Euler Hermes Brasil

Industry Sector Insight

Brazilian Steel Mills increased profitability in 2013

15 April 2014

Gustavo Ferreira (Sr. Industry Sector Credit Analyst)
✉ gustavo.ferreira@eulerhermes.com

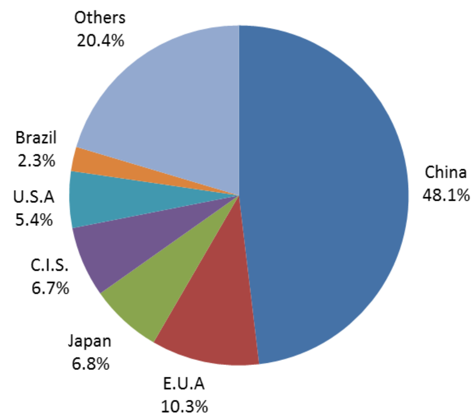
Executive Summary - 2013 highlights

- The profitability of the Brazilian steel mills was improved in comparison to 2012
- The long steel segment presented, in the last two years, higher return on equity and higher net profits than the flat steel segment
- The consumption of rolled steel grew by almost 5%yy
- Crude steel production decreased 1.5%yy
- Domestic mills are prioritizing internal sales for domestic consumption rather than export of semi-finished products

Increase in sales, decrease in imports, increase in prices and better product mix

The year 2013 was undoubtedly better than the year 2012, at least for the steel mills in Brazil. Total imports declined 2.2% yy whereas both apparent consumption and internal sales of rolled steel increased roughly 5%. Not only the volume sold by the mills was higher, but the product mix was improved, since exports of semi-finished steel, product of lower value added, decreased at the expense of the increased sales of rolled steel products (long + plans). And last, but not least, domestic prices were up, in some cases the price adjustment exceeded 10%, against an official inflation rate of approximately 6.5% over the same period. Thus, one might conclude that the increase in the import tax of steel products, with the help of the macroeconomic environment, especially the devaluation of Real currency, helped the steel mills to improve their profitability ratios. GDP growth of 2.3%, above market expectations, also contributed to the increase in consumption. For 2014 the outlook remains challenging, starting with the slowdown in the economic growth, below 2%.

Chart 1: Crude steel production by country



Source: IABR

Improved profitability and cash generation in 2013

The four steel plants analyzed, Gerdau S/A, Usiminas S/A, Companhia Siderúrgica Nacional S/A (CSN) and Votorantim Steel S/A (VS), which together account for approximately 60% of the total production of crude steel in Brazil, reported improvements in 2013 profitability and cash flow indicators in comparison to 2012.
The EBITDA margin (which expresses the ability to generate cash before interest expenses, taxes and depreciation), weighted for the group of companies listed above, rose from 7.6% in 2012 to 12.6% in 2013. The net margin, calculated after payment of all expenses, including taxes, increased from 0.7% to 3.3%. Lastly, the return on equity (ROE) increased from 0.9% to 3.9% in the same period of comparison.
However, the results presented by the long steel segment proved better than the indicators reported by the flat steel segment. This is because the flat steel segment is more susceptible to the effects of the import competition. Both Usiminas and CSN reported net loss in 2012, a year marked by fierce competition in the sector. Due to the increase of the import tax from Sep/12 onwards and the average devaluation of the Real currency by 15% against the U.S. dollar, both segments readjusted prices upwards, which ultimately improved the annual results of most companies in the sector.

The long steel segment reported higher return on equity and higher net income

The two long steel mills, Gerdau and VS, recorded together higher ROE and higher net margin than the flat mills represented by Usiminas and CSN. The exception was the EBITDA margin, which was higher for the flat's segment. This result is, however, very influenced by the iron ore business segment from CSN. The greater cash generation capacity associated to CSN is also linked to the higher leverage level in which it operates in comparison to Usiminas and to the others steel mills. The equity to the total assets ratio (Eqy / TA) from CSN stood at only 16% in Dec/13 against 60% of Usiminas, making an average of 32.4% for the flat steel segment versus 55.6% for the long steel's.

Imports down, domestic sales going up

In 2013 the flat steel segment increased domestic sales by 6.9%, close to the 7.0% drop in the import volume. The increase in the import tax was crucial to change the flat steel sales dynamics in favor of the domestic mills.
In the long steel market, however, imports rose 1.1%, to 1,250 kton. The largest probability of financial return presented by the long steel activities stimulates the increase in imports, even considering the incidence of the import tax for this segment as well.
Considering the whole market, total import of rolled steel was down 2.2% yy in 2013, which eventually, stimulated the internal sales of the

Chart 2: Key indicators - entire sector

Steel Mills*	2012	2013	Average
Ebitda	7.6%	12.6%	10.1%
Net Profit	0.7%	3.3%	2.0%
ROE	0.9%	3.9%	2.4%
Eqy / TA	41.3%	42.8%	42.1%

** Gerdau, Usiminas, CSN and Votorantim Siderurgia*
Source: Annual Financial Statements 2013 FYE

Chart 3: Key indicators - long steel segment

Long Mills*	2012	2013	Average
Ebitda	6.8%	7.3%	7.1%
Net Profit	4.0%	4.3%	4.1%
ROE	5.0%	5.3%	5.1%
Eqy / TA	55.4%	55.9%	55.6%

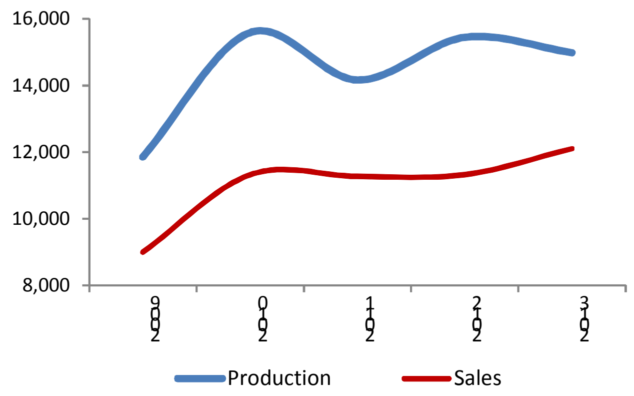
** Gerdau and Votorantim Siderurgia*
Source: Annual Financial Statements 2013 FYE

Chart 4: Key indicators - flat steel segment

Flat Mills*	2012	2013	Average
Ebitda	8.9%	20.1%	14.7%
Net Profit	-3.9%	1.8%	-0.9%
ROE	-3.9%	2.0%	-1.0%
Eqy / TA	32.0%	32.9%	32.4%

** Usiminas and CSN*
Source: Annual Financial Statements 2013 FYE

Chart 5: Flat steel production and sales (Kton)



Source: IABR

domestic mills that increased 5.3% yy, with emphasis on that flat volume.

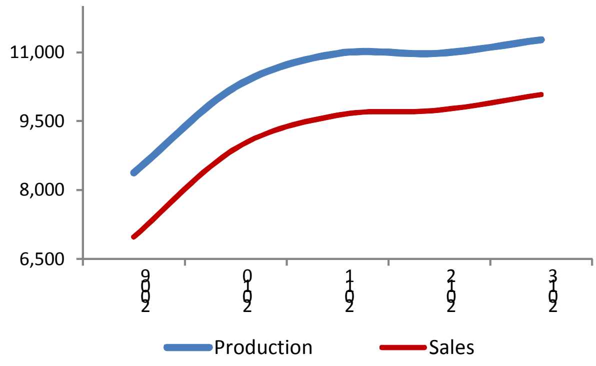
Consumption: are we back to the growth path?

After falling 4% in 2011 and increasing just 0.5% in 2012, the apparent consumption of rolled steel rose more strongly in 2013, when 26.4 million tons were consumed, an increase of almost 5% compared to 2012.
Supported by the recovery of the construction sector, which grew by 1.9% in 2013 versus 1.4% in 2012, the long steel segment grew 5.7% last year.
On its turn, the flat steel segment, favored by the 10% growth of the automotive production, recorded an increase in consumption of 4.2%.
The increase in consumption together with falling imports, reduced the share of imported steel in the apparent consumption from 13%, in 2012 steel, to 12% in 2013. For 2014, the forecast is that the consumption will grow by 3.1%, +3.4% for the flat products and +2.7% for the long products.

Major consumers, the construction and automotive sectors shall slowdown in 2014.

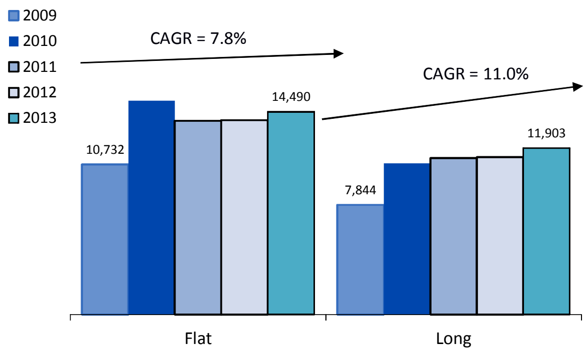
Largest steel consumer in Brazil, with approximately 35% of market share, the construction industry has recovered from the terrible year start to post a 1.9% growth rate in 2013. For 2014, despite expectations for the announced investments in infrastructure and public concessions promoted by the Federal Government, the Brazilian Central Bank forecast only 1.1% growth for the construction industry.
For the automotive industry, the second largest steel consumer in Brazil, 2014 will be also a very challenging year. In the first quarter vehicle production fell 8.4% yy, chiefly due to the 2.1% drop in sales and, more importantly, to the 34.7% reduction in exports.
The slight recovery of the Brazilian industry also helped the country to consume more steel in 2013. After falling 0.8% in 2012, the industrial GDP took advantage of the devaluation of the Real to grow 1.3% in 2013. Fortunately, the domestic industry has been sending positive signals that the recovery is still ongoing. In the first two months of the year industrial production rose 1.3% yy.

Chart 6: Long steel production and sales (Kton)



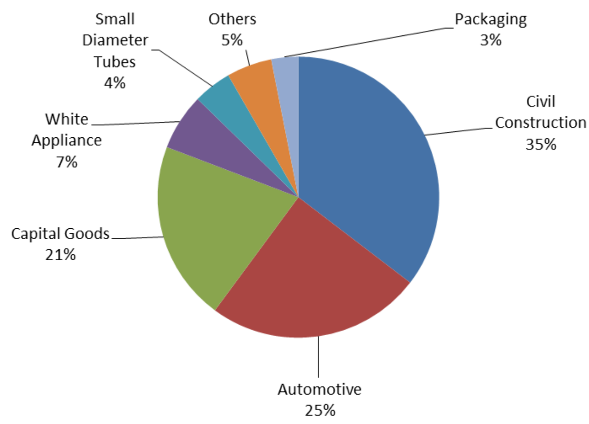
Source: IABR

Chart 7: Rolled steel consumption (Kton)



Source: IABR

Chart 8: Consumption breakdown by sector



Source: IABR (2012)

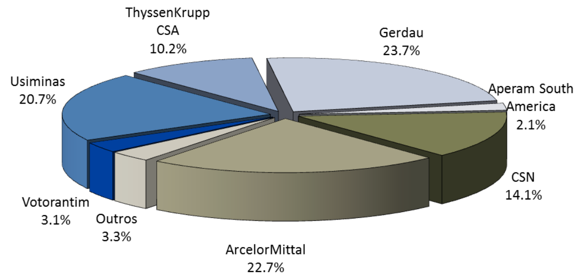
Export falling

Exports also declined in 2013. After retreating 10% in 2012, foreign sales retreated 17% last year. The main driver was the 21% drop in export of semi-finished steel item, which accounts for 65% of the total export volume of steel products.
The reduction of the activities of CSA America, subsidiary of the German Group ThyssenKrupp, explains the strong reduction in the semi-finished export volume.

The steel industry in Brazil presents an oligopolistic structure

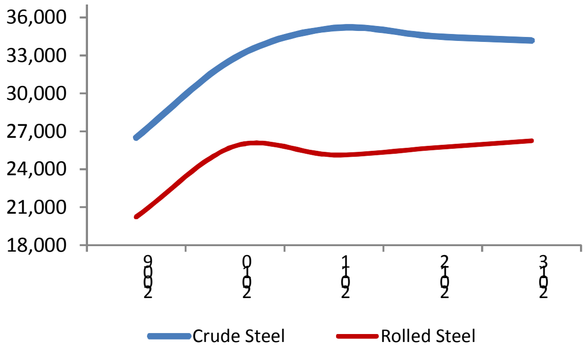
The four largest steel mills in Brazil, (ArcelorMittal, Gerdau, Usiminas and CSN), account for over 80% of the total production of crude steel that declined 1.5% yy in 2013, totaling 34.2 Mton. Given the recent difficulties that characterize the steel industry in the world, such as global oversupply and international prices under pressure, Brazilian mills also decreased local production of crude steel. On the other hand, the production of rolled steel increased to 26.3 Mton (+2.2% yy). The difference between the increased production of rolled steel and the fall in crude steel production is the decreased production of semi-finished products, whose main destination are the foreign markets. On its turn, the rolled steel items have the domestic market as their main destination. Thus, exporting less and selling more internally, Brazilian mills have improved the profitability of its operations, given that the margins in the domestic market are more attractive than the margins earned internationally.
To sum up, the strategy of prioritizing internal sales at the expense of reducing the export of semi-finished items is aimed to increase the profitability rates of the local mills, which was achieved in 2013.

Chart 9: Crude steel production by Group



Source: IABR (2012)

Chart 10: Crude steel production X rolled steel production (Kton)



Source: IABR