Q2 2007 Earnings Call

Company Participants

- Andre Gerdau Johannpeter, President and CEO
- Osvaldo Schirmer, Evp and cfo and director of ir

Other Participants

- Denis Parisien, Analyst
- Marcos Assumpcao, Analyst
- Victoria Santaella, Analyst

Presentation

Operator

Good afternoon, ladies and gentlemen. and thank you for standing by. At this time, we would like to welcome everyone to Gerdau's Second Quarter 2007 Results Conference Call. We would like to inform you that this event is recorded and all participants will be in a listen-only mode during the Company's presentation. Later, we will conduct a question and answer session. (Operator Instructions)

We would like to draw your attention to the fact that certain assessments that may be made during this conference call with regards to Gerdau businesses and its perspectives, projections and operating and financial objectives are mere forward-looking statements based on the expectations of management on the Company's future. Although the Company believes that its statements are based on reasonable assumptions, there can be no assurance that future events will not affect their accuracy.

Today, with us, we have Mr. Andre Gerdau Johannpeter, President and CEO; Mr. Osvaldo Schirmer, Executive VP and CFO and Director of Investor Relations. I would now like to turn the conference over to Mr. Andre Gerdau Johannpeter. Please you may go ahead, sir.

Andre Gerdau Johannpeter

Thank you. Good afternoon, ladies and gentlemen. Welcome to Second Quarter results conference call. It is good to be with you here again. This conference call can be followed on the Internet including a PowerPoint presentation. The second information is already available in our site at the CVM and the stock exchange. The Second Quarter results for the year in US. GAAP can also be accessed from the Gerdau website in the Investor Relation section.

We have today is our Executive Vice President from Finance and Controller's Office and Investor Relations Director Osvaldo Schirmer, who will be commenting later in more detail the quarter performance. Immediately following the presentation, we shall be available to answer questions from you.

I would like to start by pointing out some key aspects of steel industry and highlights of Gerdau's Second Quarter performance. Demand for steel product continued robust in the international market due to worldwide economic growth. According to IISI, demand in 2007 and 2008 should grow about 6% a year.

China is the leading one with forecast 13% growth in 2007 and 10% in 2008. The Middle East is expect to grow by 9% Central and South America apparent demand should grow about 6%, Europe similar levels as '06 and the NAFTA region we expect some slightly.

The world crude steel output grew 3.8% in the Second Quarter totaling about 332 million tons. China again is the leading one it production 7.6% which in 123 million tons in the Second Quarter.

From a cost point of view, there was across the broad increase we international prices for scrap going up strongly in the First Quarter and then decline in the Second Quarter. But volatility should continue. Iron ore prices were up 9.5% and Maritime freight costs remain high and this shows the strength of the economic in the international market around the world.

To go to page 3, on the presentation who are following on the internet. I will talk about Brazil the steel output in Brazil grow 4.2% to 8.3 million tons in the period and demand for steel products has been on the rise both in civil construction and industrial sector.

Because of these our domestic sales in Brazil increased by 9% quarter-on-quarter. Some of the factors contributing to that is the performance of lower interest rates, increasing personal incomes and economic growth.

Export has been holding at good level, we did scale back our shipments for export around 8.2% reductions to meet domestic demand in Brazil. Prices in the Brazilian market remain relative stable. We did a slight discount reduction that allowed us to callback some margin in the Second Quarter, which as helped to reduce cost pressures from leading raw materials a little bit. Looking ahead, we believe that domestic demand will continue to increase especially in civil construction and industrial sector, where we have our largest customers in Brazil.

Moving to page four in North America and US and Canada reduction was up 6.5% in the quarter in line with growth in regional demand and lower inputs. Demand for our products continued robust during the quarter and prices did oscillate a bit due to scrap changes in the prices. The metal spread should remain high over the next month.

In the case of Gerdau Ameristeel sales were up by 9% quarter-on-quarter due to anticipated buying in the First Quarter, when scrap prices were on the rise and there was only a partial as to across the steel products. Nevertheless operating margins improved a little, a reflection of the market condition and of our investment in improve operating efficiency, investment in infrastructure industrial and commercial construction, plus industrial demand has been fundamental to the good performance on the North American operation.

We are alert to recent advance in the US real estate and credit sectors and their impact on capital markets in order to anticipate their FX on our business as far as possible. The crisis in the residential construction business should have impact to our business, only a small part of our phase around 8% grow to the segment. From a medium to long term standpoint it is early to counter more precise even though seems to unclear how the crisis will affect or the factors in the US economy.

One important thing to notice is that in the Second Quarter the government still reach new agreement with the unions in the US and Canada. In April our Whitby in Canada, in May our Manitoba Mills in Canada and in July in Joliet Mill in Illinois. We still have two contracts open on going negotiation.

On Latin America the out put increased 1.5% on Second Quarter with respect for develop operation in Latin America. We consolidate three new companies in the first half SiderÃºrgica TultitlÃ¡n in Mexico, INCA in the Dominican Republic and SIZUCA, in Venezuela since June.

Sales were up 32.2% in the Second Quarter compared with the first, very much impact by the acquisition, without new operation sales posted 8.9% increase. Demand continues to be strong several countries in the region due to infrastructure investment and good demand from civil construction factor as well as reflecting economic growth in the region.

Moving to page 6. In Europe, Second Quarter output touch 54 million tons inline with First Quarter production. As we have already mentioned on other occasions, our business in Europe is geared to automotive sector.

In the Second Quarter, sales were off by 4% compared to the First Quarter due to the prolonged holidays in Spain. Looking forward, demand continues to intense and price are relatively stabilized. But at the high levels.

On page 7, I'll comment the Chaparral Steel acquisition agreement. The agreement was signed on July 10th. The transaction value is $4.2 billion. Chaparral is the second largest structural steel manufacture in North America and also a major bar producer. It operates two mini mills, one in Texas, one in Virginia. And Chaparral has an annual capacity of 2.5 million metric tons of crude steel.

The transaction is subject to approval of company's stockholders and the market regulators. The operation is expected to conclude by the end of the year. To settle the value of the operation, we are working on a financial structure, which will not weaken our balance sheet to any significant degree.

We are unable to provide further details since we are examining the optimum structure for Gerdau at this point. However, we can reveal that it will be made up of the following operation, an increasing Gerdau Ameristeel capital through a new share issue; term loan in favor of Gerdau Ameristeel; a bond issue by Gerdau S.A. contributing partially to the capital injection in Gerdau Ameristeel. And also available cash resources. So those are some of the alternatives we have.

Moving to page 8, I like to come back to the acquisition front. We have three acquisitions that were completed in the quarter. A total investment of $145, SIZUCA in Venezuela, INCA in Dominican Republic. And also Valley Placers, a fabricator in the US. Acquisitions of another four operations amounting to $420.3 billion, which are still pending as the joint venture in India with the Kalyani Group, the Trefusa joint company in Spain, DNR fabricator in the US. And again Chaparral Steel. The total investment in acquisitions amount to $4.7 billion in the semester. With Standard & Poor's investment grade rating Gerdau now has had a reclassification at two credit rating agents, the other one is Fitch.

On page 9, I will go over some of the investment in fixed assets, which totaled $327 million in the Second Quarter of '07 mainly was related to the expansion in the installed capacity of Ouro Branco Mill New blast furnace. And also the expansion in capacity of the melt shop at the new Jacksonville Florida. And also some other investment and improvements throughout operations in Brazil and overseas. Approximately $470 million was invested in the quarter including acquisitions of total of margin $1.1 billion in the year.

Page 10 the investment plan for the next three years. The plan is estimated at $4 billion acquisitions not included. Of this total 2.4 billion in Brazil and 1.6 billion abroad. The total amount to be invested about 40% will be allocated to maintenance and operational improvements and the remaining 60% for expanding installed capacity. This will take us from a total 20.1 million tons of crude steel capacity to 23.1 million, almost a 15% increase in the next two years.

On the rolled products, we will grow from 17.5 million tons to 19.3 million tons or an increase of 10%. This does not include Chaparral India joint venture.

Now I will go on page 11, the big picture for the highlights of the quarter. Our gross sales revenue was $7R.8 billion, which is a 4% increase from First Quarter. EBITDA of $1R.4 billion or a 4% increase from First Quarter. Our net profit of $856R million slight forward of 1.5% and sales of 4.1 million tons in line with what we did on the First Quarter.

This will end my presentation and now I ask Schirmer to comment on results in more detail. Thank you.

Osvaldo Schirmer {BIO 1754610 <GO>}

Good afternoon, everybody. In this section I will try to invite you, I will try to drive you through to the different regions, to take a good look on the margins and what have affected the margins, since Andre basically went over the major items of the balance sheet already in his explanation.

Let's start on chart or slide number 12, the Brazilian performance. Brazil as most of you know account for 40% of our physical sales, 41% of revenues, 50% of the EBITDA generation and 50% of net profit.

We as June 30, we have a gross margin of 34% and an EBITDA margin of 26%. What has affected them and basically I could say that the sales grew 2.4% in the quarter. The Brazilian market was up 9% and export dropped 8%. Important to observe certain level of stability around the 1.6 million ton in the last three quarters in terms of volume, which is in the upper part left side of your chart.

Increased of 8% in net sales revenue were driven by very good domestic demand. The revenues from exports were reduced due to the appreciation of the Real against the dollar. But basically compensated by the increase in international prices, which went up by 8% in the period or more than 8% in the period.

We also suffered in the quarter the increase in cost of scrap, iron ore, pig iron and even coal. They varied on average from 3% to 17%. So they impacted substantially the margin. We also suffered some sort of increase in general and administrative expenses, basically due to the recognition of PIS, PIS/COFINS taxes on interest on capital stock, when our subsidiaries through distributor or dividend up to Gerdau, lets say, in the last quarter, they did it through the payment of interest on capital stock. And this is taxable. And also the consolidation of new companies helped to increase this particular item of general and administrative expenses.

The gross margin presented a slight increase in the quarter. Higher domestic sales and smaller discounts. And some sort of price appreciation, we enjoy in the quarter helped to increase the margins. And it's important to notice that this trend of improvements in the margins is a clear trend in Brazil for the following quarter. The EBITDA margin decreased a little due to an increase in operational expenses caused by acquisitions, as I said and taxes.

Let's go to chart 13, the North American market. The North American market accounts for 42% of our physical sales, 41% of our revenue more than 34% of our EBITDA of cash generation and over 30% of profit. Again trying to explain the behavior of margins in this particular two quarters, I can say that sales fell 9% basically due to the anticipation of buying in the First Quarter.

In the First Quarter, the clients anticipate an increase in scrap prices ordered a lot. So we have that -- we have an increased in orders and sales. And shipments of course in the First Quarter about 28% higher than in the Fourth Quarter. So when we've got the Second Quarter, there was this reduction in shipment.

So we also had a reduction of around 6% in net sales revenue in this quarter again due to the lower ton chip. So the shipments were 9% lower. By shipping less, producing less, we have -- we had the lower dilution of fixed costs. And again so the same 9% affected the fixed cost dilution.

Price increases announced in the First Quarter they materialize and reflect in the Second Quarter. We have a 10% price increase in the quarter. So compensating EBITDA lower volume or more than compensated the lower volume effect. The metal spread, the industry is enjoying. And D&A in particular is enjoying spreads over $400 is really a mark with its outstanding position. By the way, we had $325 per ton spread in the previous quarter.

We also enjoying the Second Quarter they are falling -- they fall on the scrap price basically 10%. On average was a price reduction on the scrap. Another variable impact in the margins was the higher operational cost basically due to maintenance downtime. The operating cost was up 2% in the period.

We had better margins in the quarter. We move from 19.2 in the second to 19.5 in the Second Quarter from 19.2 in the first to 19.5 in the second sorry. And 17.5 to 17.8 in the second. What really important is to notice that if you take the last quarter December the gross margin was 14.5 in June it went up to 19.5.

The EBITDA margins went from 12.5% to more than 17% almost 18% in the Second Quarter.

Let's move to Latin America. Latin America accounts for basically or roughly 15% of our business and again that here is to explain the behavior of the margin. Basically, we had 32% growth in sales due to consolidation, due to acquisition as Andre already mentioned the plans. And we are still enjoying very good demand in the countries of the region.

Dilution of the fixed cost per ton help and also the higher volumes those acquisitions brought. So basically the volume sales increased more than 30% in the quarter. We also enjoyed higher prices for steel product on average in the whole region, about 5% increase in dollar terms in the region.

And the scrap prices in the regions they were stable. But at a very high level. And the gross margins went from 23 to 24, basically 23.9 and the EBITDA margin went from 18 to 17.8, was a reduction on EBITDA margin.

Important again is to see the improvement from the Fourth Quarter. In the Fourth Quarter, the gross margin was 21%, now is roughly 24%. And the EBITDA margin in the region was 14 now is over 18, an appreciation of 28% in EBITDA margin. And an appreciation of 24% in gross margin since the beginning of the year.

What happened in Europe? Europe is actually the -- the CorporaciÃ³n Sidenor basically. We had also very important improvement in margins and what we saw there in the Second Quarter, small decline in sales basically 4% less due to public holidays, Easter holidays the tradition in Europe. So we have a couple of days without production, without shipment and so on.

Prices of products they increased about 4% in the Peru in Real and above 10% in dollar terms. We also had high cost on our inputs. But the industry in our sales we were able to pass them onto prices.

The very strong demand in Europe for special -- for SBQs improved to, help to improve the margins. And very. And basically due to the automotive and the naval sector the demand our products. So if you take December margins, we had for gross margins 19% they went up to 22% in December and the EBITDA margin, which was 13%, in December went up to 19% in June.

On page 16, I will make a few comments on the performance on a consolidated basis. We had net sales growing 3.5% in the Second Quarter against the first in terms of physical sales they basically, where the same. But the average price went up over 3% in the Second Quarter against first.

The gross margins increased from 25 to 26. But I already made comments on that when I went by region by region.

Moving to selling expenses, we had an increase of about 12.5%. As I said, when I was talking about the region, very much due to the consolidation of new companies and also due to the increase in physical sales -- physical sales, which generated more selling expenses.

General and administrative expenses grew 10% and then again I have to refer to these tax PIS/COFINS on -- the interest paid on capital stock grows 325 million. And again the consolidation of new companies were important to justify this 10% grew in general and administrative expense.

More about financial expenses, financial expenses were positive 42 million and that was a consequence of few -- a few movements here. We paid interest in others about $227R million. And you enjoyed foreign exchange variation on -- on our investments of around 269 million. So this produce a positive $42R million.

In terms of financial revenues, our liquidity invested the net effect was about 153 million. We received interest from our investments about 180 million. And we have foreign exchange variation on our foreign receivables of 27, which net is 153 adding 153 net on the financial revenues to 42 million net on the financial expenses. We had a financial expense net positive of almost $200R million.

We didn't -- we didn't have -- we did have a negative equity pickup of 225 million in the quarter basically due to the impacts of appreciation of the Real against the dollar on our investments abroad. Every time the Real improves against the dollar, we receive negative equity pickup on our assets.

In terms of indebtedness which is showed to you on slide number 17. Our net debt was 3.7 billion in June, roughly $1.9 billion. It went up, when compared to March by 7%, almost 8%. We used our liquidity to pay the acquisitions in Venezuela and the Dominican Republic. The gross debt was 8.6 billion roughly $4.5 billion.

I should notice that more than 77% roughly 80% of that indebtedness is long-term debt. By the way our average debt maturity is over eight years now. The breakdown of gross debt, I could say that 32% of it is in domestic currency, 43% of it is foreign currency, denominated debt. And this was contracted by the companies in Brazil. And 24% in different currencies contracted by the companies overseas.

Liquidity, in terms of cash and equivalent, we had more than $5R billion in June, equivalent to $2.6 billion. 50% of it was in foreign currency index. Final words on our financial health, the debt ratios on June 30 were, net debt, over total capitalization of around 21%, gross debt over EBITDA about 1.6 times. And net debt to EBITDA 0.7. So roughly is more than -- slightly more than half of a year in terms of cash generation we pay our target.

With that said I open the floor for questions and Andre and myself will be available to answer your question. Thank you.

Questions And Answers

Operator

Thank you. The floor is now open for questions. (Operator Instructions) Our first question comes from Marcos Assumpcao of Merrill Lynch.

Q - Marcos Assumpcao {BIO 7474402 <GO>}

Good afternoon, Andre. Good afternoon, Schirmer. First my question is related to the domestic prices in Brazil. During the Second Quarter I believe that Gerdau reduced its -- some of its discounts to the local client. I would like to know what about the size of this reduction and if you have any still over effect to the Third Quarter from this deduction -- reduction in discounts?

A - Andre Gerdau Johannpeter

Marcos, this is Andre. Could you repeat, it's not clear the question?

Q - Marcos Assumpcao {BIO 7474402 <GO>}

Okay.

A - Andre Gerdau Johannpeter

The line was not good.

Q - Marcos Assumpcao {BIO 7474402 <GO>}

Okay. During the Second Quarter I believe that Gerdau reduced the domestic discounts for the sales -- internal sales in Brazil, okay. So I was --

A - Andre Gerdau Johannpeter

That's correct. Sorry interrupting you. Now I am clear. There was some sort of confusion. What was exactly your question? Our price increased due to the lower discounts were around 4% to 5%.

Q - Marcos Assumpcao {BIO 7474402 <GO>}

And I believe that this was not fully impacted during the Second Quarter right?

A - Andre Gerdau Johannpeter

No, because we did have some cost increases during the quarter you going to see them strongly more strongly reflected in the Third Quarter going forward.

Q - Marcos Assumpcao {BIO 7474402 <GO>}

Okay, perfect. And my second question is related to North American operations. I know that it's not it's only a 50% of the basis that I would to understand the EBITDA margin, it looks EBITDA margin and analysis, do you see that the margin in Latin America were the same as in the North America in the Second Quarter? I would like to understand this is the new turn for the region after the acquisition in Mexico, Dominican Republic and Venezuela because usually the South American and Latin American operations used to have a premium or a better margin than the US.

A - Andre Gerdau Johannpeter

As you can see we are not only expanding geographically in Latin America. But also incorporating profitable business. To take a reference this Peruvian operation has a great potential to grow in different market risk a much better profitable than we used to have. It has presented more than 30% increase in volumes also in terms of margin.

So we are very optimistic. You are saying and asking in the same time is the new trend in Latin America and also North America. Basically and I gave you some references what's going on in North America. Prices are stable the scrap is following, demand is strong, we are very little, we are not too much affected by the housing problem. Our focus is in the rest of the industry that consumes rebars, which is the construction of let's say shopping centers and all that.

By the way, Chaparral is going to help a lot in that because Chaparral is going to bring -- is going to add products with almost 10% or 10 basis points margin higher than the Ameristeel already has. So we will see a trend where North America will improve the margins. And Latin America is going to be counting on more market share and also profitability due to the mix of products based on the examples that I gave you.

Q - Marcos Assumpcao {BIO 7474402 <GO>}

Okay. Thank you very much.

Operator

Thank you. Our next question is coming from Victoria Santaella of Santander.

Q - Victoria Santaella {BIO 1521297 <GO>}

Hi. Osvaldo. Good morning. I have two questions. The first one is that you can't give me a better understanding on how prices have been trading in the Brazilian market for scrap especially, what are you seeing in the Third Quarter? And number two, (inaudible) showing increases into the domestic margin of 20% during the month of June, I am talking about long steel. And on the other hand, I see that that are sales volumes into the domestic markets did not increase at that same pace. Is there any specific reason for that?

A - Osvaldo Schirmer {BIO 1754610 <GO>}

Santaella, (Foreign Language). I am very sorry -- very sorry. I got the same question in the previous call. They took the Brazilian statistic provided by the Brazilian Institute of Steel on a broad term. What you should really take into consideration is that on June, we had an increase of 9.9% of long -- on long products and '07 over '06 is only 5%.

So it's basic, we are basically inline with the sector even though you are right, we didn't increase as much in the First Quarter. We had some stoppage in some of our mills. But in the Second Quarter, we strongly recuperated volumes and prices and margins as well. And this is going to be the trend for the third and very likely to the Fourth Quarter as well. So you are right in taking this observation but not as much -- not by 20% as you suggested.

Q - Victoria Santaella {BIO 1521297 <GO>}

Okay. Then you can give us some idea of how the scrap market is behaving in the Canadian market have you see a lot of tightness, you can give us some light on that although I would appreciate it?

A - Osvaldo Schirmer {BIO 1754610 <GO>}

Well I mentioned already in other conference again, is the -- the result conference today. We had some movement in this -- the price of scrap in the quarter about 8%. Talking to people in the front, we are anticipating a more stable environment in the Third Quarter. So we in Brazil are not expecting major moves in scrap. And in the US, thank god, scrap is falling.

Q - Victoria Santaella {BIO 1521297 <GO>}

Thank you. So much. (Foreign Language).

Operator

(Operator Instructions) Our next question is coming from Denis Parisien of Santander.

Q - Denis Parisien {BIO 20333702 <GO>}

Good afternoon, gentlemen. Congratulations on your results. I know, you can't give a lot of details. But I just want to check if I understood correctly that in the financing for Chaparral, there would be no debts issued at the Gerdau levels. They are only at the Ameristeel level. Thanks.

A - Andre Gerdau Johannpeter

No. Your understanding is not totally correct. The bulk of the investments is going to be raise at the G&A level for sure. But Gerdau Brazil very likely will be issuing a bond, a long-term bond let say, to fund part of the amount that will be required in the equity issue. So Gerdau intends to maintain its participation in its stake in G&A as a level it is today. So the amount required to follow that capital increase will be partially funded for present liquidity plus part of the money coming from our bond issue.

Q - Denis Parisien {BIO 20333702 <GO>}

And will that be an international bond or local debenture?

A - Andre Gerdau Johannpeter

An international bond.

Q - Denis Parisien {BIO 20333702 <GO>}

Thank you very much.

Operator

(Operator Instructions) This concludes the question-and-answer session. At this time, I would like to turn the floor back to Mr. Andre Gerdau Johannpeter for any closing remarks.

and you can follow that conference.

Assuming that there are no more questions, I do thank you for your interest and following us today. And now, I'll pass on to Andre for the last comments. Thank you.

A - Andre Gerdau Johannpeter

Thank you for your participation and interest in our conference call and I would like to invite you all, to be with us once again when we hold our next quarterly results conference call. Thank you. Good afternoon to all.

Operator

Thank you. This does conclude today's presentation. You may disconnect your lines at this time and have a wonderful day.