Research Update:

Gerdau Outlook Revised To Positive From Stable On Low Leverage And Conservative Financial Policy, 'BBB-' Rating Affirmed

July 19, 2022

Rating Action Overview

- Brazilian steelmaker Gerdau S.A. has been posting very low leverage mostly due to industry tailwinds that have boosted annual EBITDA to record-high historical level of more than R$20 billion.
- We expect Gerdau to continue to generate strong FOCF in excess of R$6 billion, even despite a significant increase in capex compared to previous years.
- On July 19, 2022, S&P Global Ratings revised the outlook on Gerdau and Gerdau Ameristeel Corp. to positive from stable, and affirmed the global scale 'BBB-' issuer credit ratings on both companies. We also affirmed our 'brAAA' Brazil national scale rating on Gerdau, and the outlook on this rating remains stable. At the same time, we affirmed all of our 'BBB-' and 'brAAA' issue-level ratings on Gerdau.
- The positive outlook reflects that we can upgrade Gerdau in the next 12-18 months if it keeps a low leverage and structurally lower gross debt even when the commodity cycle turns, while it implements countercyclical measures related to capital expenditures (capex), dividends, and share repurchases.

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Rating Action Rationale

Record-low leverage due to favorable industry fundamentals. Gerdau is posting record EBITDA amid high steel prices in Brazil and metals spread in the U.S., its two main markets. The company's higher exports should offset the likely high-single digit drop in volumes for the Brazilian market in 2022, due to weaker demand after the completion of the restocking of the chain in 2021. In the U.S., demand remains resilient in the construction and industrial sectors, with Gerdau's plants operating at more than 90% of capacity. The specialty steel business division is still suffering from lower light-vehicle production due to semiconductor shortages, but the heavy-vehicle output and oil and gas demand should offset that drop. We expect adjusted EBITDA in 2022 to remain slightly below the 2021 level, at almost R$21 billion, but to fall to R$15 billion in 2023 due to a price accommodation in Brazil and the U.S., while adjusted leverage should remain well below 1.0x in both years.

Conservative financial policy to maintain low leverage and sound liquidity once the cycle turns. Gerdau has a net leverage cap of 1.0x-1.5x and a gross debt cap of R$12 billion, which the company is close to achieving--gross debt reached R$12.8 billion as of March 31, 2022. We believe that even if EBITDA were to tumble to levels seen during Brazil's multi-year recession--about $1.2 billion--the company would keep leverage well below 2.0x by curtailing capex and shareholder remuneration.

Stronger cash flows will support higher working capital, capex, and dividends. We expect Gerdau's capex to reach about R$4.5 billion in 2022 and R$5 billion in 2023, comprising investments in the Ouro Branco and Pindamonhangaba mills in Brazil; Whitby mill in Canada; Jackson and Midlothian mills in the U.S.; and the Peruvian operations. The company is also investing in digitization and scrap collection, as well as in the new businesses under its Gerdau Next plan. This should improve operating efficiency and margins, as well as marginally expand capacity. In 2022, dividend payments should reach more than 35% of the previous year's net income, and we forecast an increase to 50% in the next few years, given that the company maintains leverage below 1.0x and gross debt below R$12 billion in our base-case scenario. We also assume R$1.2 billion in share repurchases in 2022 and 2023, according to the current plan, and R$1 billion afterwards. Nevertheless, we expect management to reduce capex and shareholder remuneration amid a potential stress scenario.

Outlook

The positive outlook reflects our expectations that Gerdau will maintain net debt to EBITDA well below 1.0x for the next 12-18 months, while it would be able to withstand an industry downturn and keep leverage well below 2.0x due to its conservative financial policy of keeping gross debt below R$12 billion. We also expect Gerdau to maintain a sound liquidity cushion to withstand the stress test to be rated above Brazil (BB-/Stable/B).

Upside scenario

An upgrade in the next 12-18 months would stem from a longer record of maintaining adjusted debt to EBITDA well below 2.0x, funds from operations (FFO) to debt above 45%, free operating cash flow (FOCF) to debt of more than 15%, and strong liquidity, even amid the bottom of the commodity cycle.

Downside scenario

We could lower the ratings on Gerdau if, when the commodity cycle turns, its net debt-to-EBITDA ratio exceeds 2.0x and FFO to debt falls below 45%. The downside scenario could also result from working capital mismanagement that leads to a large cash burn, substantial merger and acquisitions (M&A), and/or aggressive shareholder remuneration. We could also downgrade Gerdau following a meaningful worsening of its liquidity profile, limiting its ability to withstand a sovereign default scenario.

Company Description

Gerdau is one of the largest long steel producers in the Americas, with total crude steel capacity of about 17.7 million tons. Gerdau's operations are primarily located in Brazil and the U.S., but it also operates in Argentina, Canada, Colombia, the Dominican Republic, Mexico, Peru, and Uruguay, totaling 32 plants. Apart from long steel, the company also produces flat steel, specialty steel, and iron ore, the latter of which is for its own use. The company posted net revenue of R$78.3 billion (more than $14 billion) and adjusted EBITDA of R$21.8 billion (about $4 billion) in 2021.

Our Base-Case Scenario

- Brazil's real GDP to grow 1.2% in 2022 and 1.4% in 2023. We expect a high-single digit reduction in the company's domestic volumes, offset by a 60% increase in its exports.
- U.S. GDP to grow 2.4% in 2022 and 1.6% in 2023. We expect the utilization rate of close to or above 90% at Gerdau's North American division, with strong demand from the construction and industrial segments. Our medium-term outlook in the U.S. is also supportive following the approval of the $1.2 trillion infrastructure bill that could add about 5 million tons per year of steel demand in the country.
- Brazil's average inflation of about 10.5% in 2022 and 5% in 2023, affecting personnel, maintenance, and energy costs for the Brazilian business division.
- Average U.S. inflation of about 5.6% in 2022 and 3.3% in 2023. We expect metals spreads to gradually fall from the currently high levels of more than $500 per ton.
- The end-of-period exchange rate at R$5.10-R$5.15 per $1 in 2022 and 2023.
- Net revenue growth of 5%-10% in 2022 due to high demand and significant price hikes, and a 5%-10% drop in 2023 due to price accommodation.
- Capex of about R$4.5 billion in 2022 and R$5 billion in 2023, comprising maintenance, modernization, and expansion of the Ouro Branco and Pindamonhangaba mills in Brazil; Whitby mill in Canada; Jackson and Midlothian mills in the U.S.; and Peruvian operations.
- Dividend distribution in 2022 of slightly more than 35% of the previous year's net income and 50% in 2023.
- Share repurchases of almost R$1.2 billion in 2022 and 2023, given the current repurchase plan that the company's board approved.

Based on these assumptions, we arrive at the following metrics:

- EBITDA slightly above R$20 billion in 2022, falling to R$15 billion in 2023 and R$14 billion in 2024;
- EBITDA margins of 25% in 2022, falling to about 20% in 2023 and 17.5% in 2024;
- Debt to EBITDA below 0.5x in 2022 and slightly above 0.5x in 2023 and 2024; and
- FOCF to debt of about 120% in 2023, and 60%-75% in 2023 and 2024.

Liquidity

We continue to view Gerdau's liquidity as strong. Sources over uses of cash for the next 24 months will be about 1.5x, and sources would be higher than uses even if EBITDA were to decline by 30% from our base-case expectations. We expect the company to use its strong cash position and its revolving credit facility to cover its short-term needs, without needing to access the capital market. We believe Gerdau has a well-established relationship with banks and a high standing in credit markets given its large scale and solid operations. We view the company as having overall prudent risk management, and it's not subject to financial covenants on its debt.

Principal Liquidity Sources:

- Cash position of R$7.6 billion as of March 31, 2022;
- Availability under the undrawn portion of its committed credit facility due 2024 of $740 million (about R$3.7 billion) as of March 31, 2022; and
- FFO of R$15.5 billion in the next 12 months.

Principal Liquidity Uses:

- Short-term debt maturities of about R$2.1 billion as of March 31, 2022;
- Cash tender offer of R$752 million for its 2024 notes;
- Working capital outflows of nearly R$2 billion in the next 12 months and seasonal working capital of R$1.5 billion;
- Estimated capex of about R$4.5 billion for the next 12 months; and
- Dividend payments of about R$5.6 billion and share repurchases of almost R$600 million for the next 12 months.

Environmental, Social, And Governance

ESG credit indicators: E-3, S-2, G-3

Environmental factors are a moderately negative consideration in our credit rating analysis of Gerdau. In line with its downstream peers, the energy-intensive production process of steel and increasing demand to reduce GHG emissions are moderately negative environmental factors. Importantly, Gerdau produces about 70% of its steel in electric arc furnaces, which pollute significantly less than blast furnaces and are fed with scrap metal that the company sources from metal recyclers. In its upstream segment, Gerdau is decommissioning one upstream tailing dam in the state of Minas Gerais to meet this regulatory requirement, which bears a higher risk of collapse than other types of dams. However, the process requires small level of capex and should be completed in 2022. Governance factors are also a moderately negative consideration. Allegations of tax evasion took a toll on the company's reputation in 2016, when we revised our management and governance score to fair from satisfactory, but with no changes to the overall rating. Investigations now are only regarding one former and one current executive, and the company has improved compliance and internal controls considerably, transitioning to a fully professionalized executive team, moving family members to the board level.

Group Influence

We analyze consolidated figures and operations at the Metalúrgica Gerdau (MG) level, which doesn't change our view of the group's business and financial risk profiles. This is because Gerdau is MG's only asset and is therefore a core subsidiary and driver of the group's credit quality. There's no material debt at the holding level.

Rating Above The Sovereign

Given its relevant exposure to Brazil (about 60% of EBITDA), we stress Gerdau's ability to withstand a hypothetical sovereign default scenario of that country. The company passes the stress test, given its solid liquidity and cash flow contribution from foreign operations. Therefore, we can rate Gerdau above the referenced foreign currency sovereign rating, which is the weighted average between our ratings on Brazil and the U.S. The average reference country rating is 'BBB', which we lower one notch because Gerdau's country of domicile is Brazil. In our view, Gerdau operates in an industry that's highly sensitive to the domestic economy because the steel sector is primarily domestically focused, limiting the final rating to up to two notches above the referenced sovereign rating. We also analyze the transfer and convertibility (T&C) risks that reflect Gerdau's ability to satisfy its operating and financial needs in foreign currency, a risk that would rise if Brazil were to impose capital controls. Our T&C assessment of Brazil is 'BB+', and the rating on Gerdau is currently capped at two notches above this level, or 'BBB', because the company generates more than 50% of cash flows in Brazil. Under a hypothetical sovereign default scenario, we assume the following:

- Brazil's GDP to contract 10%, denting the company's domestic volumes and preventing price increases;
- Higher inflation, hurting selling, general, and administrative expenses and other costs;
- The doubling of foreign exchange rate, raising dollar-denominated debt interest, costs, and debt principal;
- Doubling of the basic interest rates, increasing Gerdau's interest expense on its floating-rate debt;
- Capex at maintenance levels, but with a larger portion (about one-third) in dollars;
- Stressed working capital levels;
- No dividend payments; and
- Haircut of 10% over the company's bank deposits (in Brazilian reals) and of 70% over its short-term investments in the same currency, and double our assumptions for its exposure to the U.S. dollar, given the real's depreciation.

Regarding the T&C stress test, we view that in a scenario of T&C restrictions, Gerdau's available cash and cash generation outside Brazil and 25% of current exports from Brazil would be sufficient to cover the company's short-term debt and interest payments in hard currency due to its dollar-denominated cash and revolving credit facility, as well as its sizeable U.S. operations.

Issue Ratings - Subordination Risk Analysis

Capital structure

As of March 31, 2022, Gerdau's capital structure mainly consisted of:

- R$9 billion in senior unsecured international bonds due 2023, 2024, 2027, 2030, and 2044. The company recently tendered the outstanding amount of its 2024 bond (about R$750 million);
- R$768 million in working capital lines, partly consisting of the drawn portion of the revolving credit facility; and
- R$3 billion in senior unsecured debentures.

Gerdau's debt position mostly comprises senior unsecured debt guaranteed or issued by the company. The subsidiaries' debt represents less than 10% of total debt. We consider the notes as Gerdau's debt, given that it acts as the unconditional guarantor.

Analytical conclusions

We rate Gerdau's senior unsecured debt at the same level as our issuer credit rating because the company has limited secured debt. Even if the senior unsecured debt ranked behind the subsidiaries' debt in the capital structure, we consider that the risk of subordination is mitigated by a priority debt ratio that is much lower than 50%.

Ratings Score Snapshot

Issuer credit rating

- Foreign currency BBB-/Positive/--
- Local currency BBB-/Positive/--

Business risk Satisfactory

- Country risk Intermediate
- Industry risk Moderately high
- Competitive position Strong

Financial risk Intermediate

- Cash flow/leverage Intermediate

Anchor bbb-

- Diversification/portfolio effect Neutral (no impact)
- Capital structure Neutral (no impact)
- Financial policy Neutral (no impact)
- Liquidity Strong (no impact)

- Management and governance Fair (no impact)
- Comparable rating analysis Neutral (no impact)

Stand-alone credit profile bbb-

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Gerdau S.A.		
Gerdau Ameristeel Corp.		
Issuer Credit Rating	BBB-/Positive/--	BBB-/Stable/--
Ratings Affirmed		
Gerdau S.A.		
Issuer Credit Rating		
Brazil National Scale	brAAA/Stable/--	
Gerdau S.A.		
Senior Unsecured	brAAA	

GTL Trade Finance Inc.	
Senior Unsecured	BBB-
GUSAP III LP	
Senior Unsecured	BBB-
Gerdau Ameristeel US Inc.	
Senior Unsecured	BBB-
Gerdau Holdings Inc.	
Senior Unsecured	BBB-
Gerdau Trade Inc.	
Senior Unsecured	BBB-