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Q3 2006 Earnings Call

Company Participants

- Fabio Barbosa, CFO

Other Participants

- Daniel Altman, Analyst
- Edmo Chagas, Analyst
- Mark Butler, Analyst
- Sayan Ghosh, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. and thank you for standing by. And welcome to the CVRD's conference call to discuss Third Quarter 2006 results. If you do not have a copy of the relevant press release, it is available at the Company's website at www.cvrd.com.br, at the Investor Relations link. (Operator Instructions) As a reminder, this conference is being recorded. The replay will be available until November 20, 2006. To access the replay, please dial 55 11 4688 6225, access code 205. The file will also be available at the Company's website at www.cvrd.com.br, at the Investor Relations section. This conference call and the slide presentation are being transmitted via internet as well. You can access the webcast by logging on to the Company's website, www.cvrd.com.br Investor Relations section, or at www.prnewswire.com.br.

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 any of macroeconomic conditions, market risks and other factors.

With us today in Rio de Janeiro is Mr. Fabio Barbosa, CVRD's Chief Financial Officer. First Mr. Barbosa will proceed through the presentation. And after that we will open for questions and answers. It is now my pleasure to turn the call over to Mr. Barbosa. Sir, you may now begin.

Fabio Barbosa {BIO 1907620 <GO>}

Thank you, very much. And first of all I'd like to thank you all for attending this conference. I would also like to apologize for my absence in the last conference call, as I was working very hard with our team to put the Inco transaction in place. And I couldn't make it to our office there in New York. So I apologize for my absence there.

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(First) we are trying to improve our procedures, as per your suggestions. So we anticipated our conference call for the following day after the day the release of the results. I hope you appreciate that as well.

Now today all our discussion will be on our results, our Third Quarter results. But also with some comments on Inco. And the perspectives of our Company. Let me start with the Third Quarter results. And we, again, posted several records in our production indicators, Iron Ore, aluminum, Alumina and Copper, with an increase as high as 64.4% increase of Alumina. That's, of course, a direct result of our expansion in the last few years.

But I would like to call your attention that, in the specific case of Iron Ore, we have been the most efficient producer, in bringing additional capacity to the market, in the last few years. So, this is a very interesting figure that we are presenting, 69.5 million tons of iron ore production is a direct result of those efforts. And in terms of the financials, as you see there, records in our gross revenues, adjusted EBIT, EBITDA and net earnings as we (promised).

In terms of our capacity, our shipments of iron ore, we -- the Third Quarter of '06 marks the start-up of Brucutu. And also the consolidation of the Carajas operations at the production level of 85 million tons per year. And, of course, on track to expand this production further next year to 100 million tons. An impressive growth rate that, you can follow in the chart in the left figure, the Third Quarter (48.4%) against the same period last year.

We -- all this production has been brought to the market, in a way to address the very strong Chinese demand that is shown in the next slide. And you can see the size of our effort, only CVRD increased its sales to China by almost 60 million tons. It's almost a similar figure to what we shipped in the Third Quarter of '06.

In fact, China has been the major driver of capacity expansion, in our case. As they continue to show, the country continues to show very strong growth prospects. And we managed to increase our supply to our Chinese clients by almost 40% in 2006, against the same period in 2005. And, of course, given the growth of the Chinese imports and the other suppliers, we are gaining market share in this very important and dynamic market.

And, as you can see, we are doing that, without entering in excessive concentration, of our sales to a single country. China in fact represents 19% of our total revenues. It's impressive and an important here of our total revenues. But its also important economy on a worldwide basis in the third and largest economy in the world. So, we must be exposed to this economy.

And I think we are reaching a very nice balance, even before the effects of the acquisition of Inco. But the fact is that, out of our more than $12 billion in revenues, slightly over $3 billion were directed to our Chinese -- originated in our -- from our Chinese clients, $3.1b.

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In terms of net earnings, again CVRD posted a record. And is the sixth consecutive quarter of above $1 billion earnings. And in terms of EBITDA is the eighteenth consecutive quarter of adjusted EBITDA growth, such an impressive figure. And our last 12 months EBITDA, in the Third Quarter of '06 reached $8.3b. With ferrous minerals is still representing 77.6% of our total revenues. Of course, the share is bound to be reduced as we aggregate Inco figures to these EBITDA figures.

In terms of cost an important item in our agenda. You can see that we -- I started to show some reserves for (effort), despite some inflationary pressures that you can appreciate in the number that we are providing. We -- our cost of goods sold plus SG&A increased from $1.6 billion to $1.8 billion from the second to the Third Quarter of '06. But I would like to point out that SG&A alone indicate a sharp reduction of ($45m) in the single quarter. So part of our effort is already noticed in this specific account.

I would like to also comment that we put in our press release. But I like to give a more (systemic) view about our cost there -- cost reduction effort, because we are seeking a more structural approach. And, in fact, I could name or indicate at least five major initiatives that should bring more cost reductions over the next few months, as we put in our press release.

First, we are reviewing the scope and average cost of our supplies contracts. So, we noticed that in the last few years, particularly, outsourced services and materials, the growth of our costs in those concepts increased by over 100%. And our production increased by 50% or so. So there is room, there may be room to capture some savings there. And, as we focus more on efficiency and productivity, in our operations and cost reduction.

So we are discussing with our suppliers. In a way, the very fact that we are moving towards these smaller trucks in our some of our operations like (Southern) (systems). Like what is being done in (area) right now, is a clear indication of our (start) four. We are seeking alternatives to the current situation, in which, we have no alternative but buy high cost equipment, or deal with high cost of parts and components that we -- that are provided by the steel suppliers. So we are discussing with their suppliers.

But also, we are trying to reach additional reserves, by changing the way we operate, in some case like (Southern) (systems), that we will have advantage. They are following the good example that we already see in some, or several MBR corporations. We are also replacing some outsourced services by in-house services, because we also noticed that today it's cheaper to do it in-house than hiring outsourced service for CVRD. Outsourced also a bit inflation there I commented with you previously.

We are also planning the closure of some high cost mines. And the (very early) start up of mines like Brucutu. And the expansion of MBR mines should produce a structured reduction of our cost of production, as they are (mineral) mines, in the case of Brucutu, or more efficient in comparison with some mines that are already operating. So a combination of closure of high cost mines. And an increasing capacity of the most efficient mines, should bring an additional downward pressure to our costs.

We also promoted the split of the Southern System in two. Now we have the South Eastern system, it is the former -- it's basically our Itaguai mine, Centrais mines and the Vitoria a Minas railroad, plus Tubarao Port as an access of the South Eastern system. And this -- the now -- the new Southern System is what used to be (inaudible) MBR, of course with the access of MRS and Rio de Janeiro port.

So, with this, we believe that we will be able to capture more synergies. And focus our attention in -- with more detail as the previous Southern System was too large. And the degree of integration of MBR and CVRD was in a way lagging behind. Now we can focus on that. And a clear example of this process was the inauguration, of last Tuesday, of highway connect in Jangada and (Sejong). Former respectively in -- or -- now Jangada that belongs to MBR and Sejong that belongs to -- used to belong to (Fratech), now its part of the Southern System. So, I think that is one example of what can be done, or how it can be achieved by integrating both systems.

And finally, we are trying to manage the supply chain in several lines of business. First you notice the reduction of third parties iron ore, acquisition of third parties iron ore in this quarter, in this year, compared to last year. As we do operate more efficiently than some of our competitors from whom we buy iron ore.

Second we are buying manganese to supply our -- some of our ferroalloy plants, as this manganese happens to be more efficient, in the critical ability of our ferroalloy plants. And could promote some cost reduction in the long term.

And thirdly we are replacing next year the bauxite that is currently provide by (MIN). We are replacing this bauxite by our own bauxite Paragominas bauxite that will be fully available in the First Quarter of '07. So this set of measures have a more structural nature. And they should yield results as time goes by. And we hope to be able to show to you as we collect the results of these measures.

I would like to turn to the issue of growth, the investment, the effort that we have been implementing in the last two years. And you see there, on the next slide, that this year, if we include the acquisition of Caemi shares, our investment would reach $7.2b. But I would like to highlight a fact that 86% of this investment, -- 86% of this investment could be called growth CapEx. So, we are growing. And that is why we are getting these results. That's why we are able to increase our supply to the Chinese market, by 40% in a single year. And something that our competitors weren't able to do.

So; and the result of this, or the development program is to (decidedly) the (17) projects that we delivered in the last five years, it started 2002. And the last two months were precisely Brucutu, with 30 million tons capacity and Carajas the consolidation of $85 million per year production.

Despite all this capital invested, we have been able also to keep the return on invested capital, we are above the 50% threshold. So it's an impressive mark, considering that our asset base increased by five times since 2003.

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In parallel, we have been taking care of the balance sheet, of our financial strength. And you see that four years later our balance sheet is much stronger than it was in 2002. And with a much bigger company, supporting a much bigger company with production that we hope to achieve this year of 260, or over 260 million tons of iron ore among others.

So total debt increased by just $2.5 billion in this period. But adjusted EBITDA the interest coverage more than tripled to 21.6 times. Total debt EBITDA is less than half what used to be in 2002. And our leverage is very small. Of course, this does not consider the effects of the acquisition of Inco in our balance sheet. But this, of course, is in another way, in a different perspective, is what enabled us to go for such an ambitious move and, at the same time, managing to keep our steady in terms of credit perception. So that's what we managed to achieved in the last few years. Growth maintaining a very, a very strong balance sheet, or even enhancing it further.

The acquisition of Inco, well you know that we acquired 87, roughly 86, roughly 87% of Inco shares. There will a general shareholders' meeting to consider amalgamation. And, of course, with the goal for acquiring the remaining 13% shares that are there. A new Board was appointed. We are in the process of delisting from NYSE, New York Stock Exchange.

And integration process is going extremely well, very smoothly. And so far no surprises, (no) negative surprises, maybe a positive surprise due to the fact that Inco may achieve the top position, in terms of Nickel production this year. It is a very difficult race lets say with the lawyers. But it's in a very good standing. And so the integration is going extremely well.

In terms of our financial, after the acquisition we reported to you that we discussed with all the rating agencies. And we were able to show them that CVRD was fully capable of repaying the debt that it was incurring with the acquisition. And without any compromise, without any disturbance in the quality of its credit. And the answer was extremely positive. And the fact that we are able to keep our investment grade rating with all of them.

We -- the first indication that of the quality of our credit should remain, or even strengthen in the long term, was the very fact that we dispersed much less than the acquisition value (that's) estimated of $17.7b. We disbursed $15.6 billion so far. Or at least we expect to disburse the $15.6 billion then we are going to use $1 billion or $2 billion of our own cash to pay for the acquisition. So we are -- we already started to reduce our total debt.

Our assets sales are taking place. You saw the sale of Usiminas in the press release yesterday. We commented that we divested all the shares that we had of (Gardow). In the case of Usiminas as well, the major change in the quality of our shareholding there, with the interest in the controlling group of Usiminas.

And, of course, our focus is on the growth of the steel industry in Brazil, for what we have been working very hard in the last few years. So. But anyway the -- for the financial standpoint there was an asset sale that we will, of course, use to redeem that as soon as possible.

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And a take out of the bridge loan, its already in progress, you saw the announcement of the bank (received) the domestic capital markets, after all the operations are taking place. And you will be duly informed when the operations are concrete.

In terms of information, what would be CVRD after the acquisition. And we put some information there. Our gross revenues in the first nine months of the year will be something like $18b. So roughly speaking if current Nickel prices remain, we are talking about total revenues of around $25 billion for the end of the year.

And very strong figures in the EBIT and EBIT margin, given the very good performance of both companies, in the first three quarters of the year. I'd like to point out that if you look at the total debt figure, we are not including, of course, the acquisition financing. But even if we consider the $15.6b. And if we analyze the EBITDA figures, you see that will be well below the two times threshold of total EBITDA. So it's a very comfortable position for CVRD.

And a very preliminary aggregation of information of CVRD and Inco, the combination of sales revenue distribution with a sharp reduction of iron ore and pellets share. The Ferroalloys Division going down from roughly 70% to 50% of our total revenues, Copper reaching 7.1%, Nickel 23.4%. And Alumina down to 9.4%. So a much more diversified solid group in our view.

Some few comments in corporate social responsibility. Of course, we have to address those issues, as we operate now in several different countries. And particularly in Brazil, which is our -- where is our headquarters. So we believe that, this is the way -- in this way we will be creating long term value for our shareholders then and is the right thing to do. So investment in social actions is key to create a business environment supportive of our long-term competitiveness.

Beyond our conviction there is this very pragmatic approach. Our focus on primary education, training and citizenship to foster economic and social mobility. We do operate in some areas that are among the poorest areas of the country. So we have to develop (as we put) -- to improve the welfare of those communities, to bring some facility. And sometime we even have to investment in infrastructure facilities. And the public facilities. Only in the Third Quarter of '06 we invested $22 million in these areas.

And finally we -- or the Indian communities that you may have heard about in the last few days, we do have a very important support program, in terms of grants and provision of health insurance. Although, sometimes this cooperation may be misunderstood by some, by few that believe that they get something -- some additional benefits. But we don't agree. And we feel (inaudible) (certain events).

Turning to the last comment on perspective growth, again I would like to make a mention here, because we have been saying, we have been forecasting GDP growth and the Chinese growth, GDP growth for some time now. And we have been among those that have one of the highest levels of, I would say that, adherence to what (reality showed afterwards). So we are very happy with that. So, this means credibility. And we have been

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saying for some time now that this global growth trend above 4%, we said that at the beginning of the year, we are restating that now.

And China, at the beginning of the year, we came with a figure of 10% growth rate, to the skepticism of several people that we met by that time. So China is delivering precisely 10% growth rate. And next year our forecast is around 9%. So no reason whatsoever to slow down Chinese growth. And demand should remain very strong there.

On a more global perspective, with the global manufacturer PMI, is also signaling, is very much in line with our perspective of the global growth. And in particular the U.S. economy. What we are trying to show is that there has been some adjustment in the investment in residential assets, some real estate assets. But its no burst of a bubble that scenario that some indicated a longer year.

So, what we maybe seeing is a very orderly adjustment, a very smooth adjustment. And we don't believe that there will be a major expansion or reversion of the growth to the end of the U.S. economies. But rather, as we put here, a (pause) that will be very welcome in order to correct some of the balances that are observed.

Chinese iron ore imports reached 323 million tons in the last 12 months ended at October, just fresh data that we collected 23.4% growth rate. So, we don't believe that this trend will be reversing. We also don't believe that the Chinese domestic iron ore is a threat in our view, as we put there on the next slide.

The actual share of domestic iron ore in total, or iron ore consumption is declining. So it's far from (representing a check). But even for those players that are able to bring more capacity to the market as it is our case. And as (imports) aside that we ran there, shows that in 2006 we've estimated pig iron ore production of 400 million tons. And if next year (implied) iron ore demand would be 635 million tons, out of which 335 million roughly would be provided by foreign suppliers. And 300 million tons by domestic producers.

But considering what the grades that prevail there in China, we are talking about a ROM of -850 million tons per year, which is a major challenge, at least from a logistics point -- standpoint. Not to mention the cost.

And then associated with this domestic production of 300 million the total waste and tailings, we are talking 3.1 billion tons of removal of material that should be performed in order to produce that. This is just to give you an idea, Brucutu waste (strip) ratio is 0.4% -- 0 -- sorry, 40%. So for each ton, each ton of iron ore removed we have waste of around 400 kilos. So in this case, for each ton we are talking about 10 tons of waste and tailings. So it's a key difference, particularly if China consolidates its presence among the market oriented economists.

We expect the global iron ore market to stay tight for the near future, not only ourselves but CISA as well is saying the say, because they are forecasting 13% average growth rate for the Chinese steel production from 2006 to 2012.

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Middle East is something that you should also pay attention to, it's booming. And a lot of investments and, as we put there, the Gulf Cooperation Council countries that are Saudi Arabia, United Emirates. And Kuwait and Oman, Qatar and Bahrain, they are growing dramatically. And very good perspective.

And on the supply side, we believe that Indian Iron Ore, as reported before in previous presentations, Indian Iron Ore exports will also lose steam due to the requirements of its domestic steel industry.

Turning to our new business, Nickel, Nickel inventories are minimal and demand is growing strongly. And you see there that the perspectives for the market are very good. And we also expect this market to remain very tight for the next few years.

Global growth in Chinese investments, in stainless steel capacity, will continue to drive demand increase, on the demand side. There is no major change in the technology that could allow a reduction in the austenitic ratio, in the long term. So prices have a more structural nature actually. And there is also the demand coming from the (steel) from the non-stainless steel area, particularly aerospace, energy and batteries industries.

So it's a very good perspective from the demand standpoint. And the supply side is very much constrained by the technological challenges and very high CapEx cost, as you may appreciate, by our own projects and other competitors in this area.

We comment on Alumina, we -- in the past we have criticized by leaving a very small part of our alumina production in the spot market. Well, I believe that now we show that -- our point. In fact, with -- we have less around 5% of our production sold on the spot market. And this -- over the next couple of years, this will protect us against the volatility, associated with the action of the Chinese players in this market, particularly the alumina market. Whereby they are importing a lot of -- or an important amount of bauxite. And processing Alumina. And depressing alumina prices in the market. So, in this context our average contract prices, long term prices, are in the range of 12.5, 13 to 14%. And the current spot prices are around 9% of the (LME) price.

Copper inventories are critically low, as we put there. There are deficiencies in the concentrates and refined metal markets. And thus the result is historical -- historic records, in terms of prices. That should remain, in our view, reflecting this cost of this particular material, considering the very good perspectives of the world economy and China in particular. And the constraints, the constraints in the supply side.

So in summary, as reported the last slide and this is supported by econometric tests that we ran here the (inaudible), it is a very interesting exercise. Showing that, what we have been telling you (implicitly) and now supported by econometric test. It was (besides) the fact that there is no reversal to the meaning in the test that we ran for (several) materials, including Iron Ore. And Alumina, Copper and Nickel.

So, it means that what we have been saying about a (secular) change, a structural change in the level of relative prices of raw materials, is very likely to be the correct answer to

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what we have been observing in the last few years. So, there is much more value to capture from this very long cycle. There is a structural change that will, in our view, benefit the most efficient producers in the industry.

With that I will conclude my initial remarks. And myself Roberto Castello Branco and his team will be available for any question you may have. Thank you.

Questions And Answers

Operator

Thank you. (Operator Instructions) Our first question comes from Daniel Altman of Bear Stearns. Please go ahead.

Q - Daniel Altman {BIO 1855515 <GO>}

Thanks. And congratulations on the great results. Two questions, firstly related to Inco, can you maybe share with us when the shareholder vote will take place that will allow you to close out the merger between the two companies?

And secondly, on the Iron Ore business, the growth that you saw in China clearly next year in 2007, you are going to need to see, with the new volumes that you have coming on line, you are going to need to see another large incremental shipment to China.

I am just wondering if you have -- your idea of selling another 25 million tons or so next year, if you think most of that will go to China? And whether contracts are set up, or whether you plan to take further market share in some of your other traditional markets? Thanks.

A - Fabio Barbosa {BIO 1907620 <GO>}

Hey Daniel, thank you. On your first question we don't have a final date yet. There are some formal procedures that should be followed in the amalgamation process, the request for amalgamation that will require a general shareholders' meeting. So this process could take some two months or so. But we don't have a precise date yet.

In terms of volumes, we -- our expansions next year consider that we are going to produce some 300 million tons from 255 million roughly that we maybe produced in this year. And the bulk of this increase will come from the production of Brucutu that should reach 23 million tons, against 12 this year, then Carajas with 15 to 16 million tons more. So, -- and I would say that the majority of this increase, of this 35 million tons will be directed to the Chinese market, no doubt about it.

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Q - Daniel Altman {BIO 1855515 <GO>}

Okay, thanks very much.

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A - Fabio Barbosa {BIO 1907620 <GO>}

Thank you.

Operator

Thank you for your question Mr. Altman. Our next question comes from Mark Butler with Aberdeen Asset Management. Please go ahead.

Q - Mark Butler {BIO 18849583 <GO>}

Hi, I wonder if you can go through the reasoning behind selling the Usiminas shares at a discount, why you chose the 90 days prior to April 15? My calculations have around a 20% discount to the closing price on November 3, the day prior to the announcement.

A - Fabio Barbosa {BIO 1907620 <GO>}

Thank you, Mark. The negotiation of this transaction took place actually several months ago. And it also; it has to consider the condition by the time of the negotiation. And the prices that were prevailing at that time, the condition -- the fact that we were outside the controlling group. And we in a way, we are paying a price for the additional liquidity and in the position that we are getting within the controlling group. So I would say that there is a strategic and actual value embedded in this. And don't forget that we are going to sell the remaining shares that will not stay in the controlling group through a public offering. And that we will announce when it's ready.

Q - Mark Butler {BIO 18849583 <GO>}

Thank you.

A - Fabio Barbosa {BIO 1907620 <GO>}

Thank you.

Operator

(Operator Instructions) We do have a question from Sayan Ghosh of SAC Capital, please go ahead.

Q - Sayan Ghosh {BIO 3452097 <GO>}

Hi, could you give us an update of how the situation, with the possible take out of minorities and Inco Indonesia is progressing?

A - Fabio Barbosa {BIO 1907620 <GO>}

Well this is, as I mentioned before, we will proceed as per the procedure is established in the amalgamation process in Canada. So, this is a formal process that requires a shareholders' meeting. And that should take some -- a couple of months to be fully completed. So we believe that early next year, or late this year this process should be concluded, more likely to be early next year.

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Q - Sayan Ghosh {BIO 3452097 <GO>}

I thought this was more to do with the Regulator's decision in Indonesia rather than the shareholders meeting?

A - Fabio Barbosa {BIO 1907620 <GO>}

Oh, you mean Indonesia?

Q - Sayan Ghosh {BIO 3452097 <GO>}

Yes, Inco Indonesia.

A - Fabio Barbosa {BIO 1907620 <GO>}

No, no in Indonesia we are discussing with the authorities, what would be the procedure we -- as we do want to comply. And we will comply with the requirements of the Government there. So, apparently there is a conflict between -- in the Indonesian legislation that is being discussed. And we believe that we will come to a mutually satisfactory conclusion in a very short period of time, in our view.

Q - Sayan Ghosh {BIO 3452097 <GO>}

Okay, thanks.

A - Fabio Barbosa {BIO 1907620 <GO>}

Thank you.

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Operator

Thank you, Mr. Ghosh. Our next question comes from Edmo Chagas with UBS, please go ahead.

Q - Edmo Chagas {BIO 1786085 <GO>}

You say that you had about 15.2 million preferred shares in Treasury. And by July you had about the same number. So, I understand that for the course of the Third Quarter you (technical difficulty).

A - Fabio Barbosa {BIO 1907620 <GO>}

Sorry, I am not hearing.

Operator

Just one moment. Just one moment please. Mr. Chagas please continue.

Q - Edmo Chagas {BIO 1786085 <GO>}

Yes, hello Fabio.

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Operator

Yes, please continue with your question. Thank you.

A - Fabio Barbosa {BIO 1907620 <GO>}

Yes I am here.

Q - Edmo Chagas {BIO 1786085 <GO>}

Okay. My question is regarding your shares in Treasury, I understand that from the Second Quarter conference call (to date), that you did not acquire a more significant number of preferred shares. The part of your financing (inaudible) I'd just like to understand if you plan to sell part of those shares in Treasury? Or if you could do in any restructuring on the (voting shares) were you hold about 28.3 million shares, voting shares in Treasury as well, if they could be sold as part of the financing of the Inco acquisition?

A - Fabio Barbosa {BIO 1907620 <GO>}

Oh, Edmo we are not considering, at this moment, any operation with these characteristics, involving the shares which we have in our Treasury.

Q - Edmo Chagas {BIO 1786085 <GO>}

Okay.

A - Fabio Barbosa {BIO 1907620 <GO>}

Thank you.

Operator

This concludes today's question and answer question. Mr. Barbosa at this time you may proceed with your closing statements.

A - Fabio Barbosa {BIO 1907620 <GO>}

Okay, well thank you very much. And myself, Roberto and his team (inaudible) his team will be available for any other questions you may have during the next few days. Thank you, very much.

Operator

Thank you for attending this conference call. The call has ended you may now disconnect your lines. Thank you.

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