Q1 2004 Earnings Call

Company Participants

- Osvaldo Schrimer, Financial Exec VP & IR Director

Other Participants

- Daniel Altman, Analyst
- Edmo Chagas, Analyst
- Evanso Dow, Analyst
- Jennifer Corou, Analyst
- Jorge Beristan, Analyst

Presentation

Operator

Good afternoon, ladies and gentlemen and welcome to the conference call for Gerdau. Thank you for standing by. At this time all participants are in a listen only mode. Later we will conduct a question and answer session and instructions to participate will be given at that time. If you should require assistance during the call, please press the star key followed by zero.

I would now like to turn the conference over to Mr. Osvaldo Schrimer, Executive Vice President and Investor Relations Director. Please go ahead sir.

Osvaldo Schrimer

Good afternoon, ladies and gentlemen. Welcome to our First Quarter conference call. We have just released this morning our First Quarter 2004 results. The release is already available at our website.

The First Quarter was characterized by a turning point in the company's international operation. This was followed by a lesser. But nonetheless important, recovery in domestic demand which throughout 2003 fell by about 13%. This turning around had been expected to happen sometime in the second semester last year. But it was held back mostly due to a sharp increase in the prices of raw materials in the last quarter of 2003.

With the increase in the prices in international markets the steel industry in North America was able to finally adjust sales prices above those of inputs throughout the quarter. In doing so it consistently recovered spread, which in the period exceeded the best mark in the last 10 years.

Actually, this quarter we witnessed a combination of factors that led to the sustainability of results that are being disclosed today. I am referring to the effort the company has made to implement a series of measures aiming at increasing efficiency and utilization of capacity in the different units that we operate.

In North America this effort combined with a recovery of spreads produced positive results in all its steel plants with no exception since February.

In other geographies, such as the South Cone where results presented by our operations have been positive. This quarter showed significant improvement in shipment given the strong recovery of the economies of Chile and Argentina in prices, spreads and cash generation. Average EBITDA per ton, for instance, in the quarter was 70% greater than that of last year.

In international trade the Brazilian based units increased exports by 8.6% when compared to the same period in 2003. Although this does not represent a significant increase in tonnage, the average price charged in the period were 27% higher than those of the First Quarter of the previous year and generated revenues 42% greater than those obtained through March of 2003.

On the Brazilian operations, the quarter's performance as measured by revenues, was 25% greater than that of the same period in 2003. Once again exports made an important contribution to these revenues as indicated above.

In consolidated terms the First Quarter presented a net profit of R$427m, 48.7% above that of the same period in 2003. It is worth mentioning that the net margins went to 10.2% from 8.6% in the period. There was a slight reduction however, when comparing this figure with the net margin of the last quarter due to a more than 20% fiscal credit benefit added to the net profit in that period.

Please note that in historical terms a net margin of 10.2% is very close to the best margins the group has every produced.

Where operating cash generation â€“ EBITDA â€“ is concerned, the First Quarter produced about R$900m, an increase over 25% compared to the same period last year and 44% when compared to that of last quarter 2003.

A reduction in SG&A of 16% in the First Quarter this year versus the Fourth Quarter last year was an important factor in the results presented. Based on the quarter's results the two Brazilian based public companies will be paying interest on capital stock equivalent to dividends on May 18th. Shareholders of Metalurgia Gerdau will be paid R$45.4 million (R$1.10) per share and shareholders of Gerdau SA R$94.4 million or R$0.64 per share.

Since we have mentioned results so far, I would like to mention that both Gerdau SA and Gerdau Ameristeel are now disclosing their financials according to US GAAP standards.

Investment in the quarter totaled $77m. Of this total, 67% were invested in Brazilian based companies and 33% in the companies abroad.

It is important to note that Gerdau decided to capitalize its subsidiary Gerdau Ameristeel in April with $100m, with the intention to enhance the capital structure of that company and provide the conditions to accelerate its industrial plant modernization program.

There was also a $25 million injection in the form of a loan from a Brazilian bank with the parent company's guarantee at a lower cost than the company's average cost in the US. This operation envisaged the reduction of financial expenses by allowing the anticipation of payment of more expensive debt.

For this year the scheduled investment program remains at the original level; $350m.

With regards to financial commitments, net debt at the end of the quarter was R$5.2b, 12% smaller than that of March 2003. We highlight the fact that the lengthening of the debt profile last year made the consolidated short-term debt exposure be reduced in half. With this action 65% of the investments is now long-term. In March, debt in the Brazilian currency was of R$900 million with a nominal cost of 14% per annum. Indebtedness in foreign currency in Brazil was of R$2.8 billion and had a cost of 5.4% per annum plus foreign exchange variation.

Companies abroad had an indebtedness of $2.7 billion and the cost was 6.3% per year.

Another topic we would like to address and which is relevant to shareholders and investors is the increase in the liquidity of our shares. In the last few quarters both Metalurgia Gerdau and Gerdau SA have presented significant improvement in their liquidity or in the liquidity of its shares.

In the quarter the financial volume traded with Metalurgia Gerdau shares increased 352% when compared with the First Quarter of 2003. Gerdau SA increased liquidity by 274%. Together these companies traded R$1.7b, about $600 million in the quarter, compared to $130 million in the same period last year. Therefore the average daily financial volume of Metalurgia Gerdau shares increased to R$6.2 million â€" about $2 million â€" in the First Quarter of 2004, up from $500,000 in the First Quarter 2003.

At Gerdau SA this liquidity increase is even more impressive. It grew from R$5.3 million (equivalent to $1.6m) per day, to roughly $7 million per day. This same upward movement can be verified with the Gerdau SA ADRs traded at the New York Stock Exchange. The financial volume traded reached $221 million in the First Quarter, 610% more than in the same period last year. The daily average surpassed $500,000, reaching $3.6 million a day when comparing quarter against quarter.

It is worth mentioning that with the goal of improving the stock base of the company and the access to these shares, the Board has submitted to the appreciation of the shareholders in the Shareholders' Meeting to be held tomorrow and Friday, a proposal to give a stock dividend of 100% over Gerdau SA shares and 30% at Metalurgia Gerdau SA. In addition to this, there will be a 70% stock split at Metalurgia Gerdau.

To finalize we would like to give you some insight on our perception of our business in the following quarters. In North America in relation to prices and volumes the steel industry counts on the maintenance of prices for at least one more quarter in spite of the reduction in the cost of the main inputs and due to the strong recovery of the economy throughout the year.

Imports. Due to the weakening of the US currency, international price, high international prices and very expensive transportation costs we expect to see imports staying at the current low levels.

Operating costs. With the higher degree of utilization of the installed capacity in the mills and a reduction in the price of steel scrap, these costs tend to go down as a result in part of lower yield loss costs.

In Brazil. Demand in the domestic market. for this fiscal year we maintain the expectation that it should grow about 12% as we have already mentioned.

Exports. Volumes are slightly lower in some types of steel products. But with international prices quite high they should continue to contribute strongly to revenues.

Input prices. Tendency to decline. But we do not eliminate the possibility that they may increase again by year's end.

Foreign exchange variation. We maintain the expectation that it should stay in line with inflation.

Interest rates. We maintain our conviction that there is room for additional reductions in interest rates.

In the South Cone. Perspectives look positive for all three countries in which we operate in spite of all the fragility that the Argentinean debt negotiation suggests, the country's economy is showing a strong rebound. It may also be affected by the energy crisis, especially gas. But given the great contribution made by the agricultural industrial segment, several factors should be able to maintain the tendency toward growth. Among them, the civil construction.

Uruguay is also reviewing all of its statistics and forecasting growth above 6% for 2004.

As for Chile, the most stable country among the three, the expectations are of GDP growth above 5% and demand for steel products absolutely in the growth mode.

Having said, we now open the Q&A session.

Questions And Answers

Operator

(Operator Instructions) Our first question comes from Mr. (Evanso Dow)(ph.) from Credit Suisse First Boston.

Q - Evanso Dow

Hi gentlemen. good afternoon. My question is giving the improvement in EBITDA margins for the Brazilian operations to around 31% how much of this could be explained by an improvement of the mix towards the industrial segment, which carries additional margin and how much could be attributed to the reduction of the discount broadly in the long steel prices?

A - Osvaldo Schrimer

Yes, you are absolutely right. There was no major price increases. But we have worked painlessly) in general maybe I could say having worked in the (use) and the discounts. So it's a combination of both. When you have the industry, or even the agri industry sector absorbing larger quantities of steel, this really contemplates a richer mix of products in more value added components. So you are right. It is a combination of price reductions and enriched mix that caused the improvement in margins.

Q - Evanso Dow

Was it about just a 50/50 of that improvement, or it was more concentrated on the mix rather than--?

A - Osvaldo Schrimer

No, there is only the mix.

Q - Evanso Dow

What would be a reasonable level of EBITDA margin going forward? Do you see room for an increase in that EBITDA margin if you can get price increases going forward? Or do you expect some additional costs in the Second Quarter, or in the second half 2004 that could make the margin in Brazil stabilize at around 31%? What would be your guess?

A - Osvaldo Schrimer

I think this margin level is sufficiently good. I would be really counting on extensive improvements on that. I hope we can maintain this. I don't have stronger reasons to credit any major event, nevertheless if we accept the possibility that international prices of raw materials continue to go down, they may cause a positive impact on the raw materials in Brazil as well improving by this reason the local margins.

But this movement normally does not happen alone. So prices will come to adjust as well. So I would rather, just for projection purposes which probably in your case, I wouldn't count on substantial improvement on those margins.

Q - Evanso Dow

Okay. Thank you. Very helpful. Thanks.

Operator

Our next question comes from Mr. Daniel Altman with Bear Stearns.

Q - Daniel Altman {BIO 1855515 <GO>}

Hi Osvaldo and congratulations on a great quarter. A couple of questions for you. First of all the shipment level that we saw in the First Quarter, would you say that you're running now at pretty close to full capacity, or was there anything you maybe shipping, difficulty to ship, that would have made your number be a little bit less than what we could expect on a going forward basis?

Then the second question is if you can walk us through the decision making process you increasing your stake at Ameristeel. Was that something that you did voluntarily, or was it something that had to be done in order to support them? When you made that decision was it based on the very strong EBITDA numbers in the First Quarter? Or was this irrespective of what their financials looked like?

A - Osvaldo Schrimer

I'm glad you raised your question because I remember reading your comments and criticisms when we decided to make that capital injection. I'll go back to the point. As far as utilization of capacity, I referred in a previous interview today that we are working with around 95% in North American operations. Really you are dealing with capacity to service higher demand. In Brazil in some products we are roughly very close to that as well.

So the trend is that you are going to continue enjoying that sort of utilization of capacity. It is also worth mentioning that as you make investments as we have made so far, we tend to pick up some additional capacity by the simple fact of improving and enhancing the operation.

Vis-Ã -vis your point and criticism, I remember reading your note when we decided to make that investment if it was based on the anticipation of a strong quarter of what. Let me tell you that when we made that decision at the beginning of the quarter we didn't know for sure that the quarter would develop in the way it developed. So the companies were still facing strong, not very strong, unfavorable raw material prices and potential trend towards higher prices for raw materials. We were absolutely conscious that we should invest more in the Capex in those operations and at the same time it was necessary to send a strong message to the market that the parent company was really standing behind that subsidiary. So was not really sure that we would have a strong quarter ahead of us. But we made that decision. We made it based on this two-fold; sending a message and enhancing the capacity of that operation to continue investing in Capex to modernize and to gain efficiency in the operation.

Q - Daniel Altman {BIO 1855515 <GO>}

So would you I guess still part of my question, knowing what we know now about Ameristeel do you still think it was necessary for you to inject another $100 million into that company?

A - Osvaldo Schrimer

Additional to that $100 million we already. You say it was the same $100 million we already did?

Q - Daniel Altman {BIO 1855515 <GO>}

Yes. No, this recent injection do you still think that that was a necessary thing to do given the--?

A - Osvaldo Schrimer

No doubt it is less than necessary absolutely because when we made the decision we were not counting on that strong cash flow generation so far in Q1. Assuming that we are going to be repeating this strong quarter this quarter and the following quarter would be even less necessary. But I think we did this thing at the right moment. It was good for the operation. It was good for the management. It was good for the suppliers. Even good for the bankers. So we don't regret having that. It is less necessary now than it was before.

Q - Daniel Altman {BIO 1855515 <GO>}

Okay. Thanks very much.

Operator

Our next question Mr. Jorge Beristan from Deutsche Bank.

Q - Jorge Beristan

Hello Osvaldo. I think you raised an important point about how quick and rapid this recovery was in Gerdau North America. In January you were unsure and by February March then the sort of very strong month over month churn. My concern is with all the news we're hearing out of China right now with the government clamping down on the steel industry and it is going to affect the imports of steel, how quickly do you think that this steel can return to the US market and start pressuring down price? Because you did mention right now freight rates are high but they're also a function of the fact that China is importing a lot. I mean could this volume very easily ricochet back across to grow instead of impacting the, as you said, the very good cash margin that you guys are generating in the US?

A - Osvaldo Schrimer

Somehow I mentioned in my voluntary speech at the beginning that we are anticipating low level of imports for the following quarter based two fold again; on the weak currency, high international prices. Even though we agree with that the demand coming from China is slowing down. The Central Government of China is even kind of recommending they slow down in the economy. But talking to our sales people and people that are currently in the front, they believe that this demand will pick up again sometime throughout the quarter â€" the following quarter. So we are not expecting, with your expression the great flow of steel from the world going back to the US. At least not until June.

Q - Jorge Beristan

Okay. It seems like really the bulk of your strong quarter-over-quarter improvement in EBITDA aside from the nice target of (inaudible) and Gerdau North America was all price driven and whether there is a lot of (audio fault). You did announce I think a couple of weeks ago your intention to sort of raise prices in Brazil. Can you try to tell us how far you are into that price hike cycle? In other words, could we expect any further price improvement or do you think you're fully priced down right now in the Brazilian market?

A - Osvaldo Schrimer

The line is somehow not clear. But you're talking about price increases in Brazil you said?

Q - Jorge Beristan

Yes.

A - Osvaldo Schrimer

Okay. Well again I had a chance to answer a question this morning regarding the future. What was said is that so far the long steel industry has been kind of moderate in terms of price increases. But the overall scenario high prices of important imports such as alloys and others, international prices are also very high and strong demand may create conditions for further price increases in the Brazilian market. But we are not in a position to say when and to what extent the prices are going to be corrected upward throughout the quarter. But very likely it will happen.

Q - Jorge Beristan

From what I understand you have a kind of agreement now with Carde that you have to basically state we intend to raise prices. I can't remember what the number was. I think it was around 10 double digits, 10% or something. You are now pitching 15%.

A - Osvaldo Schrimer

Yes.

Q - Jorge Beristan

So of that initial announcement, how much would you say you have achieved so far if you had those increases?

A - Osvaldo Schrimer

The point is that there are indications that the industry is supposed to send to the Carde. That is not mathematical. It is not even said exactly when they are going to implement and exercise. But the point is that currently the industry in Brazil was practically in crisis. Much lower than international prices. Those companies in charge of exporting somehow sacrificing a little bit of their margins in order to benefit the local consumers, which by the way is our priority market and Gerdau is absolutely in line with that (company). But you are right, there is room. There is even prices announced formally to Carde that we intend to practice some time throughout the quarter.

Q - Jorge Beristan

Thank you.

Operator

Our next question comes from Mr. Evanso Dow from Credit Suisse First Boston:

Q - Evanso Dow

Regarding forward constraints that Gerdau I believe could now face this quarter. In my view that could be the most responsible for the decline in exports. How is the current status of the Board right now because Gerdau is still facing a constraint trying to ship steel for exports or this is kind of being settled out right now?

A - Osvaldo Schrimer

We have long-term contracts with carriers within what you call them, freight forward and so on. But to some extent we are in the same boat as the rest of the industry. In some occasions, in some months, in some shipments we did better than the average based on those long-term contracts and the proximity in the location of our mills closer to the port and so on. But I would put us in the same overall picture as the rest of the industry. As the demand reduces a little bit, or the pressure is on the vessels, on the carriers also. As you probably noted the freight costs are even reducing right now. We are counting on lower costs for freight, which is a reflection of less pressure and things are smoothing and improving.

But I wouldn't eliminate the possibility of facing it again in the near future.

Q - Evanso Dow

Okay. But it is correct to assume that most of that decline came from the port constraints rather than decrease in export demands?

A - Osvaldo Schrimer

Absolutely, yes. Also if you have in the First Quarter less working days, less shipping days, you have carnival, you have at Brazil difficulty created by the authorities on strikes. So if you put them altogether there is an explanation for most of the reduction in the First Quarter.

Q - Evanso Dow

Okay. All right. Thank you, very much.

Operator

(Operator Instructions) We have a question from Mr. Edmo Chagas with UBS.

Q - Edmo Chagas {BIO 1786085 <GO>}

Hi Osvaldo. Regarding your financial strategy you have said that (you have planned) around $350 million in your Capex and you also comment that you are doing some of the projects that not yet approved. Could be approved in the future like the expansion of Acominas and new mill in SÃ£o Paulo. Do you have any kind of changes in targets regarding your financial view in the future due to your new investments and also is that -- the beginning of the quarter of investing in Ameristeel directly rather than keeping the debt level at the company?

A - Osvaldo Schrimer

Like what? Issuing debt or issuing equity?

Q - Edmo Chagas {BIO 1786085 <GO>}

Yes, increasing the levels to another say parameter or issuing equity in the future just to go ahead with your investments?

A - Osvaldo Schrimer

Basically I could say that given the level of cash flow generation this current operation is able to generate, if you take the First Quarter as a proxy. I'm not making any projection. We are talking about in excess of $1.2 billion in EBITDA generation. So it's a very comfortable situation to face with $500 million or even less than that investment program, even though we are talking about $350m. So we are not considering or contemplating any major movement toward the capital markets in terms of equity issuing or additional debt.

What I said also this morning to another interviewer was that we intend to finance, or refinance, the short-term maturities using (audio fault) coming from exports. We are pretty close to our $1 billion exports this year. So we're going to have plenty of chances to finance at very low cost even though short-term maturities based on those instruments.

Q - Edmo Chagas {BIO 1786085 <GO>}

Okay. Thank you.

Operator

(Operator Instructions) Our next question comes from Miss Jennifer Corou from Smith Barney.

Q - Jennifer Corou

Hi. I just have a couple of questions.

A - Osvaldo Schrimer

Hello Jennifer. I think we have been cut off.

Q - Jennifer Corou

(Audio fault).

A - Osvaldo Schrimer

Hello.

Q - Jennifer Corou

Hello.

A - Osvaldo Schrimer

Can you repeat your question because I think we were almost cut off? Would you mind repeating Jennifer?

Q - Jennifer Corou

Sure. I wanted to just get an idea of the level of the surcharge here (audio fault).

A - Osvaldo Schrimer

Well basically what we did -- I am not sure if you are still talking because the line is really not good. But I think I understood you. You're trying to understand how much surcharge we have placed on our products. Basically we didn't practice surcharges. There was another competitor already leading the market introducing that sort of cost to basically follow the trend in the market and they have been replaced by price increases recently. But there was more than $100 of surcharges placed on the products through all the quarters.

Are you still there? I think you were cut off. Hello. The line is off. Hello. Operator.

Operator

(Operator Instructions)

A - Osvaldo Schrimer

Operator, can you hear me?

Operator

Yes sir.

A - Osvaldo Schrimer

I am not sure if the lady was still on the line or she wasn't.

Operator

No she was not.

A - Osvaldo Schrimer

There was a problem. Hello.

Operator

(Operator Instructions)

A - Osvaldo Schrimer

Okay, if there are no more questions.

Operator

Excuse me.

A - Osvaldo Schrimer

There are some questions?

Operator

Yes. We have a question from Jorge Beristan from Deutsche Bank.

A - Osvaldo Schrimer

Okay. Sorry.

Q - Jorge Beristan

Sorry. If I could have a follow up. I have also been having phone problems cutting in and out. It was just regarding your comment, I think I caught something about you said you're not giving an official projection but something to the effect of the potential producing up to $1.2 billion of EBITDA this year. Why would you say we did not see any quarter-over-quarter reduction in net debt despite the fact (audio fault) in your US dollar net debt?

A - Osvaldo Schrimer

Well again I think the problem is persisting. I only heard half of your question. You were talking about improvements?

Q - Jorge Beristan

Yes, quarter-over-quarter why did we not see a reduction in Gerdau's net debt in dollar terms?

A - Osvaldo Schrimer

We have reductions as you probably saw year-over-year. But not quarter-over-quarter. We haven't done any formally or spontaneous in prepaying debt or so forth until we see more stability on the flows in (Q1). But as I already had a chance to mention in another interview, Gerdau's philosophy has to comply with the tax program for the year, reserving the money for the dividends and so on is the objective to reduce debt. But at the same time it is worth mentioning that our level of investment in relation to the ability to generate cash and so on is very profitable. We are about 2.8 times debt over EBITDA. So it is roughly comfortable. So I insist in not making projections of how much we're going to be reducing. But we may reduce even further assuming that those investments I mentioned are totally covered.

Q - Jorge Beristan

Okay. Thank you.

Operator

(Operator Instructions)

A - Osvaldo Schrimer

Okay now I think it is over. If you are still listening to me since we have had problems with the phone lines, we are always available to continue this Q&A on an independent call if you desire.

Okay, thank you again for your interest in our conference call. I hope to be with you next quarter and also able to disclose good results. Good afternoon, to all of you. Bye Bye.

Operator

This concludes Gerdau's conference for today. Thank you, very much for your participation. Have a good day. Thank you.