Research Update:

Brazilian Steelmaker Usiminas Upgraded To 'BB' And 'brAAA' On Record High Results And Sharp Deleveraging; Outlook Stable

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PRIMARY CREDIT ANALYST

Victor H Nomiyama, CFA
Sao Paulo
+ 55 11 3039 9764
victor.nomiyama
@spglobal.com

SECONDARY CONTACT

Flavia M Bedran
Sao Paulo
+ 55 11 3039 9758
flavia.bedran
@spglobal.com

Rating Action Overview

- Brazil-based integrated steel producer, Usinas Siderúrgicas de Minas Gerais S.A. (Usiminas), will post record results in 2021 due to elevated iron ore prices, robust steel demand, and significant prices adjustments. We currently forecast EBITDA to jump to R$11.5 billion – R$12.5 billion in 2021 from R$3.0 billion in 2020, and gross debt to EBITDA to drop well below 1.0x this year and remain close to 1.0x in 2022.
- On Sept. 15, 2021, S&P Global Ratings raised its global scale issuer credit ratings on Usiminas to 'BB' from 'BB-' and its national scale issuer credit and issue-level ratings to 'brAAA' from 'brAA+'. At the same time, the recovery ratings of '3', with an average recovery of 65% (rounded estimate), remain unchanged.
- The stable outlook reflects our expectation of strong results in the second half of 2021 and in 2022, despite cost pressures, allowing Usiminas to keep EBITDA margins above 20% and gross debt to EBITDA consistently below 2.0x. We also expect management to maintain its conservative financial policy on dividends, share repurchase and investment decisions, a robust liquidity position, and smooth debt amortization profile.

Rating Action Rationale

Record high results, sound liquidity, and sharp deleveraging underpin the upgrade. Usiminas' EBITDA and free cash flows surged in the past 12 months ended June 2021, given robust steel demand despite considerable price hikes. These factors led to the company's steel segment quarterly net revenue per ton growth of 20%-25% in each of the past two quarters, while there are currently no signs of demand weakening. Also, iron ore prices have soared and reached above $200 per ton in July, but have receded to close to $130 in the past week. This brought an average estimated price to $175-$185 per ton for the year in our base-case scenario, which is a very favorable level. Overall, we expect Usiminas to post EBITDA of R$11.5 billion – R$12.5 billion in 2021, sharply up from R$3.0 billion in 2020, and free operating cash flows (FOCF) of above R$4.0

billion, versus R$2.8 billion in 2020, leading to gross debt to EBITDA well below 1.0x this year. We forecast these figures despite Usiminas' higher working capital to adjust inventories and larger capital expenditures (capex).

The 2022 results should remain robust, which along with conservative financial policy, will support the ratings. We expect healthy results in 2022, despite iron ore prices likely dropping to $120 per ton, a deceleration in the steel demand in domestic market, rising coal, energy, and labor costs. These factors will reduce consolidated EBITDA margins from 30%-35% in 2021 to 20%-25% in 2022. Investments will also rise over the next few years from R$1.5 billion in 2021 to R$2.0 billion in 2022 and 2023, according to our estimates. Capex include the refurbishment of the third blast furnace in Ipatinga, which will also require working capital investments in order to build up steel plates inventory to maintain operations during the furnace's stoppage. Nevertheless, EBITDA and FOCF should remain solid in 2022, at about R$6.0 billion and R$1.0 billion, respectively. Despite the current lack of visibility on further capital allocation strategy for 2022 and 2023, including for the Compactos project and new galvanized steel lines, we expect management to maintain prudent financial policy. Our base-case scenario assumes that the company should fund any higher capex mostly through cash flows, and that it will abstain from aggressive shareholder remuneration amid a more stressed scenario, maintaining leverage. Also, the stronger balance sheet will help Usiminas to withstand market volatility, such potential additional impacts from the pandemic, foreign-exchange (FX) volatility, or Brazil's weaker-than-expected economy.

Support factors to the short- to medium-term fundamentals. China's efforts to cut emission, pushing the steel industry's consolidation and potentially curbing steel output in the medium term, along with the country's removal of export incentives (in form of tax rebates) could provide support to global steel prices in the intermediate term. Additionally, steel demand in Brazil has been strong, mainly in the construction and industrial segments, despite the disruption in the light-vehicle production due to the semiconductor shortfall, which should normalize only by the end of 2022. In the medium term, the domestic infrastructure segment could fuel demand growth amid higher private-sector investments in the sanitation and natural gas markets. Usiminas' mining division should maintain healthy margins of above 40% in 2022 and 2023, despite our forecast for iron ore prices falling to $120 and $90 per ton, respectively.

Consistently solid liquidity allows Usiminas to have a higher rating than that on the sovereign. Usiminas posted consolidated cash position of R$6 billion in June 2021, and it has no significant debt maturities until 2023. Also, the company should keep accumulating cash in the second half of 2021, strengthening its ability to withstand industry volatility and pass our stress test of potential sovereign default scenario, and to fund investments.

Outlook

The outlook is stable. We expect Usiminas to maintain strong results in the second half of 2021 and in 2022 thanks to the price hikes adjustments, favorable global steel prices, and strong demand in the domestic market. These factors should offset lower iron ore prices and higher costs, such as coal and energy, allowing Usiminas to keep EBITDA margins above 20%, gross debt to EBITDA below 1.0x in 2021 and below 1.5x in 2022. In the meantime, the company should maintain robust liquidity, enabling it to have a higher rating than on the sovereign.

Downside scenario

We could take a negative rating action if market conditions deteriorate, lowering Usiminas' margins to below 20%, while working capital depletes cash, raises gross debt to EBITDA to 2.5x, and reduces funds from operations (FFO) to debt below 35%. We could also take a negative rating action following the company's aggressive shareholder remuneration and/or capex without adequate funding.

Upside scenario

An upgrade in the next 12-18 months is unlikely, because it would require wider revenue diversification and proven ability to restrain margin volatility during market swings. In this scenario, we also expect Usiminas to keep gross debt to EBITDA comfortably below 2.0x, FFO to debt above 45%, and FOCF to debt above 15% on a consistent basis and throughout industry cycles.

Company Description

Usiminas is an integrated Brazilian steelmaker with a current rolling production capacity of about 6.4 million tons (MT) of flat steel and nearly 9 MT of iron ore. Usiminas operates two steel plants--Ipatinga in the state of Minas Gerais, and Cubatão in the state of São Paulo, in which the company shut down its primary areas a few years ago.

Usiminas' main clients are automakers, white goods manufacturers, and distributors. The company produces iron ore through its subsidiary, Mineração Usiminas S.A. (MUSA), which operates mines in the state of Minas Gerais. The company also owns Soluções Usiminas, the steel transformation unit. Two of the largest players in the global steel industry--Nippon Steel Corp. (BBB/Stable/--) and Ternium/Tenaris Group (not rated)--along with the employee pension fund, control Usiminas. Combined, these three entities hold 68.6% of Usiminas' voting capital and control the company through the 2018 shareholders agreement, which settled previous legal disputes between Nippon Steel and Ternium.

Our Base-Case Scenario

- Brazil's real GDP growth of 3.4% in 2021 and 2.5% in 2022;
- Brazil's inflation of 7% in 2021 and 4.4% in 2022, affecting labor-related costs;
- Average FX rate of R$5.30 per $1 in 2021 and R$5.40 per $1 in 2022;
- Steel sales volumes of nearly 4.9 MT in 2021, and 4.15-4.35 MT in 2022 and 2023;
- Domestic flat steel sales of 4.7 MT in 2021, and 3.7-4.0 MT in 2022 and 2023;
- Steel exports of 250,000-300,000 tons in 2021, and 350,000-450,000 tons in 2022 and 2023;
- Steel prices following the adjustments up to the second quarter of 2021, and with the FX rate and international prices afterwards;
- Iron ore sales of 8.5-9.0 MT in the next few years;
- Average iron ore price of $175-185 per ton, and decreasing to $120 in 2022 and $90 in 2023 and afterwards;

- Capex of about R$1.5 billion in 2021, and we estimate R$2.0 billion per year in 2022 and 2023, including the refurbishment of the third blast furnace;
- Some shares repurchases, although not announced, as part of potential cash uses; and
- Dividend payment of R$1.5 billion in 2021 and R$1.0 billion in 2022. The 2021 payment includes the dividend of the results from the first half of the year.

We expect the following credit metrics:

	2019a	2020a	2021p	2022p	2023p
(Bil. R$)					
Revenue	14.9	16.1	36.5-37.5	27.0-28.0	23.0-24.0
EBITDA	1.8	3	11.5-12.5	5.8-6.2	4.5-5.0
EBITDA margin (%)	12.3	18.6	30-35	20-25	17-22
Funds from operations (FFO)	1.4	2.4	9-11	5.0-5.5	3.5-4.0
Capex	0.7	0.8	1.5	2	2
Free operating cash flow (FOCF)	1.1	2.8	4.0-4.5	0.8-1.2	2.0-2.5
Debt/EBITDA (x)	2.9	2.2	0.5	1.0-1.5	1.0-1.5
FFO/debt (%)	25.4	37.2	150-170	75-80	65-70
FOCF/debt (%)	19.8	43.3	65-70	12-17	35-40

All figures are adjusted by S&P Global. Debt position of R$6.5 bilion as of December 2020 includes R$5.9 bilion of gross debt, plus R$67 million of leases payable and R$488 million of other adjustments, mainly pension/postretirement obligation. a--Actual. p--Projected.

Liquidity

We view Usiminas' liquidity as strong. The company has a sound cash position and doesn't have meaningful debt maturities until 2023, resulting in cash sources over uses of more than 2.5x for the next 12-24 months. In addition, we expect Usiminas to generate more than enough cash to cover its capex, working capital, and dividends for the next 12 months, and it has a very comfortable cushion for its debt acceleration covenants.

Principal Liquidity Sources:

- Available cash position of about R$5 billion as of June 30, 2021, excluding 30% of the cash held at MUSA given minority shareholders' position; and
- FFO of about R$7.6 billion for the next 12 months as of June 30, 2021.

Principal Liquidity Uses:

- Short-term debt of about R$146 million as of June 30, 2021;
- Working capital outflows of R$1.5 billion for the next 12 months;
- Capex of R$1.5 billion for the next 12 months; and
- Dividend payment of R$1.2 billion.

Covenants

Usiminas' debt payment acceleration covenants require net debt to EBITDA of up to 3.5x. The company has a comfortable cushion of over 80% for its covenants in the next few years.

Issue Ratings - Recovery Analysis

Key analytical factors

The issue-level rating on Usiminas' senior unsecured debentures is 'brAAA', at the same level as the issuer credit rating. The debentures have the recovery rating of '3', with an average recovery of 65% (rounded estimate). We analyze Usiminas' recovery on a going-concern basis. because we expect the company would be restructured following a default scenario, generating higher value to creditors. In our default scenario, the emergence EBITDA would be about R$1 billion, assuming that iron ore prices and steel demand would suffer a severe contraction over the next years.

We continue applying a 5.0x multiple applied to our projected emergence-level EBITDA, in line with the metals and mining upstream industry multiple, as currently 30-50 % of its EBITDA comes from iron ore.

Simulated default assumptions

- Simulated year of default: 2026
- EBITDA at emergence: R$1 billion
- Implied enterprise value (EV) multiple: 5.0x
- Estimated gross EV at emergence: R$4.8 billion

Simplified waterfall

- Net EV after 5% administrative costs: R$4.6 billion
- Minority equity ownership at MUSA: R$480 million
- Unsecured debt at default: R$4.8 billion
- Recovery expectation: 65% for unsecured debt (rounded estimate)

Ratings Above The Sovereign

Our global scale rating on Usiminas is now one notch above our 'BB-' foreign and local currency ratings on Brazil. Therefore, we have tested Usiminas' ability to meet its short-term obligations amid a hypothetical sovereign default scenario. The company is able to pass the stress with cash sources over uses of more than 1.5x in the year of the stress scenario. This reflects Usiminas' consistent sound liquidity, export revenues contribution from the mining and steel businesses, and ability to adjust capex. We incorporated the following assumptions for the default year in our stress test:

- Brazil's GDP contracting 10%;
- Doubling of exchange rates, resulting from a currency depreciation of 50%;
- Inflation of more than 12.5%;
- Iron ore prices at $50 per ton;
- Doubling of interest rates for the floating debt denominated in domestic currency;
- No price increases in the domestic steel market;
- Capex at around R$800 million;
- Cash haircuts of 10% to bank deposits and 70% for short-term investment position held in Brazil, and no haircut to cash position in foreign currency; and
- A minimum dividend payment.

Ratings Score Snapshot

Issuer credit rating:

- Global scale: BB/Stable/--
- National scale: brAAA/Stable/--

Business risk profile: Weak

- Country risk: Moderately high
- Industry risk: Moderately high
- Competitive position: Weak

Financial risk profile: Significant

- Cash flow/Leverage: Significant

Anchor: bb-

Modifiers

- Diversification/Portfolio Effect: Neutral
- Capital structure: Neutral
- Financial policy: Neutral
- Liquidity: Strong
- Management and governance: Fair
- Comparable rating analysis: Positive

Related Criteria

- 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: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 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

Upgraded

	To	From
Usinas Siderurgicas de Minas Gerais S.A.		
Issuer Credit Rating	BB/Stable/--	BB-/Stable/--
Brazil National Scale	brAAA/Stable/--	brAA+/Stable/--
Usinas Siderurgicas de Minas Gerais S.A.		
Senior Unsecured	brAAA	brAA+
Recovery Rating	3(65%)	3(60%)

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.