Q2 2003 Earnings Call

Company Participants

- Osvaldo Schirmer, EVP Finance and Investor Relations Director

Other Participants

- Daniel Altman, Analyst
- George Berstein, Analyst
- John Falopeso, Analyst
- Paul De Soto, Analyst
- Philip, Analyst
- Unidentified Participant

Presentation

Operator

Good afternoon, ladies and gentlemen. And welcome to the audio conference call of Gerdau S.A. Thank you for standing by. (CALLER INSTRUCTIONS) I would now like to turn the conference over to Mr. Osvaldo Schirmer, Executive Vice President and Investor Relations Director. Please go ahead, sir.

Osvaldo Schirmer {BIO 1754610 <GO>}

Good afternoon, ladies and gentlemen. Welcome to our Second Quarter conference call. The press release for the Second Quarter results was published last Tuesday, July 30. And is available at our website.

Gerdau S.A. in Brazil and abroad. The Second Quarter sees a repetition of the First Quarter. The Brazilian and South Cone operations generated positive results, whereas the North American operations, in spite of their improved performance, still reflect the impact of the increase in the cost of inputs and the hardships of reorganizing processes that involves two countries, USA and Canada, different cultures, different currencies and a lot of mills.

From a consolidated perspective, the semester ended with a much better performance than that of the same period last year. This is clear in several aspects, such as level of revenues, gross profit. And even net income. It is worthwhile to indicate that the merger with Co-Steel last October and the recovery of production capacity of AÃ§ominas contributed in a significant way to the increase in output, revenues and shipments for the period. These units acquired from Co-Steel added 1.1 million metric tons. The come back at AÃ§ominas contributed with an additional 457,000 metric ton of good steel when compared to the output in the same period last year.

Another noteworthy factor that contributed to compensate the decrease in the domestic demand was exports. In spite of depreciation of the real, 19% in the semester, the Brazilian companies were able to overcome this difficulty and increase export by 78% in the last six months. The 1.4 million metric ton shipped to international markets generated roughly 360 million U.S. dollars in revenues. The average price per ton in the last six months was 46% greater than that of the first semester of 2002.

On a quarterly basis, second versus first, there was a positive evolution. In Brazil and in the South Cone the output of crude steel remained stable, whereas in North America it increased more than 10%. Sales in the domestic market decreased by 6.5%, while exports increased 21%. Compare the Second Quarters of '03 versus '02, sales in the domestic market fell 14.3%, while exports went up by more than 180%.

Abroad, North America confirmed the growth pattern, positive 1% in the quarter. And the South Cone presented a slightly smaller volume of output in the period. Net revenues generated by the Brazilian operations increased 3% in the Second Quarter, whereas in North America, revenues fell about 21%. It is important to note that although net revenues in local currencies have increased quarter over quarter, when converting these revenues into reais they present a negative variation due to the appreciation of the real vis-a-vis the U.S. dollar.

Where margins are concerned, from gross margin to net margin, there has been a pattern of sustainability with some tendency towards improvement. In North America for instance, the EBITDA margin increased to 5.2%, up from 3.6%. In absolute terms, EBITDA generation in the quarter jumped up more than 55% in U.S. dollars. In the South Cone both margins and absolute values for EBITDA generation remain at the same level, that is about 12 million per quarter with a EBITDA margin of about 31%.

In Brazil, due to the export effort, margins dropped an average of 15%. Given the importance for the financial results in the quarter, it is important to explain that the deferral of taxes that was applied to AÃ§ominas over fiscal losses and social contribution to be compensated based on the current Company performance and perspective of future profitability. As you all very well know, AÃ§ominas has accumulated losses. And according to tax laws, can be compensated against current and future results. Due to the Company's profitability in recent years. And based on expectations of future results, AÃ§ominas took advantage this quarter of 198 million reais as deferred income tax and social contribution. For this reason, 133.7 million reais of income tax and social contribution provisions were added to the Gerdau S.A. consolidated Second Quarter operating income. This led to 262 million reais consolidated net profit in the period.

Another noteworthy aspect is that foreign exchange variation over investments abroad, which in the financials appears in the equity pickup line. The Company results are consolidated at the level of Gerdau S.A. in reais and ought to reflect the foreign exchange valuations of the Canadian dollar, the Uruguay, Chilean and Argentine pesos vis-a-vis the dollar. And the latter against the real. In the period the Canadian dollar appreciated 8.3% against the U.S. dollar. The Uruguay and Chilean and Argentinian pesos appreciated an average of 5.8%. And the real 14.4% also against the dollar. As explained in the notes to the quarter's financial statement, investments abroad totaled 2.3 billion reais as of June 30th. As a consequence of these variations in foreign exchange, 222.4 million reais were accounted as negative equity pickup in the Second Quarter.

The CapEx budget for the year is up about 230 million U.S. dollars, of which 138 million were already invested in the first semester. Of this total, 51% were allocated to AÃ§ominas, where the highlight is the wire rolling mill scheduled to start up this coming December.

Where investments is concerned, it is worth mentioning that in absolute terms the net investment in reais has decreased by 300 million reais, down to 5.6 billion from 5.9 billion in March. Relevant however, is the lengthening of the indebtedness profile of Gerdau AmeriSteel, which at the end of June concluded the restructuring of its indebtedness. This was accomplished by means of two financial operations, the private placement of senior unsecured notes, for a total of 405 million U.S. dollars. And the contracting of a senior secured credit facility with a weighted average maturity of 6.6 years. And with an average interest rate of 7.7% per annum. With this restructuring, the long-term indebtedness of the Company now accounts for 98% of the total. On a consolidated basis, Gerdau's long-term debt improved by shifting from 37% to more than 53%.

Perspective. North America prices; maintenance of Second Quarter's price levels was an upward trend. Volumes; stable and growing. Prices of main inports; a tendency to increase. Imports; stabilized at lower levels. Capturing of synergies; on schedule. Effort to improve operating costs; intense, very intense. Economic growth; slow. Brazil prices; stabilized as a result of reduction in inflation and weak demand. Prices of inputs; stabilized and scrap with solid supply. Export volumes; growing. International prices; upward tendency with Asia back on the market. Foreign exchange; volatile. But with no risk of major harm to the business. South Cone; positive perspective for all three countries, mainly Chile where it has been announced the new (inaudible) subway and new stations for the Santiago network and the gradual however consistent recovery of the Argentine economy.

Now we open the floor for questions. Please go ahead.

Questions And Answers

Operator

(CALLER INSTRUCTIONS) (Unidentified Participant) with Credit Suisse First Boston.

Q - Unidentified Participant

(inaudible) speaking. I work here with (inaudible). My first question is that given the restructuring of Gerdau and AÃ§ominas and what will be the time frame which Gerdau will be able to use the tax credit in AÃ§ominas? And what is the gain that we may see as this process is complete, given that there is a change in assumptions off of future earnings for the Company? And also if you could enter in more detail of what could be the future gains in the restructuring besides the tax credit in AÃ§ominas?

And my second question will be if you can admit that Gerdau will maintain the speculative hedge of over 200 million looking forward, or is it likely that Gerdau will liquidate this hedge? Thanks.

A - Osvaldo Schirmer {BIO 1754610 <GO>}

Okay. As I had the chance to answer to you this morning for the same question, we are not in the capacity right now to disclose much more details on the restructuring of AÃ§ominas and Gerdau S.A. Nevertheless, as I said this morning, the objective by integrating these two companies, yes, is to take advantage of fiscal losses accumulated throughout the years. The duration of (inaudible) where we can take advantage of that will depend pretty much on the volume of profits that we generate in the future. So the more we generate, the faster we can take advantage of that. So there is no precise number for that, otherwise, we would be making projections. And this is scheduled for the end of this month, to come back to the market with details related to this restructuring. Telling you how much we understand we are going to be able to capture in terms of synergies, some fiscal savings and so on.

And on top of that, I also mentioned that not only the past is a good encouragement for these restructuring. But basically the future. We do move production from one mill to the other. And operating under only one unit, we do have fiscal advantage and also operating advantage in having so.

The second question (inaudible). Ah, the hedge. Same question this morning. We basically have been doing or contracting hedge structures in the market a long time. So far we have been quite successful in having them because of the volatility of the currency did present a lot of unpleasant situations. So the dollar exposure for the Brazilian operations was kind of neutral to us due to those hedged structure. We have had, in some periods, that the hedge has worth worked against us. But I challenge you to believe that the dollar and the real are going to state in this very position it was a week ago for the rest of its life. It should take -- today's quote for instance we're back in the money. So I think we're going to continue with them, adjusting here and there. But continuing with this philosophy of having dollar (inaudible) in Brazil neutralized using market instruments to take this exposure from our operation.

Operator

George Berstein [ph] with Deutsche.

Q - George Berstein

Just some further following up on that hedge issue. Could you just clarify for me what you would consider your total real borrowing over your net debt? In other words, what percentage of your net debt is contracted in real terms if you add the additional overlay caused by your current hedges?

A - Osvaldo Schirmer {BIO 1754610 <GO>}

If I correctly understood your question, historically in the recent past our dollar indebtedness and real indebtedness was kind of half and half. Basically the Brazilian dollar exposure being 80% hedged. More recently we're slightly overhedged. But this is going to a level of being even. So a rough number, half and half.

Q - George Berstein

Sorry, just so I understand. You're saying half of your net debt position right now is contracted in reais?

A - Osvaldo Schirmer {BIO 1754610 <GO>}

More or less half in dollars -- foreign currency -- rough number.

Q - George Berstein

What I'm asking is that also included in the impact of the additional hedges that you said you have taken out? So I would assume it is actually closer to 80, 85% by my calculations?

A - Osvaldo Schirmer {BIO 1754610 <GO>}

No, in fact we are slightly overhedged. So we have more hedged than our foreign exchange currency due to renewals and things like that. And the concept is to maintain basically one-to-one dollar exposure versus the hedge in dollar.

Q - George Berstein

My second question is, could you give us a little bit more color as to what is really happening in the U.S. market? Interestingly, we saw in new core [ph] results where they were commenting on cost of goods sold pressure caused by both energy and scrap. Yet Co-Steel or Gerdau North America, (inaudible) sequentially improve margin. Can you explain how much of that was due maybe due to synergies or how much was due to something that would be happening differently on your side of the P&L versus other competitors?

A - Osvaldo Schirmer {BIO 1754610 <GO>}

Yes. We suffered the same inconvenience of a high scrap price, high-energy price. And also which caused many interruptions during the first and Second Quarter, less in the second than in the first. But still enjoying high cost of inputs. The inputs came down approaching the end of the quarter. They basically stabilized and now they may start a climbing curve again. Maybe not too much. But the trend is to grow, especially on scrap not necessarily on energy. But by the same token, the prices that cost the industry quite a lot to improve throughout the quarters are holding in this particular quarter. And are strongly indicating a trend to grow.

A few announcements were made this week. In fact the (inaudible) initiated the price announcement, the price increase announcement. And the industry as my information it is concerned, has followed. So which makes it very consistent. So we are believing that in this current quarter and the following quarter, we going to improve slightly the margins. But as I said this morning, the bulk of the work has to come from internal effort to improve the efficiencies, to improve the yields, to make those mills -- 11 mills as I said -- cooperate in a more coordination way. It takes some time, different cultures, different mills, different products, different countries.

And also counting -- also having as a problem with the fact we ship from Canada in Canadian dollars. The Canadian dollar has appreciated against the U.S. dollar. All those kinds of problems. But we are optimistic that we will be able to improve the operation, improve the margins based on external factors. But more than that, based on internal effort to improve the operations.

Operator

Daniel Altman with Bear Stearns.

Q - Daniel Altman {BIO 1855515 <GO>}

Due to linguistic problems I was not on the Brazilian call. So I will ask you new questions. In terms of the scrap pressures in Brazil, I wonder if you can comment on that? That would be my first question.

Second question is, it looks like long steel demand has been down consistently throughout the year. I am wondering if there's anything that you're hearing from the Lula administration that maybe they're may be some infrastructure projects along the way or maybe interest rates may help you start to see a pickup in long steel demand in the second half, or even heading into '04?

And then the third question I had was the stock readjustment that you did a couple of months back. I know one of the issues you talked about was to increase liquidity in the shares. I wonder if that is actually has actually had a tangible benefit? If that whole exercise was really worth -- real necessary (inaudible). Thanks.

A - Osvaldo Schirmer {BIO 1754610 <GO>}

Okay. Three questions, scrap, new projects and stock liquidity evolution evolution or increase due to the change. Okay. On the scrap, Yes, you're right, the rest of the industry faced a substantial increase in the price of scrap. If you take the last -- this year, since the beginning of the year. And mostly in the Second Quarter, we had a price increase of around 7% on the scrap prices. If you take Second Quarter last year against the prices prevailing at the end of the Second Quarter this year, the price of scrap went up more than 100%.

Energy also played hard on us. There was an increase of 10% on a quarter. And thank God we do not depend too much on pig iron. But pig iron also had a very substantial increase in prices, more than 80% in the last 12 months. In the quarter it came down around 11%.

In terms of -- for the months to come, the quarters to come, as I said in my introduction, we are expecting some stabilization because the supply of scrap is rather abundant. We're not perceiving pressures on crop prices for the time being and in the near future.

As far as new projects, you're right, we have heard many, many politicians and even government authorities talking about the urgent need of creating new jobs. And the civil construction has been from a long time one of the -- kind of multiplying factor. So the easiest way to create jobs is to really to work on infrastructural projects and so on. When we gave today, earlier today, our view on the outlook for the quarters, we're rather optimistic. But I was not counting on those projects. If they come. And very likely they'll come, because the government seems to be very conscious about the urgent need of creating jobs, this is going to be excellent for the industry. Because as I said, civil construction is one of the first and easier ways to create jobs as we invest in it.

Okay. And the stocks, the stocks split we made and so on. We have perceived already increases in the volumes. For instance, Gerdau S.A. after the split has been increased for more than 15% the volumes in the trade volumes. And MetalÃºrgica Gerdau was around 10 to 12% increase. So I think it was correct the decision of making those changes to increase the liquidity and to help the market to have a more paper available trade.

Operator

(Unidentified Participant) with J.P. Morgan.

Q - Unidentified Participant

Could you please give us a little bit more detail as to the export growth that you are seeing and where it is coming from?

A - Osvaldo Schirmer {BIO 1754610 <GO>}

If I correctly understood, you would like to know to where we're shipping, or what do you expect about exports. Would you mind repeating the question?

Q - Unidentified Participant

Yes, in terms of your expectations of export growth for the remainder of the year, what do you see demand coming from mostly?

A - Osvaldo Schirmer {BIO 1754610 <GO>}

As I said in my short speech, the Asian buyers are back in the market, mainly China. So the strongest source of demand is coming from that area. But during the First Quarter, the Second Quarter, we did develop some, I would say new clientele. But other buyers, other -- and also other traders come to the markets. But even the European and the African, in Africa we were able to find some potential customers. But mostly from Asia. Asia has been the largest and strongest buyer. And is back in the market. So assuming that you're going to continue and perhaps even grow it, the volumes in exports in the third and

Fourth Quarter, they are going to split depending on the product to different areas. But most will come from Asia very likely.

Operator

(CALLER INSTRUCTIONS) Paul De Soto [ph] with (inaudible).

Q - Paul De Soto {BIO 5508510 <GO>}

Two questions related with CapEx. What are your latest studies about capacity increase in Brazil? There was that study on the old steel mill in San Paulo. I like to have an idea what are your latest studies on CapEx. And is AÃ§ominas intending to product (inaudible) cord to compete with Gerdau in the short-term?

A - Osvaldo Schirmer {BIO 1754610 <GO>}

Yes, we're still owing a final conclusion on the San Paulo project, which was our latest, let's say, announcement in terms of production expense -- production capacity expansion. We haven't decided yet if we are going to reemphasize or to increase the speed of that particular project. And AÃ§ominas will have available a wire rod rolling mill by the end of this year. Mostly we hold it to the export and to the local markets. It is not in our short-term plans to compete directly with Velva [ph] in the project you referred to.

Operator

John Falopeso [ph] with PD Securities.

Q - John Falopeso

A couple of questions. If you could please discuss first off any difficulties you have encountered so far in integrating the operations of Ameristeel and Co-Steel, even asset-wise or personnel-wise? And the second question is, now that you're well into the integration, at what point in time do you get into the acquisition market once again? And if you're already there, are there any assets that are interesting to you so far?

A - Osvaldo Schirmer {BIO 1754610 <GO>}

Interesting question. Yes, there were some perhaps surprises in the velocity we could really integrate this new mill to the old one. And the way we would be able to capture the synergies. The synergies are, as I said, are more or less on schedule. But the market restriction, the market problems such as increases on the price of inputs and so on, complicated or delayed a little bit our ability to put those mills working at the same pace and getting the same sort of output and yields and efficiency. And also dealing with different cultures, Canadian, Americans and Brazilians, it is not an easy task. We're going to accomplish that, no doubt. There is a lot of goodwill in all our labor force. It is a matter of time in my opinion.

As I said, we didn't find any surprise as far as the quality of the machine or the capacity of the mills. It is only a matter of really getting more out of them. And this means people deeply involved. We're getting there. And you mentioned about going back to the market for additional acquisitions. We don't have anything in the pipeline. We're mostly concentrating in improving the operations of the existing ones. We have working very hard on that. So we're out of the purchasing mode, let's say.

Q - John Falopeso

Just a quick follow-up to the integration question. When the two companies came together you suggested that $25 million U.S. of synergies was a reasonable expectation. At this point in time is that number any different?

A - Osvaldo Schirmer {BIO 1754610 <GO>}

No. It is basically, as I said, on schedule and we're not revising that number.

Operator

(CALLER INSTRUCTIONS) George Berstein with Deutsch.

Q - George Berstein

I just had a follow up question regarding your long-term or medium-term strategy in the U.S. Obviously the Company now has an access of 1 million tons of products or raw material in Brazil. And you are still short in the U.S. market. Could you describe a bit the situation with how it relates to tariffs, say to be importing the billet [ph] from Brazil to the U.S. market? And if in the medium-term, you would plan a strategy of continuing to supply your U.S. operations from your Brazilian export base for raw materials?

A - Osvaldo Schirmer {BIO 1754610 <GO>}

No, it is not our plans in the short-term to export raw material in billets to be rolled in the U.S. because we do have sufficient capacity to produce our own billets in the U.S.. It is an alternative. It is a question of accommodating international prices plus freight, plus loading, unloading. So far has been more interesting to produce them up there than import. I'm not saying that it is impossible. I'm not saying it is not going to happen. But it is not our short-term plans to do that. As I said, to replace local production of billets, importing them from Brazil. We believe that will be able to continue producing our own steel and we have to improve and we are doing -- working very hard on that. And yet very competitive prices at our melt shops to fill the rolling mills in the U.S. Hello? I think we're cut off. Hello? No, That's okay.

Operator

(CALLER INSTRUCTIONS)

A - Osvaldo Schirmer {BIO 1754610 <GO>}

I think we lost the gentleman from the Deutsche Bank. Is he still there? I think we were cut off.

Operator

We have another question from Mr. Paul De Soto with (inaudible).

Q - Paul De Soto {BIO 5508510 <GO>}

This is regarding CapEx. I think the last two years you had been investing a little bit more than $200 million. And you are concluding investment on AÃ§ominas. You're probably not going to expand San Paulo (inaudible). What is the size of CapEx should we expect for 2004?

A - Osvaldo Schirmer {BIO 1754610 <GO>}

It is nothing (inaudible). It is going to be around 200 again, in that vicinity because our level of depreciation goes somewhere 170 to 190. And we would normally invest more than depreciation to maintain and keep our operations as close as possible to the state of the art. But this is a rough number for -- in years with no new projects.

Q - Paul De Soto {BIO 5508510 <GO>}

If we see a pickup on (inaudible) early next year, you don't have to invest in new capacity to capture this pick up on demand, I am correct? How much of your capacity...? (multiple speakers)

A - Osvaldo Schirmer {BIO 1754610 <GO>}

We have been working around 85, 86% of our capacity. So there is always the possibility to get more out of existing capacity before going into a new project. But the reason why we are holding the decision is to make sure -- to feel sufficiently confident that the future will absorb that additional tonnage that we are planning to produce in San Paulo. That is the major hesitation around that. We need to see more confirmation of the demand in future. It is not necessarily the next year. But in the next five or six years. This project is going to take at least 16, 15 months to be put together the first module. So that basically is what is holding our decision. And for immediate pickup in consumption, we have capacity to fact it.

Q - Paul De Soto {BIO 5508510 <GO>}

And do you have a number of net debt that you are targeting for the end of this year? I know you have finished like 5.6 million reais. Is it a number that you could share with us?

A - Osvaldo Schirmer {BIO 1754610 <GO>}

Depending on the real versus dollar exchange rate, you are going to end up with, we may have additional reduction in real. But I wouldn't be counting on that at all. I would rather say that based on the level of investment, based on the level of cash flow generation, we must maintain that sort indebtedness level through the end of year.

Operator

George Berstein with Deutsch has been reconnected. Please go ahead, sir.

Q - George Berstein

I'm really sorry about that, gentlemen. My phone had been disconnected. But I caught half of your answer relating to the North American strategy about billets. And I don't know you have already answered it. But my question is in the medium-term does it make sense for Gerdau to put through a strategy of exporting raw material from Brazil whether it be billets or pig iron possibly or some other kind of raw material to your U.S. operations?

A - Osvaldo Schirmer {BIO 1754610 <GO>}

After we were cut off, I looked at my reasoning saying that it is not in our plan to export billets from Brazil to replace local production. We are basically in balance rolling in, melting capacity in the U.S. And the idea is to improve the cost of smelting in this field, smelting the scrap in the U.S. Supply our own mills with our own production. And I also said that it is not out of question to do that, to replace local production with exports from Brazil. But it is not the case for the short run. Hello?

Q - George Berstein

And in the medium-term, is it something that would make sense to start thinking about?

A - Osvaldo Schirmer {BIO 1754610 <GO>}

Absolutely. It is always a matter of cost. Brazil is very competitive as a producer of steel for reasons that you are very likely know a lot. So it is a matter of cost. Depending on how international prices of scrap will go, depending on the sort of pressures. Looking at the medium run, as you said, we are talking about four or five years down the road. So maybe the case. Maybe the case. That will depend pretty much on the quality of steel that you need to produce a final product (inaudible). If you're thinking in terms of exporting billets from AÃ§ominas to roll them to produce rebar in the U.S., I would say very likely not. Since the quality of the steel and the price of the steel for AÃ§ominas is higher than what is necessary to produce the rebar. We better do with the scrap. But the question is going to be really solved and determined by the price of the inputs involved. For the time being, no. Medium-term, who knows?

Operator

(CALLER INSTRUCTIONS) Philip (inaudible).

Q - Philip {BIO 2157217 <GO>}

Could you elaborate a little bit more on volume in the Brazilian market? Mainly because if we are expecting the interest rates to go down, how are you feeling the increase in demand? And if you could speak a little on the timing of these increase in demand, I would appreciate that.

A - Osvaldo Schirmer {BIO 1754610 <GO>}

With pleasure I would do if I knew. What we had on the first semester was a reduction of about 9% in the local demand, 6% in the Second Quarter over the First Quarter. We are expecting to see some sort of reaction in the local demand due to the fact interest rates are coming down. Maybe there will be more liquidity in the market (inaudible) really decides to reduce the compulsory deposit. And assuming also the inflation is under control. Also meaning that the country will keep enjoying high level of exports, which it does irrigate the economy with stretch money. So all that may convey to some sort of demand increase for long products.

Not mentioning, as someone already raised the point, to see the government begin intervening in the economy and stimulating the infrastructural projects. And those are very key -- infrastructural projects are key in terms of generating jobs. And very likely consuming a lot of long common steel. So I'm not able to precise how much it is going to increase. But we tend to believe the next semester, or the semester we're in, will revert the trend of reducing the local demand, of seeing the local demand reduced.

Operator

(CALLER INSTRUCTIONS)

A - Osvaldo Schirmer {BIO 1754610 <GO>}

I believe there are no more questions. So all I can do right now is really thank you again for your interest in our conference call. And invite you to be with us at the end of the next quarter. Thank you, very much. Have you all a good weekend. Bye-bye.

Operator

That concludes the Gerdau S.A. audio conference for today. Thank you, very much for your participation. Have a good day. And thank you for using Conference Call Brazil.

(CONFERENCE CALL CONCLUDED)