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PRESENTATION

Operator

[Interpreted] Good afternoon, and welcome to Gerdau's conference call to discuss the results of the second quarter '19 of Gerdau. (Operator Instructions)

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

Here today are Mr. Gustavo Werneck, Director, President and CEO; and Harley Scardoelli, Vice President and CFO. Now I would like to give the floor to Mr. Werneck. You may proceed, sir.

Gustavo Werneck Da Cunha - Gerdau S.A. - CEO

[Interpreted] Good afternoon, everyone. I would like to begin by welcoming each one of you to our conference call to discuss Gerdau's results related to the second quarter 2019. Sitting next to me is our CFO, Harley Scardoelli, and for both of us it's always a pleasure to talk to you about our performance and also clarify any questions that you may have about our presentation.

I will start by talking about our overall results in the quarter. And next is Scardoelli, he will elaborate on the financial performance of the company. After that, I will come back to discuss the outlook for the markets where we operate, and we will also talk about our investment plan. At the end, both of us will be available to answer your questions.

So now let's move to Slide 2 to begin our conversation talking about the main highlights for the quarter. I would like to start by highlighting the translation into figures of our strategy to focus on the more profitable operations in the Americas.

The management of a new and more profitable asset portfolio allowed us to post the best EBITDA margin for the period in the last 11 years, of 15.5%, even despite a very complex scenario faced by the steel industry worldwide since 2016, led by low demand and also high offers and the high cost of raw materials.

In regards to the North America operation, although the EBITDA margin was down when compared to the first quarter of 2019, mainly due to market reasons that we will elaborate further on, the sale of most of the rebar units in the U.S., coupled with a spike in metallic spread cause EBITDA margins to be up from 9.2% in Q2 of '18 to 11.1% in Q2 '19.

I would also like to highlight that we continue to pursue and expand our strategy of being very stringent with our costs and expenditures that together with a profound digital and cultural transformation allowed us to reach BRL 354 million in SG&A in the second quarter 2019. This amount represents a reduction of 18% vis-à-vis the same quarter of the year before. And this is the lowest amount ever reached by the company.

To conclude our highlights, I want to emphasize that even with the additional inventory formation in the auto Ouro Branco Mill Minas Gerais in preparation for the scheduled maintenance of Blast Furnace 1, we were able to deliver BRL 361 million in free cash flow at the end of the second quarter of this year.

Now I'll give the floor to Scardoelli, and I will get back to you at the end of his presentation.

Harley Lorentz Scardoelli - *Gerdau S.A. - Executive VP, CFO & IR Officer*

[Interpreted] Thank you, Gustavo, and good afternoon, everyone. So now moving to my part of the presentation on Slide 4. For those of you on the web, I would like to start with the main highlights of our financial performance this quarter. Our financial expenses, consisting of interest payments net from earnings from financial investments, including foreign exchange variation, were down 58% in the second quarter '19 when compared to second quarter '18, going from BRL 730 million to BRL 300 million this quarter. When comparing the first half of this year to the first half of last year, there was a 36% reduction going from BRL 1.05 billion to BRL 675 million, resulting from the company's lower debt position.

Free cash generation. And I will elaborate on that in another slide. Became positive for the first half of the year due to our good performance in Q2. In addition, if we look at the quarterly numbers of free cash flow going back to 2015, we posted results higher than BRL 1 billion in any accumulated 12-month period.

I must also highlight the issuance of BRL 1.4 billion in debentures this quarter in the Brazilian market. And I will talk more about that in a moment. And this really demonstrates the good momentum for issuances, both in the domestic market as well as in the international market, particularly for companies that -- like Gerdau, maintain solid ratings at credit rating agencies. In regards to dividends, Gerdau S.A. will pay out BRL 119 million, \$0.07 per share on August 28, and the holding company Metalurgica Gerdau will pay out BRL 43 million, equivalent to \$0.04 per share on August 29.

Now moving to Slide 5, we'll talk about our results and the performance in the second quarter 2019. In consolidated terms, adjusted EBITDA came to BRL 1.6 billion in second Q '19. Looking at the chart on the upper part of the slide and comparing it to the second quarter '18, we noticed a reduction in adjusted EBITDA going from BRL 1.8 billion to BRL 1.6 billion in absolute values. This reduction is mainly due to the deconsolidation of the assets that were divested in 2018. In addition to lower margins in the Brazil and Special Steel BDs.

The consolidated EBITDA margin posted a positive increase year-on-year due to improved margins in North and South America BDs. When comparing the second quarter '19 versus the first quarter '19, both adjusted EBITDA and consolidated EBITDA margin were flat, which is positive, considering a business environment where raw material costs were under pressure and demand in Brazil experiences a slow recovery.

Going to Slide 6. We will talk a little bit about the company's liquidity and debt position. On June 30, 2019, gross debt was BRL 14.7 billion, down by BRL 3.4 billion vis-à-vis June 2018, is mainly attributed to debt amortization in the period. The strong reduction in the net debt over EBITDA ratio from 2.7x on June 30, 2018 to 1.9x on June 30 of this year was the result of a combination of the user proceeds from the company's divestment



plan conducted in the last few years that reached the economic value of approximately BRL 7 billion. And free cash flow generation in the last 12 months that produce a year-to-date result of BRL 2.6 billion in the period.

As mentioned in the highlights, this quarter, the company issued debentures in the Brazilian market in the amount of BRL 1.4 billion, with the intent of strengthening its cash and extending the debt profile of the issuance occurred in 2 series: the first, of BRL 600 million, 4-year term and interest rate of 105.5% of CDI; and the second of BRL 800 million, with a 7-year term and interest of 107.25% of CDI. The issuance indicates good liquidity and access to long-term funding in the Brazilian market by the company.

With that, the debt amortization schedule is well balanced and distributed along the next coming years with an average term of 7.1 years. I would also like to mention the maturity on August 9 of convertible and/or exchangeable debentures from the holding Metalurgica Gerdau issued in 2016 and that after this date have been converted or exchanged in a quantity higher than 99% of the original issued. With that, Metalurgica Gerdau settles the less current debt still posted in its balance sheet from June 2019.

Now moving to the last slide of my presentation, Slide 7. We highlight free cash flow of BRL 361 million in the second quarter of '19, reverting the negative value posted in Q1 and taking the year-to-date balance to BRL 195 million in the year 2019 and BRL 2.6 billion in the last 12 months. The company remains strongly focused on cash generation, in keeping with its financial policy. It is important to note that in the last 4 years, meaning since July 2015, accumulated free cash flow generation was BRL 9.7 billion, of which BRL 1.2 billion were payout in the form of dividends, and the significant amount was used to reduce net debt that went from a one-time high of BRL 20.8 billion in September 2015 to the current BRL 12.5 billion.

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

Gustavo Werneck Da Cunha - *Gerdau S.A. - CEO*

[Interpreted] Well, let's now continue and turning to the next slide. And I would like to detail some of the important aspects of our business operations and also talk about the outlook for the next coming months. We remain optimistic about the outlook for Brazil and the United States. Our 2 main markets of operation, even though in Brazil, our expectations had a hard time turning into effective demand growth for steel.

According to the latest figures published by the World Steel Association for this year, global demand for steel should have a moderate growth, up by 1.3% over 2018, reaching 1.735 billion tonnes driven by the investment rebound in developed countries and the performance improving in emerging economies.

Even despite a landscape of trade tensions and a possible slowdown in steel consumption in China that should be up by only 1% this year 2019. Projections from the World Steel Association, indicated earlier, have unfolded differently in the main markets where we operate. And I would like to highlight a few figures, starting with Brazil. According to the most recent data from Instituto Aço Brasil, apparent steel consumption in the country should grow 2.1% in 2019, reaching 21.7 million tonnes, boosted by an investment rebound in civil construction, infrastructure and also oil and gas projects during the second half of the year.

The decline from the previous projection, which predicted 4.6% growth to 2.1%, which is the current forecast reflects the new Brazilian GDP estimate for 2019, which should be around 0.8%. In regards to Gerdau's performance in Brazil in the second quarter 2019, I would like to highlight that we grew above the average of domestic market for flat steel. Thus, moving forward with our strategy in the heavy plate segment. The sale of flats saw their margins being pressured in the second quarter due to higher raw material costs in the Ouro Branco Mill, more particularly in regards to coal and iron ore. Although our own ore production helped to offset the steep price increase of this input. It is worth mentioning the additional impact of costs related to the preparations for the scheduled maintenance of the Blast Furnace 1, our largest equipment using the production of pig iron.

We confirm that maintenance started in the first week of July, and we also confirm the forecast of the 60-day downtime. So it should be completed by the end of August. Moreover, the impact related to the cost of the scheduled maintenance will be reflected in the third quarter of this year. Mainly due to a lower cost dilution of fixed costs. However, from September onwards, we will have both Ouro Branco blast furnaces operating at full capacity and focus on serving the domestic market and higher export shipments foreseen for the last quarter of this year.

In regards to the domestic market for longs in Brazil, we did not notice any recovery on the demand side of the second quarter. Although we are seeing the evolution of some important indicators of future demand growth, like the destocking of the residential real estate sector and a lower vacancy rate of commercial properties in cities like São Paulo and others that we monitor on a monthly basis.

Here, once again, I would like to mention the significant performance of the retail industry, meaning self-construction and low-income housing in the second quarter. There was -- in the second quarter, this scenario should prevail in the remaining 6 months of the year as well. In this context, I must highlight the strategy to strengthen commercial result that currently has 76 units and also the launching of the company's new online retail sales platform called Juntos Somos Mais, of which we operate in a partnership. Both initiatives help strengthen Gerdau's presence in the construction retail market.

As for long steel margins in the domestic market, they remain flat, vis-à-vis the first quarter 2019. Increased competition in this market, aggravated by a 0 growth demand scenario was compensated by a significant reduction in raw material costs, particularly scrap and pig iron. Semi-finished export shipments in Q2 were lower, given our decision to be more selective when closing deals due to low prices in the international market and also as a result of inventory formation to prepare for the downtime at Ouro Branco.

As I have stated repeatedly, during my presentation, the growth of steel demand in Brazil, fundamentally depends on the country's capacity to solve its structural problems, such as the severe fiscal crisis. We continue to follow the progress of the pension reform in the lower house. And also, we are attentive to the progress of other structural reforms proposed by the government like the tax -- like the tax reform and also other measures to boost the economy. We look favorably on potential privatization projects and public-private partnerships as well as other initiatives to increase competitiveness of Brazilian Industries, like the new gas margin -- new natural gas market launched by the Brazilian government on July 23.

Well, speaking about our North America BD, we believe that the U.S. economy will continue to grow. The new IMF forecasts is that the U.S. GDP will grow 2.6% vis-à-vis the previous forecast of 2.3%. The end of the rainy season in the country should lead to a more consistent increase in the shipments in the next quarters. Also influenced by good levels of demand coming from the nonreduction, construction and infrastructure. Although metallic spreads and apparent consumption of steel are in an all-time high levels, margins in the second quarter of 2019 were lower when compared to the previous quarter due to a decline in the volumes produced in our mills, caused by a significant reduction in inventories throughout the steel chain in the U.S.

Now looking at the Special Steel BD in Brazil. We continue to expect the continued recovery of the automotive industry in the second quarter as our main market of operation.

It is worth mentioning that Brazilian OEMs exported 42% less between January and June, due to the economic crises in Argentina, according to data provided by ANFAVEA. On the other hand, production and shipments to local market went up 3% and 12%, respectively, in the period. Signs that makes us optimistic with the industry in the short run.

In addition, we believe the domestic wind power market has great growth potential. As for the U.S. market for Special Steel. In the second quarter '19, there was a significant reduction in inventory levels throughout the chain and deterioration of demand in the oil and gas and distribution markets, which prevented us from recovering our margins faster due to the impact of lower volumes and production costs.

In relation to the other countries in South America, GDP estimates for Peru and Colombia remained above 3% for this year, once again, indicating a good economic outlook. Argentina, however, even though civil construction demand remains flat, the forthcoming presidential elections next October may add more uncertainties to the local economy.

Well, now let's move to the next slide and talk about investments. In the second quarter 2019 Gerdau's capital expenditure or CapEx was BRL 424 million with BRL 196 million allocated to general maintenance, BRL 96 million allocated to maintenance of the Ouro Branco Mill and BRL 132 million allocated to technological expansion and updating.



In the first half of the year, BRL 729 million went to Gerdau's operations worldwide, mainly allocated to maintenance of the units. We are following our CapEx plan for the 3-year period 2019 to 2021, estimated in BRL 7.1 billion. However, we decided to redistribute the demand given the slower recovery of the Brazilian market.

In 2019, we will invest BRL 1.8 billion, and this amount will increase to BRL 2.6 billion in 2020 and also 2021. However, as we mentioned in previous presentations, we will continue to be very selective with approvals of new investments, keeping an eye on the evolution of the markets where we operate.

To conclude, now moving to the next slide, I would like to reinstate that Gerdau continues to proceed by leaps and bounds with its transformation, and it is prepared to serve the demands of its customers in a market that will certainly grow in volumes. But above all, will be more demanding for good quality services. As part of our digitalization initiatives that aim at generating more value to our customers, we decided to add in our advanced post in the Silicon Valley, our own venture capital fund, focus on providing solutions to the civil constructions and automobile industries. We recently learned that we came in fifth in the ranking of Valor Inovação, published by the financial paper Valor Econômico in partnership with Strategy, the strategic consulting arm of PwC and the steel milling and mining sectors. But beyond the fact that we stood out as a large innovative company, we are indeed honored to be able to contribute to the development of our customers into our value chain.

In addition, as I said before, we signed a partnership agreement with Manchester University and became the first steel producer to participate in this thriving innovation ecosystem involving advanced applications of steel and other materials like graphene. And to conclude, I would like to emphasize that we continue to have the strategic discussions with the Board about the long-term future of the company, a subject that has gained momentum after the conclusion of an important stage in our history, which was the recent reorganization of Gerdau's asset portfolio.

With that, I conclude my part of the presentation, and we move to the Q&A session, whereas Scardoelli and myself will be pleased to answer your questions.

QUESTIONS AND ANSWERS

Operator

[Interpreted] (Operator Instructions) Our first question comes from Daniel Sasson from Itaú BBA.

Daniel Sasson - Itaú Corretora de Valores S.A., Research Division - Research Analyst

[Interpreted] My first question relates to your net debt. Could you please help me consolidate the BRL 300 million that you generate in cash with your net debt because even considering the payout of dividends of BRL 120 million, the exchange rate at the end of the period was lower when you compare it to the first quarter and probably, this would have helped in the reduction of your net debt. So if you could shed some light to that, it would be helpful.

The second question relates to your drivers in both U.S. and Brazil BDs. We've seen some drivers moving in the opposite direction. What are the margins that could be expected for Brazil? Do you think that there will be increases in the cost because of the downtime of the blast furnace, as you said. But on the other hand, maybe that would incur in a volume improvement or an attempt to increase in transfer prices, but that would also generate higher costs when you buy from third parties. And maybe costs will be higher in the third quarter. And in the case of the U.S., if you could comment on the metal spread in the onset of this new quarter? And what are the margins that could be expected considering the temporary accounting effect of more expensive scrap? Do you think that this could be reverted in the third quarter or maybe the results would still be under pressure with those dropping prices in the U.S. market? So these are my questions.

Gustavo Werneck Da Cunha - *Gerdau S.A. - CEO*

[Interpreted] Well, Daniel, Scardoelli will answer the first part of your question related to the debt. And after that, I will talk about margins in Brazil and U.S.

Harley Lorentz Scardoelli - *Gerdau S.A. - Executive VP, CFO & IR Officer*

[Interpreted] Daniel, the reconciliation of our free cash flow of BRL 361 million vis-à-vis net debt. In a way, quarter-on-quarter, there is always a nonrecurring item. That's why before the reconciliation, I would like to say that when you look at 1-year horizon or 4 accumulative quarters, we always have a large variation in the cost of cash when it comes to reducing net debt in the second quarter, particularly in this quarter, in addition to the dividends, because we have to discount that to arrive at this level of free cash flow, we must also consider a recurring aspect, which is the EBITDA, which is part of the cash flow calculation. And this is a cash generated by our operation, but it remains at the JV. So we have also considered the dividends of the JVs. In general, if you look at our numbers in this quarter, we have BRL 81 million, which refers to EBITDA from the JVs.

The second thing, particularly this quarter is that we -- we anticipated funded in our JV in Mexico of BRL 95 million. So this is the third item that should be deducted from this net free -- net cash and this is nonrecurring. And finally, just looking at that BRL 50 million. And this only refers to variations of other liabilities that do not affect the debt. It may affect other lines in the balance sheet. We -- there was some effects related to income tax from investment. And this is not part of the calculation of normal income tax because it's nonrecurring. But this is just an example. So in summary, these are the items. These are all items that have no cash effect that we have to make adjustments. If you look at a 1-year period, these nonrecurring items are less significant and our free cash generation is always very strong, and we use that to generate free cash flow.

Gustavo Werneck Da Cunha - *Gerdau S.A. - CEO*

[Interpreted] Okay. Let me start, Daniel, by giving you an overview about the U.S. Our metallic spreads remain at very high levels, all-time high levels. There are some minor variations throughout the last 6 months, but with no impact to our margins. We believe that the spreads should have a similar behavior until the end of this year, but the main point relates to volumes. In the second quarter, we were heavily impacted in terms of our shipments due to an unexpected period of heavy rain and mainly also due to a very heavy reduction in inventory levels throughout the chain in the U.S. but as there is strong demand for flats and longs in the U.S., and this demand is at high levels, we believe that our U.S. BD will be stable in the next coming months.

Now in regards to Brazil, my answer to you is that even despite a landscape of low demand and exports close to 0, we are well positioned in Brazil in terms of spreads and margins, especially in long steel.

And just as in the U.S., we turned the debate back to volumes because that's where lies the main leverage to take us to new levels in the next few years. Now again, talking about volumes in the different sectors. It's interesting to look at the behavior into different consumer markets where we operate in Brazil. And retail, mainly consisting of civil construction, even though the market is smaller, the retail market is growing quarter-on-quarter, and we are very well positioned, and we've been growing continuously in this industry through our 76 subsidiaries of Comercial Gerdau. And also due to our new company called Juntos Somos Mais that we can elaborate more in another opportunity.

In terms of residential and commercial construction, we noticed a slight recovery in the last few months. And this made us more optimistic in terms of what lays ahead in 2019. And to our sales, we see that it's pretty much in line with the indicators that we monitor on an ongoing basis, like vacancy in commercial properties, et cetera. In terms of infrastructure projects, where we believe is more difficult to see recovery.

I mean we know all of the gaps in Brazil because we know that we still lack better highways and logistic infrastructure. But at the same time, even with the approval -- with all of the measures to boost the economy, this industry infrastructure is very sensitive to timing because you have to wait for deals to be signed, et cetera, et cetera. So in terms of the infrastructure industry, we may start seeing a recovery in shipments of steel by 2020. And still talking about Ouro Branco in July, we initiated the downtime of Blast Furnace 1, it should be down for 60 days, BRL 440 million is the amount related to the downtime, and we want to prepare the equipment to face the next coming demand not only from Brazil but what lays ahead.

So between July and August, we are not producing 440,000 tonnes of steel in Ouro Branco. So obviously, this amount that is not being produced right now has an impact in the dilution of fixed costs. But we've been adopting other measures in other cost lines throughout the past few months, including scrap and pig iron through coal to prevent any further impact to our EBITDA margin going forward to the third quarter.

Operator

[Interpreted] Our next question is from Gustavo Allevato from Santander Bank.

Gustavo Allevato - *Santander Investment Securities Inc., Research Division - Research Analyst*

[Interpreted] I have 2 questions. Trying to look at your first North America BD, we saw a shrinkage in margins due to a drop in metal spreads. But in your view, what would be a normalized margin or an ideal margin? Would it be between the first quarter and the second, or maybe we should look at the third, look towards the third quarter looking forward? And Gustavo, in your previous answer, you talked about this but internally, do you work with any quantitative guidance in terms of demand recovery towards 2020? Or is it too soon to tell? And if you allow me, I have a very quick question related to working capital. What will be the reversal that we should expect going forward, maybe the fourth quarter? Do you think that will be a correct reading?

Gustavo Werneck Da Cunha - *Gerdau S.A. - CEO*

[Interpreted] Gustavo, speaking about the U.S. Our -- in our operation, there was no great variation in metallic spreads in the last few months. So in terms of scrap movements or even price, it did not move that much. That's why we maintain the spread. As I said, in this last quarter, volume was the issue. And as I've said before, in terms of volume, we believe that there will be a recovery in the next 6 months, very much due to the fact that inventories in the U.S. reached very low levels. It's difficult to speak about a normalized level in a scenario with a lot of volatility in Section 232, maybe we could see an expectation of margin, if all of the variables are maintained, but this 2-digit EBITDA margin in a scenario of low variational spreads in the last few months could be feasible.

Now in terms of Brazil, our total growth expectation for longs in 2019 varies between 0% and 2%. That is not according to our expectations, but we believe it's too soon to make any projections for 2020, even though those structuring elements like the effective demand for steel are taking place right now. Things like the pension reform, the tax reform and actions to boost the economy. So all in all, we are optimistic with 2020, even though it's still very soon to give you any estimate, and then I'll give the floor to Scardoelli to elaborate on working capital.

Harley Lorentz Scardoelli - *Gerdau S.A. - Executive VP, CFO & IR Officer*

[Interpreted] Gustavo, I just want to mention one more thing related to 2020. I'm not giving any guidance, but we always go back to the GDP multiples. We know that Brazil is a country with a big growth potential. So if Brazil resumes its growth, we will see an interesting consumption of steel. If we look at historic figures, when Brazil was growing 3% to 4%, this indicator was strong. So maybe this can help you model a potential growth in steel consumption. But this will certainly depend on other assumptions related to GDP. Now referring to working capital and I would say in the first 2 quarters of the year, we saw an increase in working capital and an increase in the cash conversion cycling in number of days.

And we have to prepare for the downtime in Ouro Branco. So we'll build up inventory around 390,000 tonnes, and this, in fact, impacted working capital. But when we look in terms of cash conversion cycle, as we saw last, and the impact was lower, this also impacted the cycle. In our view, in the second quarter towards the end of the year, we believe that we will go back to the number of days, which is closer to what we had at the end of last year.

Operator

[Interpreted] Our next question comes from Thiago Ojea from Goldman Sachs.



Thiago Augusto Ojea - Goldman Sachs Group Inc., Research Division - Equity Analyst

[Interpreted] First of all, I would like to ask about your North America BD, I mean, you divested the assets to commercial models, there was a new executive, appointed to take care of the business. So Werneck, if you could elaborate a bit more on that and tell us more about what is being done in terms of cost cuts, SG&A?

And so regardless of the conditions of the macro business, just give me an idea of what is going on? And Scardoelli, I have another question to you, given the cash generation this quarter and you still anticipate a reversal of working capital looking forward, so we should have a more cash generation looking forward. In the past, there was a discussion about the ideal level of leverage? Or maybe you thought about adopting a formal policy related to maximum debt position. So what is the leverage level of the company today and you think that this could be reverted into higher dividends? Or do you still have to lower the leverage levels even further?

Gustavo Werneck Da Cunha - Gerdau S.A. - CEO

[Interpreted] Thiago, about the U.S., we are extremely pleased with the outcome of that transaction in the last 2 months. Our decision to divest from our rebar assets was very assertive. And all the work we're doing there is bringing important results to the company. We know that any steel business worldwide has to look at cost, cost is an important aspect. That's why we focus a lot in the U.S. in terms of reducing SG&A. SG&A now is appointed through different methodologies, allowed us to have a very consistent evolution. And that is why we were able to retain the lowest SG&A in the company of BRL 374 million. And we also made important progress in terms of our production costs. If we -- we are pleased. And there is still room to evolve further. Now I'll give the floor to Scardoelli to answer the other part of your question.

Harley Lorentz Scardoelli - Gerdau S.A. - Executive VP, CFO & IR Officer

[Interpreted] Thiago, in terms of leverage level and our cash flow, first of all, our expectation is to reverse the working capital position, which was much related to inventory levels that -- that reached that level because of the downtime at Ouro Branco. And as we did in previous years, we have some positive free cash flow generation towards the end of the year. In terms of financial policy, earlier this year, we released our financial policy to have a net debt over EBITDA between 1, 1.25x with an average tenure of about 6 years.

So we are okay in terms of the average term, and we are still working further. In terms of free cash generation, we want to reach lower leverage indicators. Our dividend policy is still the same, 30% of the net income. I mean once you reduce debt, you reduce financial expenses, your net income increases and dividends increase alongside. So our policy is to maintain, but we are certainly working towards improving our results further and by the same token dividends will also increase.

Operator

[Interpreted] Our next question comes from Thiago Lofiego from Bredesco BBI.

Thiago K. Lofiego - Banco Bradesco BBI S.A., Research Division - Director & Head of the LatAm Pulp & Paper and Metals & Mining Equity Research

[Interpreted] I have 2 questions. But first, looking at long steels, you had impressive growth in terms of shipments, how much of that refers to strategic changes? And you also talked about heavy plates, could you give me some more details about that and the market outlook? And my second question relates to the U.S. And I do apologize if you already answered that question. But we see the increase in scrap prices in the U.S. The issues go up even further in August. And so do you see any room for further increases in steel prices?



Gustavo Werneck Da Cunha - *Gerdau S.A. - CEO*

[Interpreted] Thiago, your call -- your call was not very audible. I think your first question related to growth in flats in Ouro Branco. Well, it grew in our 2 main products. Coiled hot-rolled strips, we are adopting new measures, and we're able to add some additional volume. So we are working at full capacity, serving, particularly the domestic market. And that leads us to approve production increase in the rolling mill as soon as the market recovers a bit more, and we will submit to the Board this investment. But the main growth came from heavy plates. Not only we notice a slight recovery in that market in -- in different areas, it is aligned with our strategy, and it is occupying more space in the market. So what happened in the second quarter is perfectly aligned to our strategy and the strategy that we've been talking about since the investment has been approved.

Now in terms of the U.S., Thiago, in terms of pricing and in commercial policy, it's -- I mean it's a delicate subject. But I would say that we intend to maintain our projections for spread. This increase in scrap prices, indeed, has been announced, but it hasn't been materialized yet, especially in terms of the scrap we buy. So this possible increase will impact our different mills in the next coming months. So according to the information we have and the way we will operate, looking forward at this current spread will be maintained until the end of the year.

Operator

[Interpreted] Our next question comes from Caio Ribeiro from Crédit Suisse.

Caio B. Ribeiro - *Crédit Suisse AG, Research Division - Head of LatAm Metals and Mining Team*

[Interpreted] My first question relates to Special Steel, where we still see margins below levels from the past. It seems like, in part, this is due to the U.S. that is a bit weaker.

And you also said that this has to do with a weak demand from the oil and gas sector, but I just want to know whether you could give me a little bit more color about something that could trigger any further improvement in demand in the U.S. for Special Steel that could probably help improve the margins in this segment?

Or whether there is anything on the cost side that could probably help to grow margins in the segment. Secondly, the question is, about CapEx, CapEx that -- it was postponed from this year to the next 2 years, the next 2 years, I want to know whether somehow this changes the schedule of projects that you already approved.

Gustavo Werneck Da Cunha - *Gerdau S.A. - CEO*

[Interpreted] Let me talk about Special Steel. We have 2 operations that are operating with different dynamics at the moment, the U.S. and Brazil. We said that 2 quarters ago, I mean 2 quarters ago, at that time, there was a very steep increase in cost, especially in scrap, refractory, et cetera.

So -- and looking at the market dynamics, there was a delay in the production of that price increase into margins, especially in the way we negotiate these contracts for our customers. In fact, what happened in the past months is that we were able to recover spreads once we are renegotiating contracts with our customers. But the main problem we have in Brazil today is called volume. I recall that March of last year, when we decided to reconnect our -- to start up our melting shop in Brazil. 2 months later in May, we were impacted by the trucker strike in Brazil, and there was the beginning of the fiscal crisis in Argentina, and that meant an important reduction in volumes. And this reduction is still has not recovered yet, 6 months after in the melting shop in Mogi, we had to readjust our production.

We decided to embrace, I mean, the layoffs, there is a possibility that volumes could probably be resumed, but we believe that, that recovery will be very slow. Given the fact that we have to wait for the automotive industry to resume production. We do not believe in a quick recovery of the Argentinian economy in the short run.



Our situation in the U.S. also in terms of margins, there was a recovery. But what really affected us in the early part of the year are volumes. There are 2 segments that matter a lot to us, and that did not recover. One is distribution in oil and gas. And there is another additional complex factor that, as I said, was the shrinkage of the chain in the U.S., we see a better outlook for volume recovery in the second half, given the fact that inventories reach such a level that we believe that the inventories and volumes have to -- have to be resumed.

In terms of CapEx, we decided to reduce the disbursements in 2019 to BRL 1.2 billion, basically related to capacity expansion and these decisions, especially affected investments in Brazil. And I would like to mention maybe the most important one is the investment in the expansion of the hot -- the acquired hot-rolled strips in -- rolling mill in [Garu Verje], our investments for the next coming years will be maintained. But we just have to find what is the right timing to submit the investments to the Board. If we noticed a more consistent demand recovery, we can be quickly prepared to act when the right time comes.

Operator

[Interpreted] Our next question comes from Humberto Meireles from Santander Capital (sic) [Goldman Sachs].

Humberto Araujo Meireles - Goldman Sachs Group Inc., Research Division - Former Equity Analyst

[Interpreted] I do apologize if my question has been asked before. The question has to do about excluding ICMS in the PIS/COFINS space, we see some companies recently -- I mean being successful with their lawsuits against the government. So I just want to learn more about this process related to the exclusion of ICMS from the PIS/COFINS space. And what is the magnitude of this business, looking backwards?

Gustavo Werneck Da Cunha - Gerdau S.A. - CEO

[Interpreted] Thank you, Humberto. I will allow -- I'll give the floor to Scardoelli that can elaborate more on that.

Harley Lorentz Scardoelli - Gerdau S.A. - Executive VP, CFO & IR Officer

[Interpreted] In this regard, we are still on waiting mode. We're still on a hold. We were successful in some courts, but we are still waiting for a major decision related to the time line. So we are waiting for the ruling from the Supreme Court. But so far, there is nothing new. Nothing new regarding some cash receivables.

Operator

[Interpreted] Our next question in English from Carlos De Alba from Morgan Stanley.

Carlos De Alba - Morgan Stanley, Research Division - Equity Analyst

Could you comment on your iron ore business, how much do you expect to produce this year, maybe in the next year? And how much do you -- how much tonnes are you planning on selling to third parties, given the stronger outlook for iron ore and the fact that we're already starting to see a recovery in Vale's iron ore production, which I think you were a little bit concerned about?

And then on SG&A going forward, do you continue to see more opportunities to reduce expenses, given the remarkable work that the company has already achieved? And to what levels -- or at what levels do you think that those could be normalized?



Gustavo Werneck Da Cunha - *Gerdau S.A. - CEO*

[Interpreted] Thank you, Carlos. Carlos question is about our iron ore operation in Minas Gerais. Basically, our operation focuses on the internal demands of our Ouro Branco Mill. And certainly, we try to look for the best mix in both blast furnaces to reach the best possible production, and we sell part of our production as well, our annual production is around 7 million tonnes of iron ore. And out of that amount, we usually sell 2 million, and we buy 10 million, with the only intention to maximize or improve the ore mix in our blast furnaces. So whenever we talk about new deposits or new mines, we are always aiming at our own iron ore consumption. We do not just want to be a major player of iron ore in Brazil or abroad.

Carlos second question was about SG&A. We already reached an optimum level and whether there are other ways to promote further enhancements to SG&A. We were very successful adopting 0 based budget, so we went from SG&A over revenue of over 6.5% to 7%, to reach the current level of around 3%. We are continuously redesigning the budget of the company because there are always opportunities for further improvements in terms of costs. Therefore, all of the most important opportunities have already been captured. So this percentage of 3% and 3.5% as a percentage of revenue is, like we say, a normalized level of SG&A.

Operator

[Interpreted] Our next question from Timna Tanners from Bank of America, Merrill Lynch.

Timna Beth Tanners - *BofA Merrill Lynch, Research Division - MD*

Just wanted to follow-up a little bit, if I could, on the U.S. market outlook. 2 things. One in the short term, again, the scrap price increase of \$20 per tonne, usually would imply a margin benefit.

So I was just wondering if that's consistent. If there's anything to offset that? And if that explains your caution on the outlook. And also, as far as SBQ and some of the other products, you're hinting at a stronger outlook. But do you mean year-over-year? Or do you mean half-over-half? Because typically, typically, volumes slow down in the second half of the year. So I just want to clarify that.

And then my longer-term question is regarding beams. Some of the other beam producers in the U.S. are starting to talk about some significant market share benefit into 2020 because of the recent fabricated beam tariff decisions. And just wondered if you could comment on the opportunity there.

Gustavo Werneck Da Cunha - *Gerdau S.A. - CEO*

[Interpreted] Timna, asked 3 questions. The first relates to a reduction in scrap prices aligned with another question. So I think we've all read international publications related to scrap. Currently, the price foreseen for August is between \$20 to \$30. In fact, this increase has not been yet materialized. We do not believe that this increase will come so quickly. Therefore, we are still working with an assumption that this increase will not happen in a short period of time. But at the same token, if this increase come soon, it will not be immediately translated into our production costs. And as I said before, we work -- I mean going forward in the next 6 months with the metallic spread, very stable, very much in line with what we had in the past few months. And that's why for the next 6 months, we are also projecting an EBITDA margin very much in keeping with what we had in the last few months.

Timna also asked about Special Steel and whether our projections of lower volumes are based on the figures of last quarter and last year. Basically, with Special Steel, what we noticed in the last month is that after a Section 232 that was initiated last year, our customers, in general, were working with very high inventory levels, thinking that there would be a scarcity of products and raw materials in the U.S. market.

And once they understood the market dynamics better after Section 232, what we notice as of January of this year was that there was a significant reduction on average levels of inventories, in light and in heavy vehicles. And if you look at the orders, there is a rebound in inventories. But if we

look at our Special Steel BD in the U.S., what matters is the distribution part of it, because we haven't seen any significant rebound. And there has been some difficulties.

And the third question Timna asked refers to possible trade measures with fabricated beams or prefabricated beams that penetrate the U.S. market. In our specific case, in the case of Gerdau, we do not anticipate any significant growth in volumes over margin in case that trade measure is translated into a practical decision going forward.

Operator

[Interpreted] Our next question is from Petr Grishchenko from Barclays.

Petr Grishchenko - *Barclays Bank PLC, Research Division - Fixed Income Analyst*

I mean my question on metal spread was raised a couple of times so far. I just wanted to understand a little better why you're not seeing a volatility. I mean I'm just -- you can look at the conference calls of your competitors in the U.S., and they all point out to weaker spreads. So it must be some contractual lags. So can you specifically tell us how far contractual lags basically postponing the impact of lower spreads? And any color on kind of on that end would be helpful.

And my second question actually also -- I want to follow up on the working capital. I do fully understand why the swing was relatively benign in this quarter. I think last year, you consumed about BRL 1 billion of working capital. And this quarter, it was roughly 1/4 of that number. So does that mean we're going to have a lower cash source from working capital in the second half of the year? So any color would be helpful.

Gustavo Werneck Da Cunha - *Gerdau S.A. - CEO*

[Interpreted] Petr asked 2 questions, 1 related to metal spreads and the second related to working capital. Well, I'll answer the first on metal spreads. And after that, Scardoelli will give you some more color related to working capital. Basically, in our U.S. operation after the changes related to the divestment of assets, we basically operate in 3 segments. Two, long and large beams for commercial -- for commercial use. But when you look at the U.S. market, the way metal spreads affect long and flat and also still, it's very different. In our particular segment of long, and I'm referring to large beams and for commercial purposes, we do not have any large contracts, as you said, that could, in a case of a spike in prices of scrap, reduce our spreads.

On the other hand, as I said before, we do not anticipate any high increase in scrap prices in the U.S., but this anticipated increase in scrap prices is something that has been on the table for the last 6 months, but we've seen a reduction rather. So we don't believe that there will be a sudden change in structural issues. We do believe that considering the products we have in the markets where we operate, we will be able to -- through all of the measures that we are adopting, we will be able to maintain the spread in the next 6 months throughout the next 6 months. But Scardoelli can elaborate on the issue of working capital.

Harley Lorentz Scardoelli - *Gerdau S.A. - Executive VP, CFO & IR Officer*

In relation to working capital, Petr asked about the use of working capital because in the second half of last year, it was much higher than what we had in the first half of this year. Even though last year, our working capital in terms of cycle days was lower. It was about 24. We started out this year with about 70, but what happened is that in the second quarter, our export shipments had very strong prices, particularly in Brazil. That's why our working capital went up to much higher levels. So there was a spike in the activities, and that's why we consumed more working capital.

This year, the levels are higher in terms of cycle days, but the variation quarter-on-quarter was not very significant. And this is a justification. In the past, mostly due to a very strong demand increase and high international prices, all of that reflected in the higher use of working capital when compared to what we used this year in 2019.



Operator

[Interpreted] Next question from Jon Brandt from HSBC.

Jonathan L. Brandt - *HSBC, Research Division - Head of LatAm Cement, Construction & Real Estate Equity Research Team*

I have 2 questions. First, and I'm sorry to keep coming back to this. But just on the North America margins. So if you're right on the metal spreads, and they are stable compared to what you've witnessed over the past few months. And it sounds like you're expecting better volumes in the second half with the finishing of the destocking of inventories and potentially better weather in the third and fourth quarter, why aren't you expecting profitability to actually increase, at least in the third quarter versus what you had in the second quarter?

And then my second question just relates to leverage with the weakening environment that we're seeing in Brazil, are you still expecting to get to that 1 to 1.5x net debt and the BRL 12 billion in gross debt by the end of 2020? And is that really the basis behind the lower CapEx numbers that you announced today?

Gustavo Werneck Da Cunha - *Gerdau S.A. - CEO*

[Interpreted] Jonathan revisited the issue of metal spreads in the U.S. So our belief is that without our margins, our long steel BD in the second quarter -- and as I said before, our belief was mostly based in a high demand in the U.S. So this is a scenario of strong demand. On the other hand, there was a significant reduction in inventory levels throughout the chain, also deliveries were held back due to heavy rains in the U.S. Lower inventories can be translated into a possible increase in volume now in the second half. And the increase in volume can be translated into a better dilution of fixed costs.

We have an asset portfolio after the divestment of the rebar units, which now has healthier margins. Therefore, we do not believe that today there are international fundamentals that would allow for a very strong spike in scrap prices in the U.S., a marginal increase in scrap prices due to what will happen in the next few months. I mean in terms of our inventories, we do not believe in any strong cost pressure.

All in all, all of these facts, in addition to improvement, as I said before, to our operation in view of all of the measures adopted related to operating efficiency. Now all of these factors can generate -- can bring about more stability to metal spreads in our U.S. operation. I will give the floor to Scardoelli that can answer your second question.

Harley Lorentz Scardoelli - *Gerdau S.A. - Executive VP, CFO & IR Officer*

[Interpreted] The second part of Jonathan's question relates to our leverage level. And he asked whether we still focus on reaching a leverage -- I mean net debt leverage between 1 and 1.5x and a gross debt, more than BRL 1 billion, I think, in 2020, and he also talked about CapEx reduction in our financial policy.

Well, in terms of the second part of your question, the answer is, yes, we made it clear that our investments were flexible in terms of execution. So they would materialize as soon as we would see a recovery in the market. So that in the long and short term, we would reach that goal of 1 to 1.5x net debt over EBITDA leverage. We don't give guidance on timing. We just say that we will reach that goal in the average and long term.

So considering our free cash position, we -- it's very likely that we will reach that level, but I cannot give you a precise date, but the trend is that we will reach that in the mid- and long-range.

Operator

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

Gustavo Werneck Da Cunha - *Gerdau S.A. - CEO*

[Interpreted] As always, it's been a pleasure talking to you all, and once again, thank you for participating. I take this opportunity to invite you to join us again for our next earnings call related to the results of the third quarter that will take place on October 30. So thank you very much, and have a very good day.

Operator

[Interpreted] Gerdau's earnings conference call is now concluded. Thank you very much for participating and have a nice afternoon.

[Portions of this transcript that are marked Interpreted were spoken by an interpreter present on the live call.]

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