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US Steel might make a comeback in 2017

By Kenny Liew

After a dismal 2015 marred by supposed Chinese steel dumping in the US, layoffs of thousands of workers, shelving of plans to construct new furnaces and a net loss of USD 1.5bn, the US' second largest steel producer has undoubtedly seen a rollercoaster, but arguably brighter 2016. The RMI-CRI 1-year PD for United States Steel Corp. (US Steel), which peaked at 685.23bps on 7 December 2015, has declined to 19.60bps on Feb 3.

Its strong turnaround is characterized by its restructuring efforts, tariffs on Chinese steel and improving market conditions in the steel industry. US Steel reported a 2016 net loss that declined 73% year-on-year to USD 440mn – led mostly by its Carnegie Way restructuring program, which seeks to improve manufacturing process and logistics while slashing costs. Since the onset of the program, the company also permanently closed one steelmaking plant and further idled two plants. Benefits from the program have totaled nearly USD 2.3bn since its inception, and implementation of a more flexible cost structure has brought the breakeven point of production from 4.2mn tons to 2.2mn tons in just over 3 years. Quarterly capital spending on its flat-rolled segment – its largest revenue driver, fell from USD 30 a ton before the restructuring to USD 19 per ton now. The company also reports revenue figures for its tubular steel and US Steel Europe (USSE) segments. Its capital spending is in-line with ArcelorMittal – the world's largest steel producer, which spends USD 18 a ton.

Resolution of several Chinese steel trade cases in the US, which saw tariffs imposed on Chinese steel, coupled with remedies from other countries on China costing a total of USD 14.34bn brightened prospects for the US steel industry and severely dampened that of the Chinese. Steel prices in the US (Figure 1) has surged due to the measures. Albeit prices slumped in the third quarter of 2016 from uncertainty of Chinese steel imports, prices have rallied and currently hover around a 2-year high of USD 630. China's steel exports fell 3.5% in 2016 after a record 112.4mn tons left its shores in 2015.

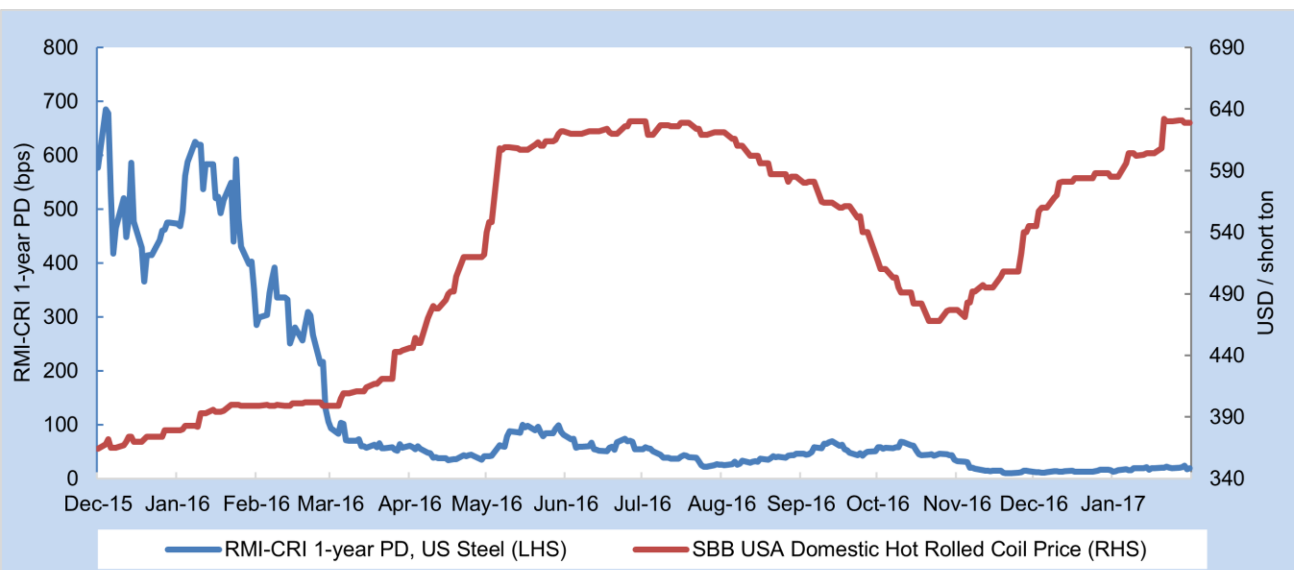

Figure 1: RMI-CRI 1-year PD for US Steel and US Domestic Hot Rolled Coil steel price. *Source: RMI-CRI, Bloomberg*

US Steel's market capitalization has jumped over 63% since Trump won the November 8 election – and is one of the best performing stocks in the US steelmaking industry; as many view President Donald Trump, who has pledged to embark on a policy of protectionism, as good for domestic businesses, and steelmakers in particular. Among others, he has promised to hit Chinese goods with tariffs of up to 45%, and has selected critics of China to top trade positions within his administration. Wilbur Ross, President Trump's pick as Secretary of Commerce, has further advocated the utilization of his department's ability to self-initiate antidumping investigations – a stance long encouraged by steelmakers. Proposed lower taxes to businesses could also improve profitability.

The company's revenue remains largely concentrated in the flat-rolled steel segments, with approximately 25% of its flat-rolled sales using spot pricing – making revenue susceptible to fluctuating steel prices. The flat-rolled sector contributed 74.24% of its reportable segment revenue; European sales comprise 21.5%, while tubular steels (used in oil and gas pipes) comprised 4.26% of revenue. Its potential output for the revived Keystone XL and Dakota Access pipelines will likely boost tubular steel revenue. A steel price rally from April to August 2016 also saw US Steel revise its earnings guidance upward twice. This followed an equity offering – raising USD 434mn. Cash ratio in Q4 jumped from 0.35 to 0.65 year-on-year as a result – a good bump to its financials.

1 year ending	31/12/2015	31/12/2016
Net Income (USD mn)	-1642.0	-440.0
Free Cash Flow (USD mn)	-141.0	421.0
EBIDTA (USD mn)	-655.0	342.0
Total Debt to Equity (X)	129.71	133.23
Cash Ratio	0.35	0.65

Table 1: Financial data for US Steel Corp. *Source: Bloomberg*

While the company has demonstrated strong momentum in its turnaround, market factors – namely input costs and exchange rates, affect the steelmaking industry significantly. The slump near the end of 2016 saw the steelmaker revise its 2016 EBITDA guidance downward to USD 475mn. Analysts also predict that the bullish steel market may not continue through 2017 – which could spell trouble for the company. Total debt to equity has been growing year-on-year, driven by increased debt issuance through bonds. The company in May 2016 doubled its proposed USD 500mn high-yield bond offering to USD 980mn – stating that proceeds are to repay near-term debt and additional funds going towards general corporate purposes. The 8.375% yield bond is set to mature in 2021. The company has USD450mn of debt maturing in 2017.

Iron ore, which is a key input for steel will likely continue its upwards price trend (see Figure 2). This comes amid new efforts from China to shut down inefficient steel mills –which consumes scrap steel and scrap metal as raw material, to make way for more efficient blast furnaces, fed with pure iron ore. Investor speculation – which is also driving up iron ore prices, further increases cost pressures on US Steel. Simultaneously, a stronger US Dollar, which has appreciated 5.2% against the Chinese Yuan (Figure 2) since 1 January 2016 makes Yuan-denominated Chinese steel imports cheaper for domestic businesses. President Trump's fiscal stimulus plan, tax reform and trade policies, coupled with the Federal Reserve's desire to maintain inflation growth will also continue to appreciate the US Dollar, threatening the competitiveness of US steel internationally.

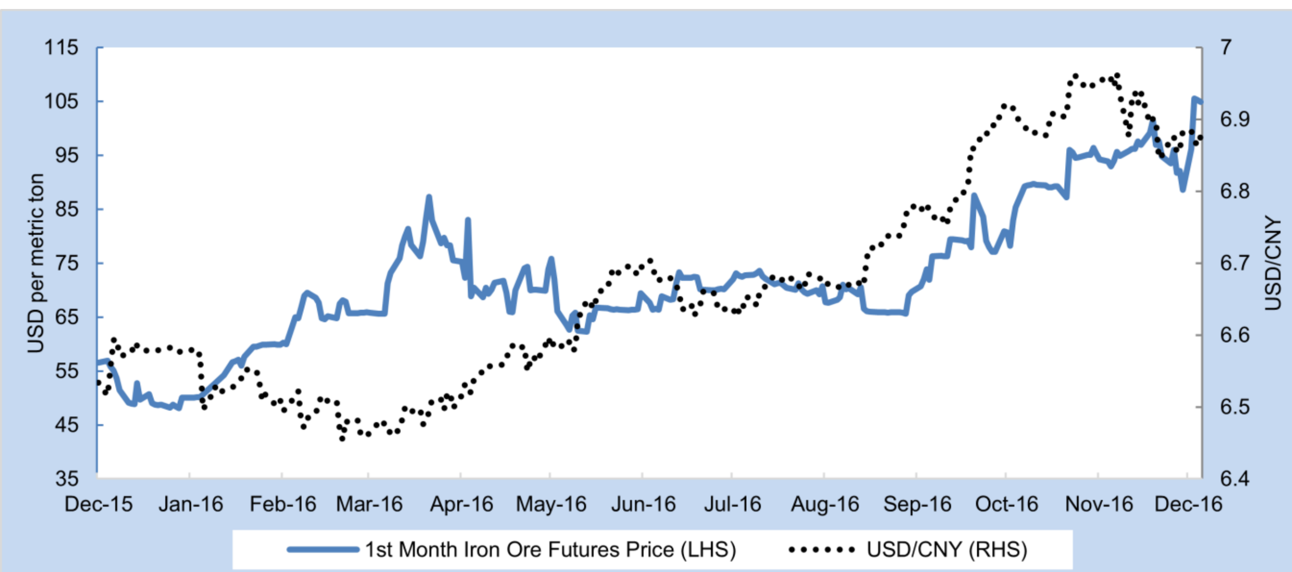

Figure 2: 1st month Iron Ore futures prices and USD/CNY *Source: Bloomberg*

Although the fortunes may seem to be coming to US Steel because of political factors and internal restructuring efforts, it must build increased resilience against market forces. In a somewhat traditional industry with new players threatening to oust old ones, US Steel must stay innovative and maintain nimble to maintain its market share. The threat of more mergers and acquisitions within the steel industry could also be turned in its favor. It could aim to acquire smaller steelmakers and leverage on their lower operating costs and increase output.

Credit News

Le Pen's French debt plan would trigger default

Feb 5. FN leader Marine Le Pen, predicted to get through to the presidential election's second round, has pledged to take France out of the euro and convert its debt into a new currency. In this situation, France would be declared default as it converts its euro-denominated obligations into new francs following a National Front election victory. The head of sovereign ratings from S&P emphasized that if an issuer does not stick to its contractual obligations to its creditors including the payment in the currency stipulated, S&P would declare a default. However, the current 'AA' S&P rating assigned on France suggests that such a turn of events is still unlikely. (TODAY)

African issuers scrutinized after Mozambique's bond default

Feb 3. Investors are concerned that another African country could default on its debt obligation after Mozambique failed to settle its USD 60mn coupon payment last month. Potential default candidates include Senegal, Tunisia, Ghana or Zambia who issued record amounts of bonds during the boom commodity years. Foreign currency denominated notes have become more difficult to service given the depreciating value of local currencies. Depleted reserves, coupled with a drop in raw material prices and a lack of investment interest meant that these African countries face an uphill battle to seek funding. (Bloomberg)

Cocoa group's bankruptcy fuels bank lending concerns

Feb 2. The impact from the bankruptcy of Transmar Commodity Group was mitigated by excess cocoa production in West Africa, as prices declined and the market's concern of a supply disruption were diminished. However, cocoa traders and processors still have difficulty accessing bank credit. Transmar's sharp decline in collateral value was described in a filing by ABN Amro, an administrative and collateral agent for a group of banks behind the a credit facility extended to Transmar have provided lenders "reason to suspect that the monthly borrowing base reports were inaccurate, if not falsified for many months before October 2016." (FT)

Ever shorter US bankruptcies have creditors scrambling

Feb 1. Bankrupt companies are emerging from Chapter 11 faster than ever, according to Reuters. Last year, the average Chapter 11 filing took 7.3 months to emerge from bankruptcy, less than half the time recorded in 2013. Observers attributed the trend to prepackaged bankruptcies and quick auctions, and the increased role of hedge funds in Chapter 11 filings. Hedge funds were more concerned about maximizing their investment returns, which often resulted in hastily arranged auctions unlike banks who wanted to reorganize the company so that they could take on loans. (Reuters)

Brazilian companies file bankruptcy in record figures (Telesur)

Under Armor's sole bond issue downgraded to junk (MarketWatch)

Regulatory Updates

Fed toughens stress test for banks

Feb 3. The Federal Reserve announced tougher stress tests for US banks which include scenarios such as a peak of at least 10% in unemployment, a sharp drop in housing prices and a deep recession in the euro area. Stress tests assist the Federal Reserve to determine if banks hold enough capital to withstand economic shocks in the financial system and have the ability to identify and measure risk appropriately. US banks must pass these stress tests before they are allowed to boost dividends or conduct share buybacks to shareholders. The results will be made public by the central bank by June 30, 2017. An important change made this year was to exclude banks with assets between USD 50bn and USD 250bn that have not been identified as globally systematically important banks. These excluded banks will still be subjected to an examination by the Federal Reserve on its risk management process but the results of the review would not have an impact on the banks' ability to pay dividends. (WSJ)

Republicans get ready to roll back Dodd-Frank law

Feb 2. Republicans in Congress are preparing to release plans to roll back the 2010 Dodd-Frank financial overhaul after an executive order by President Donald Trump to review the Dodd-Frank law. According to people familiar with the matter, House Financial Services Committee Chairman Jeb Hensarling is poised to to unveil his plan of undoing parts of Dodd-Frank. Mr. Hensarling stated that he was proud to have been present during the signing of two executive actions “that represent the beginning of the end of the Dodd-Frank mistake”. Other Significant regulatory rollbacks that were proposed includes repealing of the Volcker rule, which restricts how banks invest taxpayer-insured deposits, or the removal of mortgage-underwriting standards that were designed to try to ensure that borrowers have an ability to repay. (WSJ)

EU watchdog studies Brexit risks at rating agencies (Reuters)

Don’t bank on users to rescue clearing houses top regulator warns (Reuters)

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