Q2 2018 Earnings Call

Company Participants

- Eduardo de Salles Bartolomeo, Executive Director, Base Metals
- Fabio Schvartsman, Chief Executive Officer
- Luciano Siani Pires, Chief Financial Officer
- Peter Poppinga, Executive Director-Ferrous Minerals and Coal

Other Participants

- Alexander Hacking, Analyst
- Alfonso Salazar, Analyst
- Aman Surendra Budhwar, Analyst
- Carlos F. De Alba, Analyst
- Grant Sporre, Analyst
- Gustavo Henrique Gregori, Analyst
- John C. Tumazos, Analyst
- Jonathan Brandt, Analyst
- Marcos Assumpção, Analyst
- Thiago Lofiego, Analyst
- Tyler Broda, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. Welcome to Vale's Conference Call to discuss 2Q 2018 Results. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions will be given at that time. As a reminder, this conference is being recorded and the recording will be available on the company's website at vale.com at the Investors link. This conference call and the slide presentation are being transmitted via Internet as well, also through the company's website.

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

With us today are Mr. Fabio Schvartsman, President and CEO; Mr. Luciano Siani Pires, CFO; Mr. Peter Poppinga, Executive Director, Ferrous Minerals and Coal; Mr. Eduardo Bartolomeo, Executive Director, Base Metals; Mr. Luiz Eduardo Osorio, Executive Director, Sustainability and Institutional Relations; Mr. Alexandre Pereira, Executive Director, Business Support; Mr. Alexandre D'Ambrosio, General Counsel; and Ms. Marina Quental, Director of People.

First, Mr. Fabio Schvartsman will proceed to the presentation, and after that, we will open for questions-and-answers. It is now my pleasure to turn the call over to Mr. Fabio Schvartsman. Sir, you may now begin.

Fabio Schvartsman {BIO 2067677 <GO>}

Thank you. Good morning to all. It is a special pleasure to have you in this call, this quarter call. This quarter is actually a very special one for us, the management of Vale, the reason being not only because we had predicted but good results in the quarter, but the quality of these results was very good as I'm going to explain in a second. And it is also very important for us to see several aspects of our strategy illustrated during the quarter.

First of all, these results that we achieved was achieved even with the reduction in the iron ore and pellets price that went down $9 in average in comparison to last quarter. And in spite of the truckers drive strike that basically stopped the whole country for several days. And Vale, in this circumstance, was able to beat records in production of iron ore and sales of iron ore, therefore, showing our great flexibility. Meanwhile, the reason why we overcome the price reduction in the pellets is, because the price realization of Vale has increased by $7 in this quarter.

I would like to emphasize as well the fact that we are thinking cost long-term and we are thinking – short-term and long-term as well. Long-term, in this case, we're talking about this recent announcement of 48 new ships that will be built for utilization of Vale, and most importantly, they will represent a reduction in freight for Vale of $5 per ton in comparison to the average of freight of Vale as of today.

But the most special thing that I would like to emphasize, to put light on is capital allocation. We achieved the indebtedness that we were looking for close to $10 billion of net debt by the end of the quarter, and this give us the opportunity to start a number of movements that demonstrate very clearly how Vale is treating that allocation.

First, we transform allow the investment – potential of investment in Voisey's Bay into a highly profitable one through streaming of cobalt, and this emphasize the fact that we are open to business if we can find investments that are very accretive as this was the case.

Secondly, we had started our dividend payment, according to our new policy. For the first time we are going to pay a little more than $2 billion next September regarding the results of this semester, therefore a very good achievement for the company.

And finally, we're presenting the trust that the company will remain performing and delivering when we are announcing a buyback program of $1 billion, that represents our decision to invest in stock of the company, that it is by far the best asset with the company lows, and with that we can buy, buy it without a premium in the market.

So, this is a very quick summary of what has happened in the semester. So, now I'm going to pass to Luciano that he will give a more clear view of how the operation went in the last quarter.

Luciano Siani Pires {BIO 15951848 <GO>}

Good morning, everyone. I would like to start by addressing iron ore C1 cash costs, you saw the very steep depreciation of the business we had in the quarter, and one would expect given the exposure of Vale to the Brazilian real, C1 cash costs should come down – should have come down by about $1 per ton. And why it didn't happen?

Four factors are non-recurring on the second quarter and should not be present in the third quarter. And in addition with the volume dilution that underpins our forecasts that we are going to be substantially distinctively below $30 per ton in the third quarter already.

Talking about those four factors, two of them are directly related to the truck driver's strike, as Mr. Schvartsman mentioned, $0.30 per ton was a direct effect of the increase in cost because of the way we dealt with the strike, and the list of things that we made at increased costs, another $0.30 per ton were cost because of the lack of feed for direct reduction pellets, in our pelletizing plants, so we had to reschedule some of the ships, and we paid the mortgage for that, and the lack of feed came from the lack of inputs for our processing plants, which could not produce then the necessary feeding, the necessary quality to feed our direct reductions on our pellet lake (08:02) so the merge (08:04) cost about $0.30 per ton. Then, there are maintenance costs, which were typical in the second quarter, which is the quarter in which we prepare Vale's operations for the tremendous growth in volume that usually happen in the third quarter and fourth quarter. So, there's a $0.30 increase in maintenance costs that should come down as well.

And finally, now that we have more inventories along the chain, it takes longer for reduced production costs to flow through the cost of goods sold. So, that's another $0.30 per ton of carryover from the higher costs of the first quarter towards the second quarter. So, in the third quarter, in the absence of all of these effects, costs should be because of this $1 per ton lower and because of volume dilution that we expect 9% to 10% increase in volumes over the third quarter and not $1 per ton at least reduced. And then we'll see if the exchange rate will continue to provide – as of today, the exchange rate is higher than the average for the second quarter.

Base Metals costs and coal, certainly you'll have the opportunity to discuss with my colleagues. So, let me jump to expenses, I always talk about the pre-operating expenses. They came this quarter at $67 million and my point here is that they should be approaching zero very soon by the end of the year, because as well as indeed (09:30) pre-operating expenses should come down to zero. Pellets, pre-operating expenses should come down to zero, given the restart of our pellet plants. The three pellets plants that come back in 2018 and also the Mariana operations. We had maintenance cost because of the conveyor belt that was damaged and now it's coming back as well. So, this is an expense line which should come to zero.

R&D expenses increased that is expected from a first quarter. However, would like to underscore the quality of the R&D expenses. The part of it goes toward digital transformation program which will bring results very soon. And part of it is exploration expenditure especially in the Carajás region, especially to generate and to accelerate the growth options in the quarter in the region. So, this is still to bring good news also soon.

Financial expenses also compared to a year ago are decreasing by about 30%. This is the side effect of the reduction in indebtedness and obviously we also expect those expenses to come down substantially over the next quarters as we retire more debt. I'm sure you'll notice also investments coming at a very low number $705 million. This shows our commitment to capital discipline. Obviously, it is going to go up especially sustaining investments given the approval of for example Voisey's Bay mine extension, but this is a testimony to our commitment and you should look forward over the next few years to very well-behaved capital expenditures.

Finally, on cash flows, conversion of EBITDA into cash was very good without any detractors, there was $200 million equivalent buildup in inventories as you saw given the sales lower than production, so nothing remarkable except the good conversion.

Net debt, significant decrease, in the third quarter we are expecting a smaller decrease because most of the cash flow generated in the third quarter will be funding the dividend payment in September, but still we will approach even more the $10 billion net investments and if prices stay where they are, we should then and depending on the – how the buyback growth, we should pierce the $10 billion target in the fourth quarter and therefore then, we will get in discussions of what to do with this additional excess cash.

The dividend we are declaring $2.05 billion represents 53% of underlying earnings, and this is what we expected. So though we had a policy based on EBITDA, our expectation that this is going to be the range of income payout ratio going forward.

Having said that we should jump into Q&A straight forward.

Q&A

Operator

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

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

Good afternoon, everyone. Thank you for taking the question and congrats on the very strong dividend and share buyback. So the question has to do with Samarco, if you – maybe, Fabio could give us an update as to what are the latest developments for the operations to come back and start producing?

And also particularly, if there is any advancement – any progress on the conversations with BHP to potentially – one of the two companies becoming the sole owner of Samarco and if, this is still an – a possibility and Vale ends up with Samarco with 100% of Samarco, how would the consolidation of Samarco's debt affect the $10 billion net debt target and the possibility to pay more dividends in the next year?

And then the second, the second question that I have has to do with the, with the increase in cost that we saw in VNC? Could you comment a little bit on what we should expect for the remainder of the year and 2019, your that operation have been delivering quite a good performance with a positive trend, there seems to have been a hiccup last quarter, but I just would like to see if it is something relatively temporary or we should factor in higher cost for little bit longer? Thank you.

A - Fabio Schvartsman {BIO 2067677 <GO>}

Carlos, thank you for your questions. Regarding Samarco, we would like to emphasize that we had pretty good progress recently regarding the legal actions against the company and the shareholders of the company. That has eliminated a cloud over the business that helps for the possibility of starting up again the operation of Samarco. So we are now more than ever 100% focused in bringing Samarco back on stream.

For the sequence of your question regarding BHP, I have to tell you that it is of much importance for Vale and I guess for BHP this issue right now. We are 100% focused in what can be done in order to speed up the return of Samarco. And even if and when a deal regarding BHP and Vale will be made or the point that has to be understood, there is no business benefit here. So here the purpose is solely on the benefit of returning Samarco, so that's the way of Vale is looking into it. And then pretty sure is the same way that BHP is looking into it. So, unfortunately, it's less of a business opportunity and more a social obligation that we are taking into consideration together with BHP.

Second, regarding VNC, I would like to give a clear view on where we are. We are now better than we were a year ago. The company – the carrying costs of VNC has decreased (17:02) we are not paying for operating this company. This is in a much better situation that we have before. Nevertheless, the fact remains that this is an operation still to be stabilized. And it is – the most complex operation that Vale owns, there for the decision was to do and when to do it is not taken yet. So, we are looking to option, basically because everybody knows that we have – if we are to continue with the operation in Nouvelle-Calédonie, we have to build a new tailings dam there. And this decision has to be taken till the end of the year. So we are going to reach a final decision of how to fund it or – and if we are going to make it or not till the end of the year. So in that occasion we'll let you know what is our idea or the future of VNC.

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

Thank you.

Operator

Our next question comes from Thiago Lofiego with Bradesco BBI.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Hi. Thank you. Just one follow-up question from the Portuguese call, back to the capital allocation issue, when should we expect Vale to initiate a new growth cycle, even if more modest one? We understand the company is refocusing on dividends right now; the net debt level is close to the target of $10 billion. But just looking two-three years, four years out, when should we expect Vale to start investing in growth projects again. You guys have mentioned about potential projects on copper, eventually energy, logistics in Brazil. So what's the mindset of the company regarding those at this point? Thank you.

A - Fabio Schvartsman {BIO 2067677 <GO>}

Thiago, thank you for your question. We have a very clear stated policy for dividends in the company. So we'll be paying dividends in the future according to this policy. It doesn't mean that it will demand all of our cash flow for this payment. But, for the decision what to do with the additional – will be made in any given moment, if comparing alternatives as with this time we decide to make a buyback because it was clearly the best option for creating value for shareholders and we are going to continuously to do that.

Nevertheless, we have now some investments in Voisey's Bay. Why, because we think that the return on investment there is such that will certainly going to create value to shareholders. There is not such a thing in our mindset that is a growth season or a dividend season. Actually, we have a dividend policy, and we are going to use the excess cash either to distribute more or with buybacks or in projects if any and if the returns are deemed adequate. So the decision will be made at any given moment.

Q - Thiago Lofiego {BIO 16359318 <GO>}

Okay, that's clear. Thank you, Fabio.

Operator

Our next question comes from Jon Brandt with HSBC.

Q - Jonathan Brandt {BIO 17988091 <GO>}

Hi, good afternoon. Congratulations on the results. I first wanted to ask about the freight rates. There's some new legislation coming in in 2020 that will require a lower sulfur content. I know you've – to some extent mitigated that with the new freight contracts that you had and their results today. I'm just wondering how exposed you are to this if we look at the current fleet of vessels? Is this something that is still an issue, and what steps you could take to mitigate it?

And then secondly for Luciano, I'm just wondering if there's any more to do on the liability management side and how we should think about interest expenses? Obviously, they'll continue to come down in the next quarter or two as you pay down net debt. But is there anything left to do on the refinancing side? Are there other liability management options that you're considering, perhaps buying back the stake in MBR or on debentures? Thank you.

A - Peter Poppinga {BIO 17245689 <GO>}

Hi, Jon, thanks for the questions, Peter speaking. So, as you pointed out, this is something important, structurally shift coming in the – in January 2020, the IMO. And Vale's action plan to progressively install scrubbers, in order to progress if we depend less on the low sulfur oil because we don't know how fast the refineries will react to this new demand. But as a rule of thumb in a nutshell, you can work with the following equation. So there will be an increase in cost, let's say the low sulfer oil costs $200 more than the price of oil, as a spread, if you believe in that. Then the average freight cost we have today will be roughly the same if you take into account these effect as the average freight rate in 2023, because what we are going to do, the scrubbers will reduce this delta, this – these gaps to the low sulfur in $1.8.

The new (24:07) coming this third-generation we just announced will also reduce it in $1 (24:12) and the Valemax second-generation which is coming on stream now, we already have seven in the sea, it's also reducing $1. So, all this together, the scrubbers, the Valemax the new ultra generation and the second-generation Valemax coming in will compensate this increase in the spread between the two oil categories. It provided, this is always the worst case, provided – if of course the refineries react and the spread narrows, then we will be much better off.

Q - Jonathan Brandt {BIO 17988091 <GO>}

Thank you.

A - Luciano Siani Pires {BIO 15951848 <GO>}

Jon, on liability management, we continue to look into dual liability (25:04) management. If you look at the statement of cash flow, you'll see that we've actually retired $2.6 billion in debt this quarter. But, we issued another $700 million in debt. Some of the capital providers now are coming to us with very cheap and low attractive rates. So, we continue to extend the duration of our debt, some of these are – loans that we made or are replacing others that would mature in the short term. So, yes, we will continue to do that exercise. We continue to have loans which cost more than they should, given the current financial position of Vale.

And as regards to MBR it is one of these main alternatives that we have to use our capital and we will be comparing it to other alternatives then we have in order to see – to make a decision on the MBR stake.

Q - Jonathan Brandt {BIO 17988091 <GO>}

Great. Thanks, Luciano, thanks, Peter.

Operator

Our next question comes from Alex Hacking with Citi.

Q - Alexander Hacking {BIO 6599419 <GO>}

Hi. Good afternoon, and thank you for the questions. First, I just wanted to follow up on the freight. Peter, I just wanted to clarify the new ships with 62 million tons of capacity, will that be incremental freight capacity for Vale or that will be replacing some of the long-term contracts that were rolling off?

And then my second question is just broader to do with capital allocation, and could you maybe discuss the framework when you're deciding about capital return on buybacks versus dividends? Thank you.

A - Peter Poppinga {BIO 17245689 <GO>}

Hi, Alex. Yes, you're right that this third-generation we just announced the 48 ships, which we are calling (27:09) 325 deadweight that's new capacity coming, and we will be replacing of course some older contracts or even keep some capsize (27:56). These are very large oil carriers and they come on top of the existing fleet.

A - Fabio Schvartsman {BIO 2067677 <GO>}

Yeah. Just to clarify your question – your second question was regarding dividends against buyback, right?

Q - Alexander Hacking {BIO 6599419 <GO>}

Yeah. Sorry, yeah, the question is how are you – how are you decide – if you want to – when you return the capital next year above and beyond the stated policy, how will you decide between buybacks and dividends? What's the framework for that decision? Thank you.

That's a good question. I can explain you how we reach the decision to pay dividends according to policy and have an additional through our buyback. And the reason in this moment was basically the following. We have just announced these new policies. It was in our point of view very important to demonstrate that this is a policy that we are here to stay and we are going to follow this policy. Therefore, we are talking to be better in this moment, not to add more dividends, but instead to give it back to shareholders through a buyback that it is equally at the benefit of the company and more importantly it gives a very important sign of how the management sees the future of Vale because we are very positive in the return – on the investment that we are going to make in this buyback.

What is going to happen in the next year, that this is a flexibility that we are going to hold. It will depend in evaluating the situation in many given moment. We are going from our lives and see which is the best for the company to do – to pay more dividend than the policy or should we pay more through buybacks again, but this will be decided in – when the time comes.

Thank you.

Operator

Our next question comes from Grant Sporre with Macquarie.

Q - Grant Sporre {BIO 6780152 <GO>}

Good afternoon, gentlemen. And thank you for my questions, and congratulations on the good results. I have two questions, please. The first one is regarding the coal division. Firstly, can you just give us an outline as to you know how you see the – this best division sort of improving its performance going forward? And akin to that, if you can give us some guidance on the costs or how we should think about the costs going forward, particularly the Nacala tariffs? And my second question is, just in the iron ore division, under a scenario perhaps in the second half or later in the year, if we have a, let's say, a slowdown in the market, would you still – are you still flexible to being able to take down some tons in the southern system perhaps to let's say support the market or be a bit more market friendly? Those are my two questions. Thank you.

A - Fabio Schvartsman {BIO 2067677 <GO>}

Okay. Grant, thank you for the question. Let's start with the iron ore, if there is a slowdown in market, which we don't see coming so soon, but if there is something cyclically happening, yes, the first thing we would do is to reduce our third-party purchasing, which is around 10 million to 15 million tons a year. And second, yes, in the Southern system or in other small mines, we have mines we could reduce or shut down temporarily where we have the lower margins. So, that's a possibility, and that's our flexibility. And then, we would manage of course the – our contracts through our offshore inventories differently.

Regarding the coal, the coal actually, we have had some success. We are thinking about 2018 this year as a year of categorization, a year of trying to put things in order with a philosophy of the iron ore business, the iron ore price helping the coal guys to achieve that.

We had a good – already good progress on the commercial front where the price realization is getting better and better. The OpEx came down a little bit this quarter, but what we are doing is deliberately fixing some problems and deliberately maybe sometimes slowing down some areas. I'll give you an example, we have some waste strip ratio was behind schedule in some specific areas, so we took the decision to recover that strip ratio to normal levels.

And we had – we are drilling much more now in order to get better planning possibilities, as well as one very important thing which also affects the mix, the yield of metallurgical coal to thermal coal, which is slightly below 60 now. This is the decision we took to mine out this certain (00:34:01) where there is some ore still there but we need to mine that out in order to use this pit for the new tailings. Then in order to avoid – to build the new tailing then.

So, you see there is lots of actions – we could mine better, but we are deliberately going for a more sustainable preparation for 2019 and also we get a more sustainable operations. And we should take out the tariffs for the loans, the project finance instruments, if you look down the road we see OpEx around $60 a ton.

And the tariff also has an important fixed cost component so therefore with increased volumes should down. We are expecting it to stabilize between $20 and $25 per ton – shared ton for the $60. And the return to Vale between $5 to $10. So all in, it should be a pro forma cost that you can see at least around $80 per ton.

Q - Grant Sporre {BIO 6780152 <GO>}

Thank you. Thank you very much. Just to clarify, so the – this is the tariff is basically a fixed cost, it's not a variable cost?

A - Luciano Siani Pires {BIO 15951848 <GO>}

It has variable component as well because the logistics (00:35:29) has to pay some – it has some obligations of the concession which are variable. You may argue that some of the maintenance costs are variable as well, depending on volume because it pays for everything. It pays for us. Yeah. There's two components, that the debt service component is mostly fixed.

A - Fabio Schvartsman {BIO 2067677 <GO>}

So most of it is fixed.

A - Luciano Siani Pires {BIO 15951848 <GO>}

Yes. Most of it is fixed.

Q - Grant Sporre {BIO 6780152 <GO>}

Got it. Okay. Thank you very much.

Operator

Our next question comes from Alfonso Salazar with Scotiabank.

Q - Alfonso Salazar {BIO 18358082 <GO>}

Thank you. My question goes back to future growth. And I understand that right now, the priority is in dividends and the buyback, but if the opportunity arises later on to grow through M&A, is there any preference in terms of commodity or any possibility that Vale diversifies away? And I understand you want to be less exposed to iron ore in the future. So, what do you think that could make sense for Vale's portfolio? And regarding the logistics and energy, what are your plans to unlock value there? Thank you.

A - Fabio Schvartsman {BIO 2067677 <GO>}

Alfonso, thank you for your questions. Regarding diversification, as it was emphasized that we are totally dependent upon the work that (00:37:04) will do in business because this is our real diversification. This is what we'll be looking for is to increase the stake of these metals in our total cash generation. So, yes, we want to be market that right, but the diversification has to happen internally through this effort that we already made in the past. We are not looking into any other acquisition that will represent the diversification additional to the company.

Q - Alfonso Salazar {BIO 18358082 <GO>}

Thank you. And regarding the logistics and the energy portfolio that you own?

A - Fabio Schvartsman {BIO 2067677 <GO>}

Actually, our policy for energy is very clear one. We want to be self-sufficient in the production of energy, because in Brazil regarding taxes and transportation cost is very efficient, return wise when you're self-sufficient and we are far from that. That means that we have a lot of opportunities to increase our stake in energy for the purpose of reducing our total cost in our operations. In logistics, we are actually – we are in the – again, in the opposite position and we want to increase our stake in VLI as of today, because we think that their VLI is a very good operation with a fantastic upside. So, if there is an opportunity, we are going to increase and not decrease our participation in VLI.

Q - Alfonso Salazar {BIO 18358082 <GO>}

Excellent. Thank you very much.

Operator

Our next question comes from John Tumazos with John Tumazos Very Independent Research.

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

Thank you very much. I am a shareholder and I couldn't be happier. The production in the first half was below the rates of the Vale Day guidance December 6 in each product line. Will the second half catch up? And the first half rate was 35% short in coal. What do you think the total coal production will be this year and next year?

A - Peter Poppinga {BIO 17245689 <GO>}

Hi, John. Thanks for the question, Peter speaking. Yes, what we think and we are keeping our guidance of around 390 million tons production in this year. That means in the second half of this year, we are going to produce – in both quarters we are going to produce over 100 million tons. For your information, in June, we already are close to this space. Regarding coal, we are really analyzing during this quarter all the actions we have taken in order to recover the production loss and we will probably then analyze it and if the case we are going to pronounce it and talk about in new guidance in the next quarter. Thank you.

Operator

Our next question comes from Tyler Broda with RBC.

Q - Tyler Broda {BIO 16281303 <GO>}

Yes. Thank you. Thank you very much for the call today. I just have a quick question and perhaps for Peter just on some of the changes in the iron ore market. We've seen a big increase in the discounts for elements like alumina and phosphorous. I'm wondering if you could describe in your view how much of this is – I mean this real being out of the market or is this more just the natural progression now with the changing blast furnace size in China? And I guess in your view what would – what level of profitability would you need to get to in China to move the markets away from the structural trade trends that we've seen recently?

A - Peter Poppinga {BIO 17245689 <GO>}

Hi, Tyler. Thanks for the question. I stated in the previous call that I do believe this is a structural trend. It has to do with two – it has to do with three facts actually, the fact that the Chinese concentrate which has a very low alumina silica ratio went up – dropped and went out of the market substantially in the last years. Vale itself took out some high silica product, which happens to have a low alumina too. And then there's the whole depletion going on and we'll get – get worse not in terms of quantity, but in terms of quality alumina wise and phosphorous wise in Australia.

Therefore I don't expect this to change so drastically. That explains also why our new product a flagship the BR – the Brazilian Blend Fines, which next year will become our biggest volume of sales. And why this is so successful, we are achieving premiums of $5 to $7 over the – over the $6 to $2 benchmark. We also have a niche – developed a niche product called sinter feed, a low alumina synthesis, which comes directly from Tubarão and this is achieving actually $10 premium in certain segments. So we believe this is – this is here to stay and is actually what we believe is if there is a change in margins of steel mills or in the coke price, which will actually reinforce the existing trend for productivity, which comes from the supplier side reform. So we don't see this changing, and it's a tremendous opportunity for Vale to differentiate itself. Because what we are doing, we first differentiate it ourselves with a 65 Carajás premium. Now we are going to differentiate further progressive fleet with the Brazilian Blend wines. in terms of low impurities. Thank you.

A - Luciano Siani Pires {BIO 15951848 <GO>}

Thanks, Peter.

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Operator

Our next question comes from Aman Budhwar with Westwood International.

Q - Aman Surendra Budhwar {BIO 19334053 <GO>}

Hi. Thank you for doing the call today. Actually my question that I had in mind was along the same lines of the previous question. In the second quarter, you had average premiums to $7. Just wanted to know what do you think are the sustainable premiums.

And also, if you can comment on your competitors, if we've heard various bits and pieces of news of other players also trying to upgrade their product and you did mention in your previous remarks that Australian products is depleting, but if you can talk about any of your competitors and their strategy and how they might benefit from this to the detriment of Vale if at all?

A - Peter Poppinga {BIO 17245689 <GO>}

Yeah. Hi, Aman, thanks for the question. Yes, this is a trend, of course, nobody is standing still. What you see is lots of initiatives happening in Australia. FMG announced their Eliwana project, which has higher Fe content. You have others like BHPB and Rio announcing South Flank and Silvergrass. But all those – and then, you have the (00:46:08) depletion coming and looming in the next year.

So this means there is a structural – the quantities will be there, but the qualities will be different and they may achieve the same Fe content, but the impurities will be not the same. That means that the alumina silica ratio will go up, which helps our premiums and that's where we differentiate ourselves.

So you mentioned a $7 premium in this quarter, it will go up. It will go up in the next – of course, cyclical elements will be there, but it will be going up. For instance, the new BRBF we are selling to the market, we have some contracts where we don't have sales premiums, right, and we are a company honoring our contracts. But the market will, in the next quarters and years, realize that this is a new trend and it will be priced accordingly to the benefit of everybody. So I think we are in a very good moment, and again, we are differentiating ourselves from our competitors through the premium credits.

Q - Aman Surendra Budhwar {BIO 19334053 <GO>}

If I can ask – sorry.

A - Fabio Schvartsman {BIO 2067677 <GO>}

Sorry, just a second, I just want to complement Peter has just said just to emphasize and make it clear. The factors that are going to increase our price realization or premiums are, first, we have more volumes coming out of Carajás. Second, we have more pellets production coming into stream in the next few quarters. Third, we have this BRBF that was explained by Peter that we are going to renegotiate contracts and, therefore, during time crisis, we will react accordingly to the premiums that the market starts seeing today.

So all-in-all, all these movements translate into premiums increases during time. So we are very, very pleased with the fact that we are going to see next quarter, for instance, the premiums will continue to increase.

A - Peter Poppinga {BIO 17245689 <GO>}

And just to finalize, the other fear that the market has that Carajás will have excess volumes coming, because we are still ramping up in S11D. That is not a concern for us anymore. We are selling Carajás – we are completely sold out in terms of Carajás for the next years. We are selling Carajás into different segments like Eastern Europe, like some volumes to India. We are feeding Carajás fines into our own pellet plants in order to maximize productivity.

And in China, there is opening up a big opportunity for us. Since China is investing very much into the pellet business because of the pollution, because of the supply-side reform. I don't know if you know, but it's roughly – we are investing roughly the capacity of 50 million tons, new capacity of 50 million tons of pellets production capacity in China.

We've traveling grate technology, which means they can use hematite ore. This is – 50 million tons is the size of the whole Vale, the size of pellets business is 50 million tons. So where is the feed going to come from for this new capacity? And we hope and we expect that part of this new demand will exactly come from the Carajás fines, which will be ground and will, therefore, be absorbed by this new market opportunity, so no excess volume at all anymore in the market for Carajás fines.

Q - Aman Surendra Budhwar {BIO 19334053 <GO>}

Just as a follow-up to that in terms of investments happening in the Chinese market, we've also heard various reports about them investing in electric arc furnaces, and then, developing the scrap market, which over the long-term would be a threat, I guess, to the iron ore market as a whole and especially to Vale.

In the short-term, I guess that's not, from what we've heard, has not taken up as much due to the cost differential of scrap being higher. But do you think that is a threat that – of course, the market is worried about, but is Vale concerned about the threat from electric arc furnaces taking up market share from blast furnaces in China?

A - Peter Poppinga {BIO 17245689 <GO>}

I think, of course, this element is structurally there. China will have more obsolete scrap generated in the next years. But their scrap story is a really long-term story. It's roughly 10 years out. And we – it has to be structured first in China. First of all, the electric arc furnaces – the energy is not cheap in China. So electric arc furnaces, they use lot of energy. The scrap distribution channels in China are not organized. And so, of course, there will be some effect, but I don't expect this to have to be in the short or medium term, it will be in the long term.

A - Fabio Schvartsman {BIO 2067677 <GO>}

(00:52:07) in this moment, we will need at least a portion of pellets of high quality for the protection of steel in electrical furnaces and for the feed for it will mostly come from where it's going to come today (00:52:30). So it is obviously always a concern we are following very closely. But not only it is a long-term concern, but even when and if it happens, the market will adapt to another structure as it happened in the U.S. where we are selling pellets to all the electrical furnaces there.

Q - Aman Surendra Budhwar {BIO 19334053 <GO>}

(00:52:57) Thank you.

Operator

Our next question comes from Gustavo Gregori with Bradesco BBI.

Q - Gustavo Henrique Gregori {BIO 16209398 <GO>}

Hi. Good morning. I have a quick question regarding the debt. I'm trying to understand here with the net debt target being right around the corner, should we expect further reductions in gross debt and to that point, where would the company place gross debt reduction its priority vis-à-vis other capital intensive activities such as on extraordinary dividend or the purchase of new shares or even the purchase of new assets?

A - Fabio Schvartsman {BIO 2067677 <GO>}

Look, in the same proportion that we are reducing net debt, we are going to reduce gross debt. That means that, it is our total priority. It is being performed this way and it will continue to be performed this way.

Q - Gustavo Henrique Gregori {BIO 16209398 <GO>}

Okay. Thank you.

Operator

Our next question comes from Marcos Assumpção with Itaú BBA.

Q - Marcos Assumpção

Hi, good morning, everyone. Quick question – a quick follow-up on the BRBF, Peter, the premium on BRBF is quite new to us and it has varied a lot in the recent months, right, according to the chart you put in the press release. So it was below $2 in May and above $10 in July. So if you could explain to us the main reasons why it varied so much? And what is the sustainable level that you think it should be in place going forward?

And the second question for Eduardo, you mentioned in the previous call about the trend of electric cars becoming the reality. So I'd like to hear from you what is the company's view on the size of the potential market and where will the growth come from. Thank you.

A - Peter Poppinga {BIO 17245689 <GO>}

Thanks for the question. Look, the BRBF is, in fact, a recent story that it becomes so explicit in the market, but it was always there. The difference is that we have changed our policy in terms of sales. We are not selling at index anymore; we are selling at fixed price. That means that the BRBF is becoming part more and more of the price formation of the 62 index, okay?

And the reason that is the first answer, why is it becoming so clear now, and the reason why it happened two months ago is simply the fact that if you look at the stockpile sitting in China, you see that Australian material is piling up and the Brazilian material is decreasing and that's not because Brazil is not delivering volumes, it's because the demand of Brazilian ore is higher than the demand of some of the Australian ores and that means the premiums.

So the structure – that's what I'm saying on the depletion, I told the alumina story. There is some fundamental unbalance in the market, which now becomes very explicit and the markets will have to react to that. For the moment, market is reacting giving Brazilian blend material higher premiums. And we expect them to increase a little bit in the future, but – and then, probably stay at those levels.

A - Eduardo de Salles Bartolomeo {BIO 15365202 <GO>}

Okay, Marcos, just to give you some clarity on the story, I think if this is a train and, in fact, (00:57:29) this is coming, and say the train has left the station, the question is always exactly how fast and how big is the train.

This year, we're talking about 38,000 tons demand for our batteries from pure nickel foil battery. So it's almost, I would say, relevant but very, very how can I say not although impact. But taking some areas that we could (00:57:55) government decisions are being taken around the world, we can see in 2025 from 350,000 tons to 500,000 tons of nickel. That takes all the excess capacity that has to be on Class 1 that is being fed into Class 2.

So we are positive, we always work in the conservative scenarios to do our homework here. That has to be done as we mentioned in the previous call. We need to organize our house to be ready for this growth, but the growth is coming in mainly as we are at China an addict (00:58:30) we believe this is the China play.

Although there was initiative coming from the U.S. and Europe is also concerned about the environment, I believe that the true driver behind the growth of EVs is China due to multiple factors. It's relevant for the pollution that is impacting iron ore as we're talking all the time. It's relevant for the geopolitical, so they're going to build a new industry around the EVs. It's relevant for their grid. They're going to have to storage all the renewable that they have. So for China, it's a no-brainer. They already produce in the range of 1 million cars a year this year.

It's obviously a game, but it's a game that we are really conservative on how we approach to it. So we really focus on our homework to be ready for that, now giving (00:59:22) some numbers to you, now 38,000 tons, and we believe it's going to be 350,000 tons to 500,000 tons in 2025. Okay? Thank you.

Q - Marcos Assumpção

Perfect. Thank you very much.

Operator

This concludes today's question-and-answer session. Mr. Fabio Schvartsman, at this time, you may proceed with your closing statements.

A - Fabio Schvartsman {BIO 2067677 <GO>}

Thank you, again. Once more, it was a pleasure to have all of you in this call, and I hope to have you back in the next one, in the next quarter. And only to finalize, I just want to emphasize that the company will continue to perform the same way it has been performing. So the profitability (01:00:08) and the stability of the company is there. We are hoping to get in the next quarter the same kind of results or even a little better than the results the company had delivered in the former quarters.

So thank you so much for all of you and have a good day. Bye-bye.

Operator

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