric Emissions Reduction project and we come back up on July 1. And at the end of Q3, beginning of Q4, we'll move to one furnace in Sudbury permanently, and that one furnace, albeit, will have an expanded capacity. The long-term reduction in (33:53) production out of Sudbury is about 25%, but next year it will be probably about 7% down.

So with the combination of higher maintenance costs and lower production because of the downtime, there is increasing costs in 2017. And also as you ramp up Long Harbour and its contributing more until it gets fully ramped up. But we have, in parallel, action plans to return ourselves and to reduce fixed cost consistent with the reduction in production as we move forward into 2018 and 2019.

In terms of the capital, from a Base Metals perspective in the next few years, we have to finish the Atmospheric Emissions Reduction program in Sudbury. But then we have to turn our attention to investment in the mines. Predominantly in Sudbury, we have a Copper Cliff mine expansion project there that we will begin this year, which will increase the mine feed in Sudbury in the years going forward. But I would say it's predominantly focused on mine investment in Canada, the CapEx program over the next few years.

Operator

The next question comes from Andreas Bokkenheuser with UBS.

Q - Andreas Bokkenheuser {BIO 7182883 <GO>}

Thank you very much for taking my question and also congratulation on the solid set of results. Just one clarification on the balance sheet, obviously, you've seen net leverage per EBITDA come down quite significantly, can you update us on your target on your deleveraging process? I mean, initially, I think you were mentioning $15 billion to $17 billion in 18 months. Obviously, EBITDA is driving down the multiple but the actual absolute number seems unchanged with net debt still around $25 billion. What's your timeline to get it down to $15 billion? That would be my first question.

And my second question just on the ramp-up at S11D, as you also mentioned on the Portuguese call this morning, Vale certainly is going to go in and imbalance the market, which is certainly understandable. I guess my question is hypothetically speaking, if you did want to ramp up S11D within the initial 24-month period, which I understand is now four years, but if you did want to ramp it up in 24 months, could you do that or are you constrained on the Railway? Thank you very much. Those are my two questions.

36.38: Andreas, on the debt, the 18-month target was established when we did the same results call one year ago, and we were talking about the end of 2017 and we put down this 18-month target. Most recently, we have stated that we don't intend to do any further divestitures rather than Fertilizers and Coal. We were considering beforehand to do perhaps another larger transaction within our core asset base. So given the improved cash flows, we have put this out of the table. So therefore, we're working only with Coal and Fertilizer as the key divestitures, which together, with the prevailing cash flows, probably take this timeline to the end of this year. Obviously, that depends on the average prices for the year.

But nevertheless, even if we are wrong on prices, we're just talking about taking another three months, worst-case scenario, another six months, to say that it is very likely that we will reach that $15 billion to $17 billion target by the end of the year, so we continue to go in that direction.

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

Yes, Andreas, thank you for the question on the ramp-up, but it's like I said before, we have decided to go for four years. Yes, we could, a little bit, we could speed it up. But we don't want to do that. We don't want to do that because we have a very well structured profile now, ramp-up profile. And our expansion of the Railway is following a very well defined system. And also, we don't want to change that. And that's the answer. So we don't want to change this four years ramp-up.

Operator

The next question comes from John Tumazos with Very Independent Research (sic) [John Tumazos Very Independent Research] (38:55).

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

Thank you very much for the nice dividends and great performance, and good job. First issue, dredge (39:09) individual tributaries, you must have rebuilt a lot of houses by now. How are the actual costs coming versus projections? And second, is it a practical goal to buy out BHP in Samarco so it can be integrated into one company and a more streamlined decision-making structure?

A - Operator

About the potential acquisition of Samarco, John, I think that it's something that it's out of the contest at this stage. We believe that our priority is to reduce our leverage. And my understanding that BHP is very committed with the whole process, into the river, in the region and mainly going back with Samarco (40:10). I think that the subject that we have on the table is precisely just to go back and to work as should be. We know that we can reach the level of 70% of the nominal capacity, but it must be a very important milestone to Samarco to pay its debt, and to go ahead with all the obligations. Peter.

(40:49) John, on the costs on the Samarco recovery, they're pretty much in line what was expected when we drafted the original agreement by March last year. We've been obviously updating and getting more comfort with the numbers but the good news is that they are adhering very much to what has been outlined a year ago.

And just to say that also we flew over the river very recently and the progress of the remediation work is amazing. I would say that – we would say that in a very short time, we will be very proud – we already are, we would be very proud of what we're delivering to the communities in terms of remediation.

The next question comes from David Wang with Morningstar.

Q - David Wang {BIO 19190330 <GO>}

Hi, morning. Thanks for taking my question. I just wanted to see if you could offer some thoughts on the dynamics for supply and demand going forward. I know previously you mentioned on the call that a lot of the new supply will be coming from Vale, but I'm wondering with the higher pricing, are you seeing a lot of other smaller players wanting to reenter the market because they would be profitable as well? And what's your, I guess, longer term outlook on the sustainability of the sort of credit fueled boom in demand that we saw last year.

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

David, hi. So the supply and demand and about other players coming back, well, I already said that we have a better demand than last year. We have less new supply this year coming in than last year and we have imbalanced stocks. This means a very strong environment for our enterprises (42:49). I don't see the prices at all. The players coming back either being Chinese mines or seaborne because the cost curve has shifted. It's not only about cost anymore, it's now really about quality. This translates into a huge discount and translates into additional cost. So that is distinctly higher than $70, this breakeven, $70 – including some sustaining – $70, which is sort of natural floor, sort of limit. And then the other one (43:33) we believe they don't come back eagerly and (43:37) quickly because there are environmental restrictions more and more in China. And it's just not so elastic like we have seen in the past.

So in terms of the longer term, there is also the depletion issue. Lots of them will face huge depletion issues and I don't see them coming back easily. They may come back a little bit, but it's not from one day to the other. That's my call here.

Operator

The next question comes from Jamie Nicholson with Credit Suisse.

Q - Jamie Eileen Nicholson {BIO 1540918 <GO>}

Hi, thanks so much for the call. Just quickly, given your comments on strong net debt reduction, do you expect to continue with liability management on your bonds and buyback, some additional bond debt? And if so, would you be focusing on the higher coupon debt or the near-term maturities, or what objectives would you be looking to achieve? Thank you.

A - Operator

Well, we just did one example of what you're mentioning. The bond that we issued a few weeks ago, we announced yesterday that we are repurchasing the eurobond which matures in 2018. So, yes, we look forward to continue to do a liability management which doesn't mean that we will keep accessing the markets. We have other alternatives outside of the capital markets to do liability management. But it's good to use this nice window in terms of lowering costs of that in order to refinance part of the maturities.

We did, in our view, a good job last year by cleaning up 2017. We have only $1 billion of major – mostly in ages, it's (45:31) maturing this year and we now have the task to push forward the maturities of 2018 and 2019, which will happen simultaneously at debt reduction. And now, we don't have a clear preference. There are some high coupon debt over the longer term. Should the cash flows surprise on the upside, we should also remove some of those high-coupon debt. But the priority over the short term still is to refinance shorter-time maturities.

[Foreign Language] (46:11-46:14) Our next question comes from [ph] Tiago Silva (46:16) of Citibank.

Hi, thanks for the question. I would like to get, if you can provide, what is your expectations on pellet productions for this year and next year? And regarding Moatize, I know that you mentioned briefly on to 2017 production, but what is the expectation about the expansion to 22 million tons? Thank you.

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

Hi, Tiago (46:45). Thanks for the question. Pellet production this year, we will have higher production than we had last year; so, probably coming close to 50 million tons. But the pellet production is, of course, one of our competitive advantages and we will do everything in this current environment to increase production without the jeopardizing the quality. We are even considering controlling options around the world where we provide the pellet feed and get back to pellets. So, pellets will be – and by the way, the pellet – the new pellet price, which in the previous call was, why it didn't reflect in the fourth quarter, this will kick in only in the first quarter of this year. And you will see the effect this year.

So, it will be increased, the production. And we also announced the São Luís pellet plant restart (47:48). This will only happen in first half of 2018 since we have to do some works there. And the rationale is actually really that we have this plant there. What changed from the past is that we have now the logistic infrastructure. We have not infrastructure at that time. So, we have to make a choice between selling sinter feed and grinding sinter feed for the pellet plant.

Now, we have the infrastructure with the logistics taking. And also, what we are doing in São Luís is we are going to recover pellets feed from tailing dams where we have huge tailing dams, which will be reutilized. There is no concentration needed, just cycloning and getting this pellets feed ready to be pelletized with minimum of grinding.

And so, this is a very good case – a very nice case in terms of sustainability of the region, but also about making use of the resources we have. And the plan is to make blast furnace pellets and to swap some of the blast furnace pellets from the Tubarão plant into this São Luís plant and to create more space – make space available in the Tubarão plant for increase in the production of the direct reduced iron (49:14) segment, which is the segment really growing in the world in the next years. Thank you.

A - Murilo Pinto de Oliveira Ferreira {BIO 1921488 <GO>}

Okay. Downey, please.

A - Roger Allan Downey {BIO 7419641 <GO>}

Hi. Good afternoon. We are ramping up in tandem with the railway, expecting to reach 18 million tons next year, followed by 19, 20 million tons in 2019. After that, it really depends on the market. We will be obviously going to be disciplined and sensible about how we move towards any bigger targets. Obviously, with some investments, the market can (49:57) even go to 30 million tons. It's just a matter of what the model looks like and how the investments pay out. Thank you.

Operator

The next question comes from Thiago Lofiego with Bradesco BBA.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Thank you, gentlemen. I have two follow-up questions. One is, Peter, why do you think swing capacity is not coming back online, at least, not in a massive way for now? What do you think are factors behind that?

And second question, considering no changes in oil prices from here, where should we expect your average freight rates to stabilize? You still have higher priced contracts majoring (50:46), that should be replaced by lower priced ones, I mean, just to understand the dynamics. Thank you.

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

Regarding on the freight, once the second-generation volume of the shipments, once they kicked in, it will be (51:05) more than 30 ships; as you know, $3.5 more competitive than the first generation. And once we have rebalanced our portfolio, I would say, at a bunker of BRL 250 million (51:16) – based on BRL 250 million (51:18), I would say that we should come close to $11 (51:21) in the midterm. That's our average portfolio, which is, of course, lower than what we have today, but it really depends on how we can rebalance our spot contracts. (51:49).

The other question was on why would they not come back – the margin of supplies? Well, they will, but it's a question of – in China, for instance, what you're seeing is more and more environmental restrictions, lots of mines reluctant to come back, lots of strict controls. And as I said, the breakeven on, truly on the cost basis, even if they got – they've got the recent tax incentive. But even with that, if you check the average, the average breakeven cost is $64, $65 including the sustaining.

And if you're now at the quality plus those concentrates, they have 6%, 7% silicon average. But now, (52:44) is coming back, they would have 8%, 9% silicon. And this is in today's market conditions, with today's coal price is very difficult and translates into another $5, $6, $7 (52:58) penalties. So, we are talking $75 (53:03), which is, today, possible. We are higher in C1, but it is – the reluctance that we see, it is also the elasticity, which is not there. And lots of those are actually underground, which is not easy to restart a mine like that from one day to the other. That's why we think it's not from one day to other.

A - Murilo Pinto de Oliveira Ferreira {BIO 1921488 <GO>}

Just to add one further comment, we needed the attention. As you know, just recently, we have learned about eventually the government cannot allow to mine coal in some provinces. We must pay attention; we can see some chance not allowing iron ore as well. Thank you.

Operator

The next question comes from Marcos Assumpção with Itaú BBA.

Q - Marcos Assumpção

Sorry. Can you hear me?

A - Murilo Pinto de Oliveira Ferreira {BIO 1921488 <GO>}

Yeah. Go ahead.

Q - Marcos Assumpção

Okay, okay. Sorry. I have a question on coal. You mentioned on the press release that as the Chinese mines will be able to get back to the 330 days of production per year, the market could get back to equilibrium. So, if you could mention what is the equilibrium level that you're expecting?

And also, when we take a look at the Sena-Beira, the profitability of the Sena-Beira Corridor, we see that it's actually much, much lower than the one for Nacala. So, for how long will you still have like the take-or-pay contracts for Sena-Beira? And – so, we should see some lower profitability in this corridor. And so, if you could comment a bit of the volumes that you have to carry on, on that corridor would be nice.

And last question on iron ore, we're seeing some talks about the Simandou being sold to Chinalco. If by any chance this is confirmed, as you know the project very well, how long do you think it would take to put a project like that in place? Thank you.

A - Roger Allan Downey {BIO 7419641 <GO>}

Hi, Marcos. Good afternoon. I'd just start off with Coal then. We – first, on the market there (55:45), we have seen the coal prices move exactly with the news flow which kind of tells you that the difference between 276 says and 330 days production in China is where the balance lies.

When the 276-day curfew was implemented – and yes, we did have some supply disruptions at the time – coal prices shot up to $300. Since then, with the flex – when they flexed production to threaten 330 days, coal prices started basically to free fall. And now, with the announcement of the resumption of the 276 days curb, they started – they bounced back.

So, what I would say is that – so that's basically – I think we've seen a floor. We've seen where were prices need to be in order to – and when to bend (56:49) to satisfy supply/demand today, and where they will probably remain, at least, over the course this year.

Peter's comments about the steel industry in China and steel prices just corroborate the fact that we're probably going to see the balance lying a bit above where we are today. The other comment that, I think, is worth making in that respect is that because the volatility we saw, especially in the fourth quarter 2016, the buyers, and a lot of those buyers, were left without volume at the end of last year. Probably don't want to see the volatility, and they want to make sure, especially those who are on contracts, want to make sure that have a benchmark price which is sufficient to guarantee their volume. So, we would say that it's probably worth a risk with saying that the first quarter of the Japanese fiscal year starting April 1 will likely to see a benchmark at least (57:54) settled above where the spot market is, which I think is a very good reading for our business.

Regarding your comments on the Beira railway, this is the last year of our take-or-pay contract. Any volumes that we push down Beira now will obviously be in addition to what we can do in Nacala. And Nacala, we will be ramping up towards the 19, 20 million-ton target by 2019. And again, anything above that will be – depends on the market, I mean, where the market is, whether the market needs more coal, and whether we can be competitive through Beira.

A - Murilo Pinto de Oliveira Ferreira {BIO 1921488 <GO>}

The maturity, or should I think of that business (58:41) third quarter of this year, the maturity of the existing contracts.

A - Roger Allan Downey {BIO 7419641 <GO>}

The contracts, yeah, end of this year – end of third quarter.

A - Murilo Pinto de Oliveira Ferreira {BIO 1921488 <GO>}

And just to answer, Marcos, I think that the level of complexity and having a green light in the Simandou project is very high. As you know the project is facing a huge dispute regarding the past into the court and I think that before anything, it must be decided about the process, BSGR, and to solve some issues.

And regardless of these, I think that's just in the first phase that used to having the Rio Tinto. Hence, I have learned that the cost could be above $20 billion, which is, in our view, (59:43) that can jeopardize the whole project.

But it's very early to say because, first of all, (59:52) regarding the illegal dispute. Thank you very much, Marcos.

I would like to say thank you very much for spend your time with us. And we appreciate your questions and all the best. Bye-bye.

Operator

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