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Research Update:

Brazilian Steelmaker Usiminas Upgraded To 'BB-' From 'B+' On Strong Industry Upswing And Low Leverage; Outlook Stable

February 19, 2021

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Rating Action Overview

- Brazil-based integrated steel producer, Usinas Siderúrgicas de Minas Gerais S.A. (Usiminas), has benefited from record-high iron ore prices, strong demand, and rebounding margins in the steel segment since the end of 2020.— As a result, we estimate EBITDA in 2021 will double 2019 levels.
- In addition, the company has a very smooth debt amortization profile, with no principal debt maturities before the end of 2023, a robust liquidity to cushion against industry and foreign exchange (FX) volatility with expectation of positive free operating cash flow (FOCF) even in a scenario of larger investments and working capital requirements.
- On Feb. 19, 2021, S&P Global Ratings raised all its issuer credit and issue-level ratings on Usiminas to 'BB-' from 'B+' on the global scale and to 'brAA+' from 'brAA' on the national scale. We also affirmed the '3' recovery rating on the issue ratings, which reflects an estimated recovery of about 60%.
- The stable outlook reflects our expectation that Usiminas will benefit from favorable business conditions and its financial flexibility to support higher investments to improve operating efficiency. Even with expected lower FOCF, we think Usiminas will maintain an ample cushion on credit metrics, with adjusted gross debt to EBITDA close to 2.0x and FFO to debt close to 45%.

Rating Action Rationale

Brighter industry fundamentals will support EBITDA growth. Usiminas' mining division will compose slightly more than half of its total consolidated forecasted EBITDA in 2021, assuming an average iron ore price of $117 per ton for 2021, which is about 30% lower than current spot prices (above $160 per ton). The steel segment in Brazil is also enjoying favorable headwinds, stemming from recovering demand in the country, high international steel prices, and a depreciated FX rate allowing for significant price adjustments for Usiminas' main clients, distributors and automakers. In addition, the restocking of the value chain will warrant strong demand for at least the next few months. Using our more conservative estimate for iron ore prices, we forecast Usiminas' consolidated EBITDA will reach close to R$4.0 billion in 2021. It would then lower to about R$3.0 billion in 2022, assuming iron ore price down to $85 per ton, so we think there are potential upsides.

Deleveraging will continue in 2021, despite higher investments pressuring FOCF. After many years of subdued investments barely covering depreciation rates because of an unclear industry outlook, we estimate Usiminas will gradually increase capital expenditures (capex) to improve efficiency of its operations and gradually increase volume capacity. We estimate investments will increase to R$1.5 billion per year in the next two years, mainly including a large reform of blast furnace #3 in Ipatinga, which will also result in higher working capital needs to build up slab inventories to sustain rolling mill capacity while the furnace is stopped. In this scenario, gross adjusted debt to EBITDA would remain close to 2.0x in the next few years.

Significant headroom in metrics and liquidity. With no relevant debt maturities until the end of 2023, Usiminas will continue to build up cash to cushion it from industry volatility and increase financial flexibility to meet its larger investments, including potential sizable investments in its mining business from 2023 onward to increase the life of its mine. We believe Usiminas will maintain a conservative remuneration policy, using the minimal dividend payout of 25% of net income to focus on improving its business, which will help sustain rating headroom even amid less favorable economic conditions.

Outlook

The stable outlook reflects the higher iron ore prices, the sharp recovery of the steel domestic demand, and still healthy premiums in the domestic market--allowing for price adjustments and resulting in record-high forecasted EBITDA. This would also lead to positive FOCF generation, despite the higher capex. We expect the company's adjusted gross debt to EBITDA to fall below 2.0x in 2021 and funds from operations (FFO) to debt above 40%, but metrics will slightly worsen in 2022 following lower iron ore prices.

Downside scenario

A negative rating action is possible in the next 12 months if market conditions worsen, resulting in much lower iron ore prices and declining steel sales volumes in the domestic market, hindering the company's ability to adjust prices, deteriorating EBITDA, and leading to cash burn amid the higher capex plan. In this scenario, adjusted gross debt to EBITDA would rise above 3.0x and FFO to debt would remain below 30%, with negative FOCF, consistently.

Upside scenario

An upgrade is unlikely in the next 12 months because the ratings are limited by the company's business risk profile, but we could raise the ratings in the next 24 months if higher iron ore prices and steady volumes, combined with steady steel demand, continue to bolster EBITDA generation. The company would also need to maintain sources over uses of cash comfortably above 1.2x and pass the liquidity stress test to be rated above the sovereign rating on Brazil (BB-/Stable/B). In this scenario, adjusted gross debt to EBITDA would remain below 2.0x, FFO to debt above 45%, and FOCF to debt above 15%, in a consistent basis and throughout the 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 10 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 crude steel operations a few years ago. Usiminas' main clients are automakers, white goods industry players, and distribution market. The company produces iron ore through its subsidiary, Mineração Usiminas S.A. (MUSA), which operates mining assets in the state of Minas Gerais. The company also operates other businesses: Soluções Usiminas, the steel transformation unit, and Usiminas Mecânica, which produces industrial equipment, heavy metallic structures, and other products for several industry sectors. The company recently decided to close the latter entity.

Two of the largest groups in the steel industry--Nippon Steel Corp. (BBB/Negative/--) and Ternium/Tenaris Group (not rated)--along with the employees' pension fund, control Usiminas. Combined, these three groups hold 68.6% of Usiminas' voting capital and control the company through the 2018 shareholders agreement, which settled previous legal disputes between both entities.

Our Base-Case Scenario

- Brazil's real GDP to contract 3.9% in 2021 and grow 3.5% in 2022.
- Brazil's inflation of 3.9% in 2021 and 3.5% in 2022, affecting labor-related costs.
- Average exchange rate of R$5.30 per $1 in 2021 and R$5.15 per $1 in 2022.
- Usiminas' steel sales volumes declining to about 4.1 MT in 2021 and 4.2 MT in 2022.
- Domestic steel prices following the recent adjustments, the foreign-exchange rate, and international prices.
- Iron ore production of 8.5 MT-9.0 MT in the next few years.
- Iron ore prices in line with year-to-date realized prices and our expectation of $110 per ton for the remainder of 2021, resulting in an average of $117 per ton this year, decreasing to $85/ton in 2022 and $70/ton in 2023.
- Capex of about R$1.5 billion in 2021 and 2022, including the investments in mining (dry stacking ore) and steel operations (modernization of blast furnace #3).
- Dividend payout at minimum legal payout of 25% of previous year net income.

Based on the assumptions above, we expect the following credit metrics:

- Adjusted gross debt to EBITDA of 1.5x-2.0x in 2021 and ticking up to 2.0x-2.5x in 2022, compared with 2.2x at the end of 2020;
- FFO to debt of 40%-45% in 2021 and 35%-40% in 2022, compared with 37.2% at the end of 2020; and
- FOCF to debt of 10%-15% in 2021 and 5%-10% in 2022, compared with 43.3% in 2020.

Table 1

Usinas Siderurgicas de Minas Gerais S.A. -- Financial Summary

Industry Sector: Metals

	December 2020	September 2020	June 2020	March 2020	December 2019
(Mil. R$)					
Revenue	5,474.3	4,381.2	2,424.7	3,807.9	3,872.9
EBITDA	1,509.1	791.9	163.6	535.4	444.0
Funds from operations (FFO)	1,420.2	567.4	104.4	340.9	391.0
Interest expense	56.6	88.6	97.8	81.2	86.0
Cash interest paid	1.6	172.9	10.0	152.6	24.3
Cash flow from operations	1,102.0	1,526.2	379.0	615.2	763.7
Capital expenditure	249.8	178.8	187.6	182.5	352.4
Free operating cash flow (FOCF)	852.2	1,347.4	191.4	432.8	411.3
Discretionary cash flow (DCF)	843.6	1,347.4	132.0	432.8	378.7
Cash and short-term investments	4,868.1	3,734.3	2,506.2	2,373.5	1,921.1
Gross available cash	4,868.1	3,734.3	2,506.2	2,373.5	1,921.1
Debt	6,680.8	6,652.7	6,570.3	6,343.8	5,377.4
Equity	16,838.2	15,416.6	15,219.1	15,620.0	15,565.7
Adjusted ratios					
EBITDA margin (%)	18.7	13.4	11.1	12.6	12.3
Return on capital (%)	12.5	3.7	2.7	4.4	4.1
EBITDA interest coverage (x)	8.9	5.5	4.0	5.0	4.5
FFO cash interest coverage (x)	8.3	4.9	5.0	4.5	4.7
Debt/EBITDA (x)	2.2	3.4	4.2	3.3	2.9
FFO/debt (%)	36.6	21.1	17.0	22.0	25.4
Cash flow from operations/debt (%)	54.2	49.4	37.1	28.8	32.5
FOCF/debt (%)	42.3	35.8	24.0	16.5	19.8
DCF/debt (%)	41.2	34.4	22.1	12.5	15.1

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 sources over uses of cash above 3.0x for the next 12 months and above 2.5x for the subsequent year. In addition, we expect it 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:

- Cash position of about R$4.9 billion as of Dec. 31, 2020; and
- FFO of about R$2.9 billion for the next 12 months starting Dec. 31, 2020.

Principal Liquidity Uses:

- Short-term debt, including accrued interest, of about R$140 million as of Dec. 31, 2020;
- Working capital outflows of R$600 million for the next 12 months;
- Capex of R$1.5 billion for the next 12 months; and
- Dividend payout of 25% of the previous year net income.

Covenants

Usiminas' debt acceleration covenants are measured on a semiannual basis and 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.

Environmental, Social, And Governance

We believe that Usiminas' environmental risk is similar to the industry average. The company began investments in June 2020 to end the use of a tailings dam at the mine of its subsidiary, Mineração Usiminas S.A. (MUSA), moving instead to a dry stacking process, which should be concluded in 2021.

In terms of social factors, Usiminas has supported health measures in Brazil, supporting local hospitals and donating protection and health equipment in the regions where it operates. However, some accidents have occurred in the past, such as in 2018 when a gasometer exploded.

The disputes between its two main shareholders--Nippon Steel Corporation and Ternium/Tenaris Group--ended in 2018 when they signed a shareholders agreement. This has benefitted the company's operating performance and its governance, which we continue to view as fair.

Issue Ratings - Recovery Analysis

- We raised the issue-level rating on Usiminas' senior unsecured debentures to 'brAA+', the same level as the issuer credit rating. The debentures also have the recovery rating of '3', with an average recovery of 60% (rounded estimate).

Key analytical factors

- 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$950 million, a drop of about 68% from its EBITDA in 2020, because in our default scenario iron ore prices and steel demand would severely contract 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, given the company's exposure to the industry.

Simulated default assumptions

- Simulated year of default: 2025
- EBITDA at emergence: R$950 million
- Implied enterprise value (EV) multiple: 5.0x
- Estimated gross EV at emergence: R$4.750 billion

Simplified waterfall

- Net EV after 5% administrative costs: R$4.5 billion
- Unsecured debt: R$6.2 billion
- Recovery expectation: 60% for unsecured debt (rounded estimate)

Table 2

Usinas Siderurgicas de Minas Gerais S.A.--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts

	--Fiscal year ended Dec. 31, 2020--						
Usinas Siderurgicas de Minas Gerais S.A. reported amounts (mil. R$)							
	Debt	**Shareholders' equity**	**EBITDA**	**Operating income**	**Interest expense**	**S&P Global Ratings' adjusted EBITDA**	**Cash flow from operations**
	5,968.4	14,867.5	3,198.0	2,928.5	278.6	2,991.6	3,759.4
S&P Global Ratings' adjustments							
Cash taxes paid	--	--	--	--	--	(230.0)	--
Cash interest paid	--	--	--	--	--	(337.1)	--
Reported lease liabilities	64.7	--	--	--	--	--	--
Postretirement benefit obligations/deferred compensation	484.1	--	37.2	37.2	59.2	--	--
Accessible cash and liquid investments	(880.7)	--	--	--	--	--	--
Dividends received from equity investments	--	--	136.9	--	--	--	--
Income (expense) of unconsolidated companies	--	--	(159.8)	--	--	--	--
Nonoperating income (expense)	--	--	--	87.3	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	--	(136.9)
Noncontrolling interest/minority interest	--	1,970.7	--	--	--	--	--

Table 2

Usinas Siderurgicas de Minas Gerais S.A.--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts (cont.)

Debt: Tax liabilities	4.4	--	--	--	--	--	--
Debt: Other	880.7	--	--	--	--	--	--
EBITDA: Gain/(loss) on disposals of PP&E	--	--	(174.8)	(174.8)	--	--	--
EBITDA: Other	--	--	(46.0)	(46.0)	--	--	--
Total adjustments	553.2	1,970.7	(206.4)	(96.3)	59.2	(567.1)	(136.9)
S&P Global Ratings' adjusted amounts							
	Debt	**Equity**	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**
	6,521.5	16,838.2	2,991.6	2,832.2	337.7	2,424.5	3,622.5

Ratings Score Snapshot

Issuer credit rating:

- Global scale: BB-/Stable/--
- National scale: brAA+/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: Neutral

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
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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/--	B+/Stable/--
Brazil National Scale	brAA+/Stable/--	brAA/Stable/--
Usinas Siderurgicas de Minas Gerais S.A.		
Senior Unsecured	brAA+	brAA
Recovery Rating	3(60%)	3(55%)

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.