FitchRatings

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Fitch Upgrades Gerdau S.A. to 'BBB'; Outlook Stable

Fitch Ratings - New York - 08 Jun 2022: Fitch Ratings has upgraded Gerdau S.A.'s Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) to 'BBB' from 'BBB-', and has affirmed Gerdau's National Scale Ratings at 'AAA (bra)'. In addition, Fitch has upgraded Gerdau's senior unsecured notes, and the senior unsecured notes issued by its related or subsidiary companies to 'BBB' from 'BBB-'. The Rating Outlook remains Stable.

Gerdau's upgrade follows three years of gross debt reduction of more than USD1.2 billion. Gerdau's investment-grade ratings are buttressed by its consistent commitment to a sound capital structure, extended debt-amortization profile, robust liquidity position, geographic operational diversification, and flexible operating structure of electric arc furnace (EAF) steel production, which allows it to swiftly respond to changing market conditions.

Gerdau's ratings are above Brazil's 'BB' Country Ceiling based on the company's ability to service its debt with cash flow generated by its U.S. subsidiaries and/or the cash and marketable securities it holds outside of Brazil.

Key Rating Drivers

Solid Capital Structure: Gerdau's consistent use of measures like asset sales, equity issuances, and debt repayments to maintain a strong capital structure was a key rating consideration for the upgrade. The company has reduced gross debt by USD1.2 billion to BRL12.8 billion (USD2.7 billion) at the end of March 2022 from its peak of BRL 16.1 billion (USD 3.9 billion) at the end of 2019, and the company holds BRL7.6 billion of cash and marketable securities. The company's gross debt/EBITDA ratio reached 0.6x in LTM 1Q22, from 3.0x in 2019, and its net debt/EBITDA ratio was 0.2x from 1.8x in 2019. Fitch expects additional gross debt reduction to reach a level below Gerdau's BRL 12.0 billion long term target. Fitch expects the company will maintain a net leverage ratio at approximately 0.2x in 2022 and 0.3x in 2023.

Sturdy Business Position: Gerdau is the leading long steel producer in the Americas. The company's diversified portfolio of assets hedges the company to sharp downturns in key markets, such as Brazil or the U.S., and provides the company's cash flow a degree of stability. Gerdau has a flexible production cost structure, with approximately 75% of output from electric arc furnaces mini-mills and 25% from integrated blast furnaces. This allows the company to react to changes in steel demand in Brazil and the U.S. The company's EBITDA during 2021 was comprised of Brazil at 56%, North America at 27%, South America (excluding Brazil) at 9% and Special Steel at 8%

North American Cash Flow: Gerdau's ratings are not constrained by a country ceiling. Fitch believes the company's applicable country ceiling is North America at 'AAA', as Fitch estimates its EBITDA from operations in the U.S. can comfortably cover its consolidated hard-currency interest expense by an average of 5.0x over the next 24 months.

Should the company's North American operations EBITDA fail to cover 12 months of hard-currency interest expense by at least 1.0x, the company's rating, per Fitch's Non-Financials Exceeding the Country Ceiling criteria, will be limited to three-notches above the next applicable country ceiling, which is 'BB'. Therefore, a downgrade of Brazil (Negative Outlook), coupled with deteriorating cash flows from its North American business division would have a negative impact on Gerdau's ratings.

Brazilian Steel Demand Softening, Neutral Impact: Steel prices started to fall in Brazil from the August 2021 peak and continued to decrease in 2022 amid political risk, inflationary pressures, tighter monetary policy and a growth slowdown. Long steel apparent consumption fell 13.2%, and flats by 15% in January-April of 2022 compared with a year ago, according to the Brazilian Steel Institute. Notwithstanding, March and April higher apparent production approached 2021 levels, and an easing of the semiconductor shortage is expected to improve auto making in 2H22. Gerdau's 1Q22 shipments to Brazil fell, but exports more than offset the decline.

High FCF Generation: Higher steel price dynamics in North America allowed EBITDA/tonne to reach BRL2,477 (USD414), compared with about BRL1,410 (USD270) in Brazil, boosting profitability in 1Q22. Fitch forecasts Gerdau's EBITDA will decrease to BRL16.7 billion in 2022 from BRL23.3 billion in 2021 with average EBITDA/tonne at BRL1,350 (USD 270) in 2022. Gerdau targets a BRL 4.5 billion capex for 2022, including BRL0.5 billion previously postponed focused on maintenance, expansion and technological updating. The company is expected to generate BRL3.2 billion of FCF after capex and dividends in 2022.

Derivation Summary

Gerdau's diversified operational footprint, significant operating cash flows from its assets abroad, mainly in the U.S., and flexible business model that allows it to better withstand economic and commodity cycles, are all key competitive advantages. Gerdau has also met creditors' demands proactively by selling assets twice in the last six years and raising equity three times with most of the proceeds reallocated to repay debt in the last 13 years.

Gerdau's vertical integration as a dominant competitor in the scrap market and downstream multiproduct distribution network compares with Companhia Siderurgica Nacional's (CSN; BB/Positive) and Usinas Siderurgicas de Minas Gerais S.A.'s (Usiminas; BB/Stable) integrated business profile. CSN and Usiminas are highly exposed to the local steel industry in Brazil, particularly to the flat steel sector, and have large iron ore exports.

Among the three Brazilian steel producers, Gerdau has consistently maintained the strongest balance sheet, most manageable debt amortization schedule, and has consistently made efforts to improve its capital structure through assets sales or equity issuances. Gerdau's Fitch adjusted gross debt (BRL 14 billion at YE 2021) is higher than Usiminas's (BRL7 billion), but lower than CSN's (BRL 36 billion). Gerdau's gross and net leverage of 0.6x and 0.3x, at YE 2021, and Usiminas's 0.6x and 0.0x are slightly lower than CSN's at 1.6x and 0.8x.

Unlike the operating profile of blast furnace led North American peer's U.S. Steel (BB-/Positive) or Cleveland-Cliffs (BB-/Positive), Gerdau's operation is more similar to Steel Dynamics (BBB/Stable) and Commercial Metals Company (BB+/Stable), with Electric Arc Furnace facilities, scrap collection markets presence, long steel predominance and U.S. operations. Gerdau has a larger production capacity (17 million tonnes of crude steel) than Steel Dynamics (13 million tonnes, 16 million tonnes including new

Texas operation) and Commercial Metals (10 million tonnes). Commercial Metals sources a higher percentage of raw materials from scrap (98%) than Steel Dynamics (84%) or Gerdau (about 73%).

Gerdau has obtained better profitability in 2021 with EBITDA/tonne of USD350 (USD197 is the last three years average), higher than Commercial Metals (USD163 in NA, USD92 in Europe), but lower than Steel Dynamics (USD420/tonne), and has posted a higher three-year average EBITDA margin of 19.9% than Steel Dynamics' 17.2% and Commercial Metals' 11.5%. Gerdau's product diversification is larger than Commercial Metal's with its emphasis on the North American rebar, but lower than Steel Dynamics.

Gerdau is more geographically diversified across the Americas compared with Commercial Metals U.S. and Poland operations or Steel Dynamics' sole North American focus. Gerdau's leverage metrics (three-year average gross and net leverage of 2.0 and 1.2x) are lower than Commercial Metals (2.2x and 1.6x), but higher than Steel Dynamics (1.8x and 0.9x).

Key Assumptions

Fitch's Key Assumptions Within The Rating Case for the Issuer:

--Brazil's domestic steel volumes decrease by 13% in 2022, and stabilize in 2023 and in 2024;

--Brazilian export steel volumes grow by 70% in 2022, and remain elevated in 2023 and in 2024;

--Specialty steel volumes grow by 1% in 2022, and remain stable in 2023 and in 2024;

--North America steel volumes decrease by 1%, and remain stable in 2023 and in 2024;

--Combined EBITDA/tonne fall to BRL 1,350 in 2022, to BRL 900 in 2023 and BRL 630 in 2024;

--Capex at BRL 4.5 billion in 2022, and averaging BRL 3.0 billion over the rating horizon;

--Taxes at BRL 3.3 billion in 2022, BRL 1.9 billion in 2023 and BRL 1.1 billion in 2024

--An exchange rate of BRL5.35/USD1.00 at YE 2022, and BRL5.25/USD1.00 in average FX rate for the next years.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--An upgrade is unlikely given the inherent business risk of the company with operations concentrated in Brazil.;

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Sustained adjusted total debt/EBITDA above 2.5x and/or adjusted net debt/EBITDA above 1.5x;

--Persistent negative FCF;

--EBITDA margins below 12% on a sustained basis.

Best/Worst Case Rating Scenario

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

Liquidity and Debt Structure

Ample Liquidity: Gerdau consistently has kept a conservative financial strategy resulting in the company terming out its debt and holding enough cash to cover upcoming maturities. The company had BRL7.6 billion of cash and marketable securities as of March 31, 2022. Gerdau's cash holdings are sufficient to cover amortizations over the next six years. Its debt profile has an average term of 7.7 years.

Approximately 66% of Gerdau's cash was held in U.S. dollars as of March 2021. During the same period, the company kept its Brazilian reals denominated cash in time deposits and exclusive closed funds. Its U.S. dollar-denominated cash was kept in time deposits and interest-bearing accounts or sweep accounts. In addition to the cash it holds, Gerdau has a USD800 million global credit revolving facility till 2024, out of which USD60 million has been used.

Gerdau has strong access to local and international debt markets, as well as Brazilian and international banks. Gerdau's debt consists of cross-border issuances (70%), local Brazilian debentures (24%) and working capital lines (6%). Approximately 70% of the company's debt is U.S. dollar denominated.

Issuer Profile

Gerdau S.A. is a leading manufacturer of long steel in the Americas and has a strong presence in special steel in the U.S. and Brazil. It also produces flat steel and has iron ore operations in Brazil. It has integrated blast furnaces and also flexible electric arc furnace mini-mills with a strong presence in the scrap market.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

Fitch Ratings Analysts

Hector Collantes
Associate Director
Primary Rating Analyst
+1 212 908 0369
Fitch Ratings, Inc. Hearst Tower 300 W. 57th Street New York, NY 10019

Fernanda Rezende
Senior Director
Secondary Rating Analyst
+55 21 4503 2619

Saverio Minervini
Senior Director
Committee Chairperson
+1 212 908 0364

Media Contacts

Elizabeth Fogerty
New York
+1 212 908 0526
elizabeth.fogerty@thefitchgroup.com

Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
Gerdau Trade Inc.					
• senior unsecured	LT	BBB	Upgrade		BBB-
Gerdau S.A.	LT IDR	BBB	Upgrade		BBB-
	LC LT IDR	BBB	Upgrade		BBB-
	Natl LT	AAA(bra)	Affirmed		AAA(bra)
• senior unsecured	LT	BBB	Upgrade		BBB-
GTL Trade Finance Inc.					

ENTITY/DEBT	RATING			RECOVERY	PRIOR
• senior unsecured	LT	BBB	Upgrade		BBB-
GUSAP III LP					
• senior unsecured	LT	BBB	Upgrade		BBB-

RATINGS KEY	OUTLOOK	WATCH
POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

Applicable Criteria

Corporate Rating Criteria (pub.15 Oct 2021) (including rating assumption sensitivity)

National Scale Rating Criteria (pub.22 Dec 2020)

Non-Financial Corporates Exceeding the Country Ceiling Rating Criteria (pub.08 Jan 2021)

Sector Navigators - Addendum to the Corporate Rating Criteria (pub.15 Oct 2021)

Applicable Models

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.0.3 (1)

Additional Disclosures

Solicitation Status

Endorsement Status

Gerdau Holdings Inc.	EU Endorsed, UK Endorsed
Gerdau S.A.	EU Endorsed, UK Endorsed
Gerdau Trade Inc.	EU Endorsed, UK Endorsed
GTL Trade Finance Inc.	EU Endorsed, UK Endorsed
GUSAP III LP	EU Endorsed, UK Endorsed

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