FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Gerdau S.A. at 'BBB-'; Stable Outlook

Wed 09 Jun, 2021 - 16:09 ET

Fitch Ratings - New York - 09 Jun 2021: Fitch Ratings affirmed Gerdau S.A.'s Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) at 'BBB-', and its National Scale Rating at 'AAA (bra)'. Fitch also affirmed Gerdau's senior unsecured notes at 'BBB-', and the senior unsecured notes issued by its related or subsidiary companies. A full list of ratings follows at the end of this release. The Rating Outlook is Stable.

Gerdau's investment-grade ratings reflect its consistent commitment to a sound capital structure, its extended debt-amortization profile, its robust liquidity position and its flexible operating structure spread across the Americas. Gerdau's ratings are above Brazil's 'BB' Country Ceiling based on the company's ability to service its debt with cash flow generated or held outside of Brazil.

KEY RATING DRIVERS

Competitive Business Position: Gerdau is the leading long steel producer in the Americas. The company's diversified portfolio of assets hedges the company against sharp downturns in key markets, such as Brazil or the U.S., and provides a degree of stability to the company's cash flow. 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 quickly to changes in steel demand in Brazil and the U.S. The company's EBITDA during 2020 was comprised of Brazil at 53%, North America at 23%, South America (excluding Brazil) at 14% and Special Steel at 9%.

Strong Steel Demand Recovery: Steel prices remained strong in Brazil during 2020 and are expected to remain elevated in 2021. The strategic production cuts that Brazilian steel producers undertook in Brazil caused a 4.5% volume drop in 2020 despite a 1.2% rise in apparent consumption, according to the Brazilian Steel Institute. Gerdau temporarily closed several mini-mills and its blast furnace No. 2 at its Ouro Branco mill to maintain high capacity rates despite volume drops.

Industry associations and CRU project demand in both long and flat steels to expand approximately 7% in 2021. Gerdau's 1Q21 shipments to Brazil have already risen 31% year-on-year, heralding a pickup in demand that will outpace that of GDP.

Growing FCF: Local suppliers' inability to keep up with demand is boosting steel prices in Brazil and bolstering Gerdau's FCF generation. The Brazilian Steel Institute noted that steel consumption has surpassed production for 10 of the past 12 months. CRU forecasts steel prices to climb more than 30% in 2021. Gerdau is skewing deliveries towards the domestic market where EBITDA/ton has been BRL1,975 in the 1Q21, up from the BRL784 average of 2020. Fitch projects Gerdau's EBITDA will rise to BRL16.7 billion in 2021 from BRL7.5 billion in 2020. The company is expected to generate BRL7.1 billion of FCF after capex and dividends in 2021.

Strong Capital Structure: Gerdau's consistent use of asset sales, or equity issuances to maintain a strong capital structure is a key rating consideration. The company had BRL17.8 billion of total debt at the end of March 2021 and BRL7.0 billion of cash and marketable securities. The company's net debt/EBITDA ratio during this period was 0.9x, which was down from 1.3x at YE 2020 and from 2.6x at the end of March 2020. Fitch expects the company will continue to pursue liability management exercises, and forecasts Gerdau's YE net leverage ratio will be around 0.4x, and remain low in 2022.

North American Cash Flow: Fitch measures the relationship between cash flow generation in a given country or region relative to hard currency gross interest expense over a three- to five-year time horizon in determining a multinational company's applicable Country Ceiling. Gerdau's applicable Country Ceiling is unconstrained by Brazil's 'BB' Country Ceiling, given the amount of EBITDA generated by its U.S. and Canadian operations relative to its annual debt service. This hard currency interest expense coverage ratio was 2.0x in 2020, and will grow to around 4.4x in 2021 and stabilize at 3.0x in 2022.

DERIVATION SUMMARY

Gerdau has key competitive advantages from its diversified footprint of operations, with significant operating cash flows from its assets abroad, mainly in the U.S., and a flexible business model that allows it to better withstand economic and commodity cycles. Gerdau has consistently demonstrated its commitment to maintaining a sound capital structure by selling assets twice in the last five years and raising equity three times in the last 12 years. Its policy to have a long-term net debt/EBITDA ratio between 1.0x and 1.5x continues to steer capital structure decision making.

Approximately 65% of Gerdau's sales are from exports and assets abroad (approximately 45% from the U.S. and Canada operations), which compares favorably with Russian peers PJSC Novolipetsk Steel (NLMK, BBB/Stable) at 63%, and PAO Severstal (BBB/Stable) and PJSC Magnitogorsk Iron & Steel Works (MMK, BBB/Stable), which export around 25%-30% of their production.

Gerdau's vertical integration as a dominant player in the scrap market and leading position for long products and downstream multiproduct distribution network is similar to that of ArcelorMittal S.A. 's (BB+/Positive). Both companies enjoy extensive scrap collection networks that support their very profitable Brazilian long steel businesses, which track the dynamic construction sector closely. Market discipline is viewed as high in this segment, as the market is relatively concentrated. For Gerdau, this is a positive, as Brazil represents around 50% of EBITDA, versus around 20% for Arcelor Mittal.

Compared with Russian peers, NLMK benefits from high vertical integration in iron ore (90%) and reached 100% self-sufficiency on the recent launch of its pelletizing plant. NLMK is also 100% integrated into coke. However, NLMK does not own coking coal deposits. By comparison, Severstal is 70% integrated into coal and 100% into iron ore. MMK compares less favorably with 40% integration in coal and up to 18% in iron ore.

From a financial risk perspective, NLMK, Severstal and MMK have stronger EBITDA/ton and lower leverage, which highlight their first-quartile positions on the global hot-rolled coil steel curve, benefiting from access to reasonably priced raw materials and energy, and efficiency of their steelmaking operations and supportive FX rate, given ruble depreciation in 2020. Their earnings also reflect integrated production profiles, as opposed to Gerdau's high reliance on maintaining a per-ton spread between scrap steel prices and the sale prices of its finished goods. However, the Russian producers' ratings incorporate higher than average systemic risks associated with Russian businesses and their operating environment.

Gerdau's credit metrics are stronger than those of ArcelorMittal's. Gerdau has higher EBITDA/ton figures stemming from Brazil and the rest of South America whereas ArcelorMittal's high EBITDA/ton in Brazil is averaged down by its operations in Europe and ACIS. Both, Gerdau and Arcelor Mittal boast comfortable maturity schedules and ample liquidity.

KEY ASSUMPTIONS

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

--Brazil's domestic steel volumes grow by 25% in 2021, and by 2% in 2022 and in 2023;

--Brazilian export steel volumes fall by 70% in 2021, and by 5% in 2022 and in 2023;

--Specialty steel volumes grow by 30% in 2021, and by 5% in 2022 and in 2023;

--North America steel volumes grow by 5% in 2021 and in 2022, and by 2% in 2023;

--Capex at BRL 3.5 billion in 2021 and in 2022;

--An exchange rate of BRL5.20/USD1.00 at YE 2021 and BRL5.20/USD1.00 average FX rate.

RATING SENSITIVITIES

Factors That Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade:

--Higher share of the Special Steel segment with higher value-added products;

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

--EBITDA margins sustained above 15%.

Factors That Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade:

--Sustained adjusted total debt/EBITDA above 3.5x and/or adjusted net debt/EBITDA above 2.5x;

--Persistent negative FCF;

--EBITDA margins below 10% 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

Strong Liquidity: Gerdau's consistently conservative financial strategy results in the company terming out its debt and holding enough cash to cover upcoming maturities. The company had BRL7 billion of cash and marketable securities as of March 31, 2021. Gerdau's cash holdings are sufficient to cover amortizations as it faces debt amortizations of BRL1.6 billion in the next 12 months, BRL0.1 billion in 2021, and BRL1.5 billion in 2022.

Gerdau's companies abroad held 24% of its cash 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 interest-bearing accounts or sweep accounts, in addition to time deposits. In addition to the cash it holds, Gerdau has an USD800 million global credit line that matures at the end of 2024, USD60 million was the outstanding balance at the end of March 2021.

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 (76%), local Brazilian debentures (17%) and working capital lines (7%). Approximately 77% of the company's debt is U.S. dollar denominated.

ISSUER PROFILE

Gerdau is a leading manufacturer of long steel and an important producer of flat steel in the Americas with a strong special steel presence in the U.S. and Brazil. It operates iron ore mines in Brazil and is a key player in the scrap market.

SUMMARY OF FINANCIAL ADJUSTMENTS

Fitch's debt figure excludes lease related debt from its adjustments

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.

Gerdau S.A.	LT IDR	BBB- Rating Outlook Stable	Affirmed	BBB- Rating Outlook Stable
	LC LT	BBB- Rating Outlook Stable	Affirmed	BBB- Rating Outlook Stable

ENTITY/DEBT	IDR RATING			PRIOR
	Natl LT	AAA(bra) Rating Outlook Stable	Affirmed	AAA(bra) Rating Outlook Stable
• senior unsecured	LT	BBB-	Affirmed	BBB-
GTL Trade Finance Inc.				
• senior unsecured	LT	BBB-	Affirmed	BBB-

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Corporate Rating Criteria (pub. 21 Dec 2020) (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. 30 Apr 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), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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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