Q1 2019 Earnings Call

Company Participants

- Gustavo Werneck Da Cunha, Chief Executive Officer
- Harley Lorentz Scardoelli, Executive Vice President, Chief Financial Officer & IR Officer
- Unidentified Speaker

Other Participants

- Analyst
- Caio B. Ribeiro, Analyst
- Carlos De Alba, Analyst
- Daniel Sasson, Analyst
- Gustavo Allevato, Analyst
- Leonardo Correa, Analyst
- Milton Sullyvan, Analyst
- Petr Grishchenko, Analyst
- Thiago Augusto Ojea, Analyst
- Thiago K. Lofiego, Analyst

Presentation

Operator

Good afternoon, and welcome to Gerdau's conference call to discuss the results related to the first quarter 2019. (Operator Instructions)

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

Now I would like to give the floor to Mr. Gustavo Werneck. You may proceed, sir.

Gustavo Allevato {BIO 18933135 <GO>}

Good afternoon, everyone. As usual, I would like to begin by welcoming each one of you to Gerdau's earnings conference call to discuss the results for the first quarter 2019. Next to me is Scardoelli, our CFO and we're always pleased to talk to you about our performance and discuss and clarify questions you might have. I will initiate talking about our overall results in the quarter, and next Scardoelli will elaborate on the financial figures of the company. Next to that, I will talk about the outlook for the markets where we operate and also our investments. At the end, we will both be available to answer your questions.

Let's move to Slide 2 to initiate our conversation on the main highlights of the quarter. We came to the end of the first quarter 2019 keeping the good results we posted on the same period of 2018. Net income was BRL 443 million and a 5% EBITDA growth, mainly due to improved results coming from the North American operation that posted an EBITDA margin of 13.2%, and also lower SG&A. This is, therefore, the best EBITDA of the company in the first quarter in the last 12 months.

Now I would like to emphasize that we are confident that we did a great job regarding the divestment plan carried out along the last few years and concluded in 2018. Even with the sale of several operations, which accounted for a 23% reduction in shipments this quarter when compared to the same quarter of the previous year, we were able to grow EBITDA by 5% and EBITDA margin by 1.2 percentage points. This successful divestment plan, which economic value amounted to approximately BRL 7 billion resulted in a sharp reduction of our debt. When we look at the net debt over EBITDA ratio, that went from 2.7x to 1.8x when comparing first Q '19 to the same period of 2018.

In our North America BD, we posted a significant increase in EBITDA that more than double in the quarter vis-a-vis first Q '18. The good results reflect the full impact of the measures to boost local production as a result of Section 232 and the all-time high of metallic spreads. The value of the spread was influenced by higher prices in the region and high utilization of installed capacity. It's also worth mentioning our management efforts in this operation that include SG&A reduction and the acceleration of the cultural and digital transformation program.

On the other hand, steel consumption in the first 3 months of the year was mainly impacted by poor climate conditions in the U.S. and Canada impacted by heavy rains above historic levels that affected several of our markets.

In Brazil, I would like to stress that our shipments of finished goods had a good performance in the quarter. Flats and longs, that performed above-market average despite the weak performance of the economy in the period. It's worth mentioning that the 14.6% drop in shipments of flat steel in the domestic market in the quarter when compared to the same period of the previous year should not be interpreted as a like-for-like demand reduction as we reduced shipments of semi-finished goods available to the market. This quarter, we were more selective in relation to our shipments exported from our Brazil BD due to the drop in prices in the international market and the strong pressure from raw material costs, especially iron ore and coal.

In our Special Steels operation, we entered a cycle of recovery of margins after the renegotiation of contracts with our customers resulting from the significant cost pressure we experienced in 2018 in this operation that could not be immediately transferred to our products due to the market dynamics of part of our Special Steel business.

Now I'll give the floor to Scardoelli and will get back to you after that.

Harley Lorentz Scardoelli {BIO 7283603 <GO>}

Thank you, Gustavo, and good afternoon to you all. For those of you following us on the web, we are now on Slide #4 and I will talk about the results and the performance of the company in the first quarter of 2019. In consolidated terms, adjusted EBITDA in the first quarter of this year was BRL 1.6 billion and this, as Gustavo said, was the best result for this quarter in the last 11 years. Looking at the chart on the upper part of the slide, if we compare to the first Q of '18, we notice that adjusted EBITDA went from BRL 1.5 billion to BRL 1.6 billion in absolute values. This increase was mainly due to the enhanced performance in the North America BD and lower SG&A.

The significant improvement of the North America BD in the first quarter of '19 in relation to Q1 '18, as mentioned by Gustavo, was caused by the measures to stimulate production in the U.S. stemming from Section 232 and the all-time record of the metallic spread supported by favorable economic growth. So the 5% increase in consolidated EBITDA vis-a-vis the first quarter '18 even with the 23% reduction in shipments and in production volumes demonstrated the success of our divestment plan carried out in the last few years.

Also when you look at EBITDA per tonne sold, we achieve impressive levels. When we compare to BRL 373 in the same period of last year, meaning an increase of 33%.

I would also like to highlight that at the end of the quarterly earnings results that was published today, we posted the main figures and results net of the effects from the divestment program for the entire year of 2018 and broken down by quarter. This is done in order to help you in your modeling analysis.

Now moving to Slide 5. Adding to the previous slide, on the bridge chart, we see the evolution of EBITDA from Q1 '18 to Q1 '19 and we can see the increase of net sales per tonne sold and lower shipments in the period, all due to the deconsolidation of assets sold throughout 2018. This reflects the good momentum of the world steel industry combined with cost management efforts that we already talked about and also the simplification of the organizational structure consistent with the new governance introduced in the company in 2018. It also reflects a significant improvement of the North America BD that once again accounted for 30%, or even more than 30% of consolidated EBITDA in the first quarter of '19.

In terms of dividends, dividend payout in Q1 '19 will be BRL 0.07 per share to shareholders of Gerdau S.A. and BRL 0.04 per share to shareholders of Metalurgica Gerdau S.A.

Now I move to Slide 6, and I'll talk about the company's liquidity and debt position. Gross debt on March 31, 2019, was BRL 15 billion, down by BRL 1.7 billion in relation to March of last year, was mainly due to debt amortization in the period even considering the negative impact from the BRL depreciation of 17% vis-a-vis U.S. dollars, considering that great part of our debt is denominated in U.S. dollars. The strong reduction in the level of net debt over EBITDA ratio of 2.7x on March 31, 2018, to 1.8x March 31 of this year came as a consequence of the continuous improvement of EBITDA and the proceeds from the divestment program, focus on the financial deleveraging and optimization of the asset portfolio of the company.

The debt amortization schedule is well-balanced and also well-distributed along the next coming years with an average term of 7.2 years. It is also very important to mention the financial policy of the company already announced during our last earnings call with a mid- to long-term with a net debt over EBITDA ratio between 1 and 1.5x average tenure of the debt, no higher than 6 years and maximum gross debt of BRL 12 billion. It's also very important to say that the holding of Gerdau S.A. called Metalurgica Gerdau S.A. conducted this quarter the anticipated payment of BRL 400 million of debt through the sale of GGBR4 shares, which is an important step towards the full liquidation of its debt.

And finally, moving to Slide 7, we show our free cash flow in the first Q '19 where we see that EBITDA was sufficient to -- on our CapEx commitment, income tax and interest rates. However, with the use of BRL 1.2 billion of working capital stemming from the readjustment of inventories and increase of accounts receivables, free cash flow was negative by BRL 166 million, representing the usual seasonality very typical from the first quarter of every year that usually requires more working capital when compared to other quarters.

In addition to the seasonality, we rearranged our strategic inventory of products and inputs, mainly iron ore and slabs, aiming at preparing Ouro Branco Mill in Minas Gerais for the scheduled maintenance shutdown of the Blast Furnace 1 in the second half of 2019. All in all, management remains focused on generating positive free cash flow as we see because we managed to accomplish that by generating BRL 2.4 billion in the last 12 months.

Thank you for your attention, and now I'll turn the floor back to Gustavo.

Gustavo Werneck Da Cunha {BIO 20318216 <GO>}

Thank you, Scardoelli. Now I would like to move to Slide #8 where we will talk about the outlook looking forward. We remain very optimistic in relation to the main markets we operate, mainly Brazil and the U.S. According the most recent figures for this year published by the World Steel Association, global steel demand should experience moderate growth of 1.3% over 2018 to 1.735 billion tonnes driven by the rebound of investments in developed countries and the enhanced performance from emerging economies. Also despite a scenario of commercial tensions and a possible deceleration of steel consumption in China, that should increase by only 1% in 2019.

In Brazil, despite the fact that the steel consuming sectors posted a lower-than-expected performance in the first quarter, below expected particularly in the industrial segment, we believe in an effective rebound of the economy throughout the year.

According to data from Instituto Aco Brasil, it's estimated that the apparent consumption of steel in the country should grow 4.6% in 2019, jumping to 22 million tonnes, driven by the recovery of the industry and civil construction sectors. The number was reviewed in line with the GDP projections for Brazil this year pointing to a growth of 1.49% against the previous forecast of 2.5% growth according to the Focus report from the Central Bank.

I would also like to mention the strong performance of the retail segment in the quarter, and I'm referring to self construction in low income housing that was captured by over 75 branches of Commercial Gerdau located throughout the country and the growth of our new company Juntos Somos Mais, launched in the last quarter of 2018. It is the largest national loyalty program of the retail market for civil construction. And today, it has approximately 45,000 stores and 135,000 registered professionals. Moreover, preliminary results publicized by several developers indicate a solid growth of real estate launches and sales early this year, something that makes us all very optimistic in relation to the rebound of civil construction activities.

However, as I said in previous presentations, Brazil's sustainable growth depends on the solution of the tax crisis in the country that necessarily involves the pension fund reform. We are monitoring the issue closely and remain optimistic in relation to the reform approval by the Constitution and Justice Commission of the lower house and the developments of the debate of the social commission in the past weeks.

In that regard, I would like to reinforce the important participation of the group called (inaudible) or industry coalition that gathers 11 productive sectors of the country, including steel around a debate with the government to discuss measures to minimize red tape and boost competitiveness of the Brazilian industry.

I always like to recall that from within the walls of the plant, the production cost of Brazilian steel is very competitive, but this changes completely when we look beyond the walls of our plants because of the tax burden, infrastructure issues and financial costs. That's why we advocate in favor of correcting all competitive asymmetries.

Well, in terms of our operation in North America, we believe that the U.S. economy would continue to grow with estimates around 2.3% of GDP according to data from the IMF. In the meantime, consumption of longs in the country should remain flat with the expectation of a reaction from the civil construction market since demands from infrastructure and nonresidential construction markets remain high. One of the figures we monitor closely in the U.S. in the construction market is an indicator called CPI PNR that is projecting a 2.4% growth in 2019 reinforcing our expectation for increased demand in the construction market.

Now looking at our Special Steel operations in Brazil, we believe the automotive industry, our main market, should recover during the year. More recently, we launched a layoff program in the Pindamonhangaba and Mogi das Cruzes mills due to the recent moves of the Brazilian automobile industry. Main consumers of Special Steels, which decided to grant collective vacations and reduced their inventories, mainly due to the economic crisis in Argentina. It is worth mentioning that the Brazilian automotive industry exported 42% less to Argentina this quarter when compared to the same period of the previous year. But despite the drop of 0.6% in vehicle production in the first Q, sales to the domestic market were up more than 11.4% according to ANFAVEA. This sign of recovery makes us optimistic with market performance looking forward. In addition, we believe that the wind power industry has a positive perspective.

In that regard, we are prepared to cater to the growth in Brazilian demand with products manufactured at Gerdau Summit, a plant located in Pindamonhangaba.

As for the U.S. market, we expect the demand for Special Steels to remain at high levels. The production of heavy trucks continues to grow this first half and the segments of agricultural machinery (inaudible) product should also keep the strong performance and strong growth of last year. On the other hand, the oil and gas industry should present some recovery started in the second half of the year.

In terms of the other countries in South America, the outlook is for economic growth in the region, especially in Peru and Colombia, those with estimates of GDP growth above 3% in 2019. Argentina continues to merit attention in South America with the forecast of stagnation in the economy and uncertainties due to the next coming presidential elections scheduled for October.

Now let's jump to the next slide, Slide 9, and talk about our investments. In the first 3 months of 2019, Gerdau invested BRL 305 million in fixed assets, CapEx being BRL 191 million in general maintenance, BRL 37 million in the maintenance of Ouro Branco and BRL 77 million in expansion and technological update. This amount is part of our CapEx program of BRL 7.1 billion for a period of 3 years announced earlier this year.

For 2019, our CapEx investment plan contemplates BRL 2.2 billion. In this program of BRL 7 billion, BRL 2.4 billion refers to investments in expansion and technological updating, of which most of it refers to capacity increase.

All investments in the category comply with a criteria of a minimum rate of return of 15% a year and they will be made insofar as the expectations for market growth and free cash flow generation for the period are confirmed.

I would now like to reinforce the investment of BRL 532 million in the Special Steel unit of Pindamonhangaba is already underway with the start of the civil works and equipment purchases. In addition, inventory from ACEA began in anticipation of the shutdown of the Blast Furnace 1 of Ouro Branco in the second half of the year as previously announced.

To conclude, and moving to the next slide, I would like to clearly state that our focus for 2019 is on safety in the workplace, generating value to our customers, profitability in all our operations, positive free cash flow and continuous investments in innovation as part of our business strategy. We are already partnering with Manchester University in the U.K. to develop advanced applications in steel and other materials like graphene. Manchester

University is one of the largest innovation hubs of the West and this agreement is another example of the important work we've been developing in our center for innovation in advanced materials that we call NIMA.

As part of this project, in the second half of the year, we will have an office in Manchester very similar to the one we inaugurated in the Silicon Valley at the end of last year. The purpose is to prospect new businesses, conduct research and also offer innovative solutions to our customers.

Also I would like to say that we believe that the value -- that valuing diversity in our company has been an important leverage of performance and innovation. We are making progress and working diligently so that all of our employees are committed to promoting equality, thus creating a more inclusive culture, their respects and values diversity. This initiative strengthens our commitment to promote the development of society aligned to Gerdau's purpose to empower people who build the future.

To conclude, I want once again to thank our employees for their dedication in this challenging first months of the year and also our customers and shareholders for their trust.

We now conclude the presentation and move to the Q&A session.

Questions And Answers

Operator

(Operator Instructions) Our first question comes from Daniel Sasson from Itau. You may proceed.

Q - Daniel Sasson {BIO 19234542 <GO>}

Hello. Thank you very much for taking my question and Congratulations on your results. My first question refers to the U.S. We know that enhanced margins came from an all-time high metallic spreads and also the divestment of assets that you've conducted recently. Could you please elaborate on how metal spread levels are today, I mean, in the first quarter? And whether there is any further space for further cost reductions? And what would be a sustainable EBITDA margin in the U.S. BD from now on? Could we expect further improvements, something like 14% to 15%? And my second question relates to Brazil.

We saw a 6% decline quarter-on-quarter of prices in the domestic market. Could you please elaborate and tell me a little bit more about what happened and whether there is any impact of lower sales of iron ore and slabs and maybe you decided to hold on to sales for the availability of market in the domestic market? And also whether you see any more room for further price increases in the Mexican market in the second quarter?

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

Daniel, this is Gustavo. I will start with the U.S. and metallic spreads. In fact, in the first 3 months, we saw high figures, high amounts, historically speaking, for the metallic spread. It's about $500, but this margin for metallic spread should be maintained in the second quarter. Now about the possibility of reducing costs, that's still a possibility. As we said, last year, we -- what we did in that operation, we are reducing unnecessary costs and we haven't yet factored in the entire cost reduction program. We may see still higher costs in the second quarter. So we do not believe that the EBITDA margin should evolve further in the second and third quarters. But in terms of what we were able to do in the first quarter, I think it's absolutely possible.

Now in terms of Brazil, especially in relation to the drop in net revenue, it's important to remember that net revenue into the domestic market consists of the revenue from the sale of steel and also revenues from the sale of iron ore. The total revenue for steel production should have some changes in relation to a reduction in the sale of ore. More particularly, in the fourth quarter of last year, we had about 650,000 tonnes of ore, but in the first quarter of '19, there was 250,000 tonnes. Basically, because we maintain the inventory of strategic ore in our mills to be more comfortable and to be able to go through the current momentum. If we disregard that ore, our prices should be more flat in the second quarter.

Now in terms of the possibility of any price increases in the second quarter, even though consumption is low, we see lower costs of scrap prices. And we're looking at imports for longs and flats, there it's negative. But in the next few months, we will have to see whether the scenario will be more favorable to price increases.

Operator

Next question from Leonardo Correa from BTG Pactual. Please go ahead.

Q - Leonardo Correa {BIO 16441222 <GO>}

Thank you.My first point, Werneck, still talking about Brazil and still talking about demand and how you see the evolution in the -- into the second quarter, I think it's very clear and all businessmen in Brazil are waiting for a stronger recovery in the second quarter. But looking at the second quarter, particularly with this base, which is higher, the market expected EBITDA of BRL 1.4 billion in the fourth quarter and you went beyond that number.

So now the question that remains is, I know, of course, you can answer in qualitative ways, but what about the evolution of the second quarter to you and whether you can make improvement? And in general, what kind of improvement should be expected? I think that there is an attempt to tamper with prices or maybe volume in Brazil. You already said that you expect a constant margin in the U.S. So with all of these variables, how do they -- how should they behave in the second quarter even before we talk about the second half of the year?

And in addition, I have a question to Harley. The quarter is a bit polluted in regards to working capital. And when we look at the cash conversion cycle, the number is now 83 days. So it's clearly very different than the average, which has been around 75 days. So I just want to hear from you what could be expected in the coming quarters considering that you still have to do some inventory rearrangements to accommodate also Minas. And so how can this working capital behave in the following quarters?

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

In regards to the question on Brazil, in this current business environment in Brazil, the second quarter should be very similar to what we saw in the first quarter. But traditionally, we have seasonality in the first quarter, that's why the second quarter should be better than the first. But when we compare first Q of this year with first Q of last year, there -- steel sales in Brazil in first Q of '19 was over 400,000 tonnes, which was in keeping with the numbers from the first Q of last year, especially in the new Gerdau, we were able to make advances in retail. And so the segment has reflected the strategy adopted in the last quarters, especially from Commercial Gerdau. And we are seeing the different behavior from retail when compared to previous years. Therefore, I think we may evolve in terms of our volumes.

In general, for the second quarter, in Brazil, we do not see major advances in the economy or even a move towards increasing demand. And in the second half of the year, after the approval of the reforms, we may see a more positive landscape.

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

This is Harley, and I will now answer your question on working capital. The fact is that you have to factor in the seasonality of the first quarter. And in this quarter, it was an enhanced effect due to several effects. One is the shutdown of Ouro Branco when we are replenishing our inventory to be able to cope with the demand from the market and there is also the fact that we had to work to maintain our strategic inventory to keep our operation at adequate levels.

If we look at the first quarter of last year, we also consumed CapEx of around BRL 400,000. So in a way, it is justified. There is only one -- there's another thing that I would like to say, which is very important. If you look at inventory in accounts receivable, the bulk of it comes from accounts receivable. Our average term of receivable is just 30 days, and when we run a comparison quarter-on-quarter, we are comparing our December to March.

December is usually a very weak month because there are many holidays, collective vacation and Christmas holidays. So it is difficult to run an equal comparison, a like-for-like comparison, it's clear. Maybe, I would just add like to add something to your question. In terms of cash conversion cycle, we have about 86 days, but once again, as we still have a very positive outlook for the next quarters, our outlook for the cash conversion cycle is to resume the levels of what we had in the past 70 to 75 days.

Q - Leonardo Correa {BIO 16441222 <GO>}

It's clear, Harley. If you allow me, I know we got a lot of questions this morning about the accounting changes. Many companies reported on accounting changes. I mean, all companies reported on changes. I would just like to hear from you whether there is anything that is worth knowing about this change to IFRS 16. I don't know, could you tell us whether anything changed that would merit our attention?

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

In fact, we started to apply this new norm in the mid of last year. We didn't abandon our final results, but there was an impact on the EBITDA, but this was not a heavy impact. It was around BRL 50 million in the quarter. If we consider and we said that at the end of our quarterly results that the effect of divestments last year was around BRL 74 million. So one thing offsets the other. Therefore, the comparison is valid, quarter-on-quarter. But in fact, we posted BRL 50 million in the quarter and things may be different from now on.

Operator

Our next question is from Thiago Lofiego from Bradesco BBI. Please go ahead.

Q - Thiago K. Lofiego {BIO 16359318 <GO>}

Good afternoon and thank you.Could you please revisit your North America BD. You said that there isn't a lot of room for margin improvement. But looking at the last 2 quarters with positive seasonality on volumes, the metallic spread may not change that much.

And considering all the work you're doing in your U.S. operation, I just want to understand how come you don't see an upside on that 13% margin now towards the second quarter? So what's different here. My second question is on mining. After the request to expand iron ore in the (inaudible) Valley, how much should you increase production?

And along the same lines, whether you already started doing something in the upstream dam and what would you expect in terms of third parties and iron exports from Gerdau this year?

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

Thiago, in terms of the U.S., as I said, we had high metallic spreads when compared to the past few years. I think this high numbers for metallic spread should remain in the next quarters. In terms of third parties, there is a possibility of expand that number. With high spreads, there may be investments coming from civil construction and if we are capable of deploying our action plans in a consistent fashion in the months looking forward, we may post further growth. But the -- when we look at our planning, the comparison is difficult to do.

In North America, even though GDP growth is about 2%, general steel demand in the U.S. when compared to last year should remain flat. In the first quarter of this year, more specifically, sales in general in the U.S. were a bit lower, around 5% in general, particularly because of the very heavy winter and heavy rains that affected most regions. In terms of our planning, we believe that next quarters in the U.S. should be very similar to what we experienced in this first quarter.

Now in terms of Brazil, I would just like to say that more recently, we submitted to local authorities a request to expand our mine and the the purpose of that is not even to increase production or to grow organic production. So it's part of our strategic plan. Since last year, we just want to increase the supply of iron ore to our own production. Some ore mines have been explored for some time. We just want to expand that area in order to increase supply. We may open a new mining deposit to increase our consumption by 1 million. So in Ouro Branco that should occur in about 5 to 6 years.

Now about the other dams. There are 2 dams, 2 ore dams; one is Bocaina, more recently. We already have all the documentation for that dam. The dam is dry and is totally decommissioned. There is another dam called (inaudible) that it's an upstream mining dam, 1.5 million cubic meters. And at the moment, we are designing a project that in the next 24 months, we may decharacterize that dam and we should introduce other processes.

I just want to add another detail. Recently on March 12, we received a favorable opinion about that dam. So the dam today is totally complying to current legislation. It's been monitored complying -- following the legislation and we already received the approval from the regulating agencies.

Q - Thiago K. Lofiego {BIO 16359318 <GO>}

Can you give me a production estimate for ore this year? Or it's still too soon to tell?

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

Thiago, it's difficult to give you figures on production. We are very conservative in terms of the volumes due to the volatile scenario. So we are still looking at the issue so that we will have a more comfortable year. We buy pellets from historic suppliers and that is to improve our raw material. So in that regards, we have been working with Instituto Aco Brasil and other agencies to sort that problem out.

Operator

Our next question from Thiago Ojea from Goldman Sachs. Please go ahead.

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

Thank you and good afternoon.I would like to revisit the margins for Brazil. And if you could comment on the fact that we saw a reduction in the scrap cost, it was almost BRL 1,100 earlier this year and today, we see some traders trading at below BRL 800. So this reduction in scrap prices combined with price increases that you announced for early April, do you think this should increase margins in the second quarter in Brazil?

And so given that possible margin expansion, how could that be -- how could you -- how could that be offset by the shutdown in Ouro Branco in the second quarter? And my second question is whether you could comment on that margin increase in South America. We saw a good expansion of about more than 20%. What was the reason behind that, and what should we expect in the second quarter in relation to South America?

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

Thiago, first of all, scrap prices have been following for some time. We start buying scrap at lower prices and it goes to our inventory, and it does not reflect in price formation. So we believe that in the second quarter in terms of cost, in general production cost, our production cost will be better when compared to the first Q. In a scenario of low demand, we will be able to only grow margins if we -- what we see in the second quarter is still a market moving sideways, but we still have to wait and see whether there is room for growth in Brazil.

In terms of imports, we are having negative import premium. We notice that imports have -- import premium have achieved the 2 negative digits on the other hand, with a reduction in scrap prices and low demand. There are some difficulties, therefore, we have to wait and see what will happen in June to see whether we will be able to improve production and enhance our margins in the second quarter. When we look at the margins of the Brazil BD as a whole, we are looking at export margins. If we look at the figures, we are still discounting 30% of the Brazilian production when we compare prices last year to today, prices are lower.

It is a unique situation. The shutdown that is forecast for June is for 70 days, so we will shut down in July and August. And we have an inventory of rebars 378 tonnes probably will be put in inventory until July. This is assuming possible margin growth expected for the second quarter. I will give the floor to Scardoelli who will tell you a little bit about margins in South America.

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

Good afternoon, Thiago. In relation to South America, what we see is that margins will be like we had now. If we look -- well, another aspect to be considered is that here we consolidate (inaudible) it's consumed as EBITDA and does not affect our revenue. For example, if you look 4Q and first Q, we had better results. There was only an effect on the margin of the fourth Q.

Another aspect is SG&A. So things improved and this had an effect. And as the operation is large, there is an effect that is carried over to -- for us to reach that margin. That level is more normalized for that operation.

Operator

Next question from Caio Ribeiro from Credit Suisse. Please go ahead.

Q - Caio B. Ribeiro {BIO 18420483 <GO>}

Good afternoon everyone.My first question is about prices of longs in the U.S. We've heard some news referring to recent price discounts. And I know you said that you expect a relatively flat margin in the second quarter, but I just want to hear from you whether these discounts could hamper the results in the quarter or you see a decline in scrap offsetting by that? And secondly, about Special Steels segment. Even though this segment had an increase in margins quarter-on-quarter, is this margin still below the margin that you have delivered in the past few years?

Can you please elaborate on the main reasons behind this price margin and how do you see cost pressure? And whether you see any factor that could probably lead us to a recovery in the next quarter?

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

Caio, this is Gustavo. About the U.S., this is exactly what you said. Currently, there is a one-off price reduction in some product lines like being in commercial profiles. And this has been driven by scrap production. When I say that we will have a reduction in spreads, so as you have price reductions at the same time, you see an important reduction in the procurement of scrap. And in the U.S., this is very much related to exports into

Turkey. In terms of Special Steels, I was saying, Caio, that due to the dynamic of that market that involves long-term contracts, there are also large cost operations even upwards and downwards. And this is felt in the margins in the following quarters because in long-term contracts, we cannot transfer that variations immediately. So last year, there was a significant cost pressure, especially of scrap, electrodes and metallic alloys and that cost pressure put pressure on the margins.

And as we said last year, there is an expectation of those resuming margins as of the first quarter of this year. If we could transfer prices into the new contracts in the first quarter, we will be able to see the rebound of the margins. And as the contracts are maturing and impacting our revenues, we will see a growth in margin in the next coming quarters.

Operator

Next question from Gustavo Allevato from Santander Bank. Please go ahead.

Q - Gustavo Allevato {BIO 18933135 <GO>}

Good afternoon.I have 2 questions. The first relates to the supply cost of pellets. And you mentioned the difficulty of obtaining the product. Does that involve additional transportation cost in Brazil and whether this is impacting you and other players or other vendors? And the second question relates to working capital, especially in terms of accounts receivable. How do you see the financial health of your customers giving a more challenging scenario internally?

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

Gustavo, to answer your first question on the pellets, basically, is the kind of ore that we've been buying in the market in the past few years. In our 2 blast furnaces of Ouro Branco, we can produce steel without pellets. So if we do not find pellets in the market, we can continue to produce. Pellets can help us to increase productivity. We are now looking at volumes of pellets, logistic costs, productivity of the blast furnace and export prices. We're running a calculation that will allow us to find an appropriate balance for the Ouro Branco Mill.

So in terms of the continuity of the operations of Ouro Branco, the pellets are not that significant, but certainly the pellets allow us to increase productivity, especially when we increase the production of the 2 blast furnaces. I will now turn the floor to Harley to talk about working capital, delinquency and other topics.

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

Gustavo, in terms of working capital and accounts receivable, it has to do with the revenues that I mentioned before when you compare December to March. In terms of financial health of our customers, this is very much under control. Delinquency is below 10% and much lower when compared to other years like 2015, '16 and '17. So delinquency has declined and we do not see any major problem with our customers.

Operator

Next question comes from (inaudible) from Bank of America. Please go ahead.

Q - Analyst

Good afternoon.I just have a follow-up about Brazil. Harley or Werneck, if you could tell me a bit more about demand and your price attempt in the first and second quarter, how much were you able to increase? You said that you have a negative parity. So what is the main issue for you to transfer that even with parity at the current levels?

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

Let me tell you a bit about the figures of the first quarter. We thought and we anticipated demand growth for Brazil in the first quarter when compared to last Q of last year, but that did materialize. Now when you compare first Q of '18 to '19, sales in Brazil were very much the same. I mean, for flats, there was some growth and it's been growing since last year in the first quarter. There was a growth of about 1% and longs was down by 2.5%.

Longs also caters to some subsegments. There is nothing in infrastructure taking place in Brazil right now. The deliveries are very low. Commercial or non-residential construction is still slow. But I'm sure that we will see growing volumes in the second quarter because of the construction. Even though construction does not consume as much, it still continues to grow. But when you put everything in the same basket, the numbers were down by 1.4% when compared to the first quarter of last year.

We do not give details about that, but we hope to optimize our margins considering a scenario of low demand and repressed economy. So if you ask me whether we see a momentum to increase prices in the next few months, I would say, yes, even though we are pursuing our commercial policy.

Operator

Our next question is in English from Carlos De Alba. Please go ahead.

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

Thank you very much.I Apologies if this question has been asked before. But in terms of working capital, do you still see a negative impact in the second quarter as you get probably for that repair for the shutdown of Ouro Branco in the third quarter? Or we saw the most significant and negative contribution to cash flow -- to cash from operations this year from higher inventories, particularly. And then second, coming back to the question about import parity, I'm surprised to hear that it is as high as you suggested of double-digit. Could you provide a little bit more details as to whether these double-digit discount is across the board or are there a couple of specific products that are dragging or influencing these big discounts?

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

Carlos, your 2 questions about working capital, I will give the floor to Scardoelli to give you further information about that.

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

Hey, you're asking us whether in the second quarter, there is any projection in terms of increased consumption of working capital because of the shutdown in Ouro Branco. We are currently forming our inventory of about 350,000 tonnes especially of plate so that we can cope with market demand during the shutdown. Most part of that inventory is being generated through our own production. We are buying 15% of that inventory in the domestic market. So that inventory that is produced in-house, we already have a lot of things in stock. So the bulk of cash consumption will be in the second quarter because of the shutdown of Ouro Branco. And could you repeat the question?

A - Unidentified Speaker

About the second part of Carlos' question, he referred to a premium in the Brazilian market and whether there was any split of products.

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

In fact, yes, there is. We see a plant close to 0 when it comes to the production of longs. This has been positive some time ago. And in the case of flats, it's negative. Negative between minus 8 or 10%. So, in fact, when we said minus 10, it's 0 for longs, and there was a 10% discount for the flat line.

Operator

Our next question in English from Petr Grishchenko. Please go ahead.

Q - Petr Grishchenko {BIO 19084897 <GO>}

Good afternoon. Thanks for taking my questions.I guess, just speaking on North America given it's been a sweet spot in the quarter, can you maybe talk a little bit more about your realized price dynamics? I listened to the conference calls of your competitors and they cited slightly different dynamics, basically steel prices coming off hard and pulling spreads lower, given scrap did not decrease as significantly. So I'm just wondering what do you think is the difference and also, I'm wondering how far of a lag we should expect for the second quarter?

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

Petr's question was about the spread dynamics in the U.S. market. Some other players are referring to a higher price decline in terms of scrap prices. In our market, what we are seeing right now are declines in prices and scrap prices because of the metal spread. Metal spread is still very strong. It's close to $500 per short tonne. And some months ago, it was slightly higher than that, but it's still very robust and very strong, that's what we're saying. And the expectation looking forward is to increase those levels in a short run.

Operator

Our next question in English is from (inaudible) Bradesco. Please go ahead.

Q - Analyst

My. Thanks for the call.Could we just have an update on your plan to reduce gross debt to BRL 12 billion, just what the timing is and if that's going to be funded just with cash flow generation or do you think more asset sales could be in the pipeline? And then just related to that, what part of the capital structure do you think you'll target for the debt reduction? Should we expect working capital financing lines to come down, maybe not be rolled or do you think you'd look at some of the bond maturities and possibly liability management?

A - Unidentified Speaker

His question has to do with our financial policy and that figure of BRL 12 billion what would be the timing for us to remain at that level. And to arrive at that level, what time of financial instruments we would use, whether we would look at issuance of bonus or other credit lines, et cetera.

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

We don't have a fixed period of time to reach that. But if I can give you an idea on how to calculate that, all of our generation of free cash flow is geared towards payment of debt. And historically, we've been generating something around $500 million, $600 million a year. That difference from BRL 15 billion to BRL 12 billion. So you can run an approximate calculation depending on your -- our expectation to generate free cash flow and when we get there. So this is our -- these are the assumptions, but I would say mid- to long-term. So when are we going to reduce our debt? 60% to 70% of our debt is still based on issuance of bonds in the international market. So possibly, at some point in the future, we may work again with debt management or the replacement of syndicated debt or debt with the banking market. But there will be a reduction further on.

Operator

Our next question from Milton Sullyvan from XP Asset Management. Please go ahead.

Q - Milton Sullyvan {BIO 19085202 <GO>}

How are you. Thank you for the questions.My first question is about export volumes in Brazil. We -- when I breakdown that volume between flats and longs, longs volume was relatively strong even similar to the volumes we had in the beginning of 2018 when prices were more robust. So what is the level that should be expected looking forward? And at the same time, we saw more stability due to a drop in the volume of exports of flats. Is that due to the inventory formation of Ouro Branco, and so what should we expect looking forward and what do you intend to have as total volume of exports for the year?

And going back to working capital, and I do apologize for revisiting that topic once again, I do understand the issue of seasonality. But if I look at the number of days looking year-on-year, we still notice that the main impact of bringing working capital in the quarter was both in the receivables line and even in the supplier's line, there was also an impact. So could you tell me what was behind that? And given the fact that you do not intend to bring cash and working capital this year, I would just like to get a better understanding of what is behind it.

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

In terms of your first question, in fact the share of longs in exports increased because we are exporting less to have inventory in Ouro Branco. The second quarter position should be similar to that of the first and the second quarter we will have the shutdown of Ouro Branco. And then after that, we should resume normal levels when it comes to exports and that would be -- I can tell you more towards the fourth quarter. Now in relation to working capital, you're right.

We call the attention to accounts receivable because it was the most important factor, but there was also a reduction in the suppliers line if we compare this quarter to the end of the last year. And we had a level of activities in December that was recovered in March. This is one aspect. Another aspect refers to the suppliers and inventory. We make an adjustment. So sometimes the effect is a bit lower. The number in a way is the same in total is about BRL 1.2 billion. There is also some exchange variation, but we make adjustments for foreign exchange. So from 670, that number goes to 920. So the level is about the same, but the vendor effect goes from 170 to 110. So the bulk of that related to accounts receivable.

But in terms of cash environment, we want to maintain our inventory position and we continue to believe that throughout the year, we will be able to resume our normal levels of the cash conversion cycle to 75 days. We could even go below 70 days, this is feasible. But because of the inventory formation of Ouro Branco, we want to leave that prediction for the forecast for later on. But for the year, working capital shouldn't be a very significant item in our cash position.

Operator

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

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

I would like to thank you very much for joining us. It's always a pleasure to talk to you. Also I would like to invite you all to join us again in our next quarterly results related to the second quarter 2019 that will take place on August 7. Thank you very much, and have a very good day.

Operator

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