Metals Summer 2023

Sector overview

Over the course of several years, the global metals industry has undergone a turbulent journey, navigating a volatile operating environment influenced by industrial, political and macroeconomic pressures.

Following a long period of government support (via furlough, coronavirus government-backed funding and energy relief schemes), the onset of 2022 was characterised by buoyant pricing for mills, stockholders and traders, which was ultimately reflected in margins and shored-up balance sheets. This in combination with Russia's invasion of Ukraine (which damaged infrastructure and capacity and introduced implications from international sanctions) caused extreme volatility in metal pricing.

The tail end of 2022 then saw prices transition to a downward trajectory. Destocking efforts across the supply chain were a major spearhead of this softening.

This was coupled with economic headwinds consisting of inflationary pressures, deteriorating market sentiment and a slower-than-expected recovery in some primary end markets, including automotive and manufacturing. For the main part, these headwinds have spilt over into 2023 and continue to pose challenges to an industry that remains in long-term decline (within the UK).

Recent trends indicate a steadying of input and selling prices and whilst this should help curb uncertainty, the values of both noticeably exceed their historic normal levels and are feeding through into higher cost bases. Nonetheless, fundamental disparities remain around the UK's international competitiveness and the level of their decarbonisation spend against their European counterparts.

The outlook for the remainder of 2023 is expected to be challenging, with demand forecast to fall by 0.4% amid increasing insolvencies and high indebtedness in a period where the costs of borrowing are soaring.

Notable insolvency events

> **SE-TEK Limited (July 2022)** – Steel fabrication – No filings

> **Que Steel Limited (December 2022) –** Steel fabrication – Equity £489k

> **Aartee Bright Bar Limited (February 2023) –** Steel distribution and processing – Turnover £44.3m and equity £19.8m

> **J.C.C. Engineering Limited (March 2023) –** Steel fabrication – Equity £491k

> **Intelligent Steel Solutions Limited (April 2023) –** Steel fabrication – Equity £107k

> **Nasmyth Group Limited (May 2023) –** Precision engineering – Turnover £62.0m and equity £16.9m

> **Frank Brown & Son (Luton) Ltd (June 2023) –** Aviation engineering – Equity £2.8m

Economic data

> **ONS:** Decline in monthly production output by 0.3% in April 2023 to 104.7, following a low-digit expansion in the prior month. Nonetheless, this figure is tracking 0.1% up on February 2020 (last normal trading period). As an industry, output within basic metal and metal products fell by 0.7 in April 2023.

> **Gazette:** Insolvencies in England and Wales throughout May 2023 were 40% up on the previous year at 2,552, with the majority (close to 85%) being creditors' voluntary liquidations (CVL). Total insolvencies within the manufacture of basic metals and fabricated metal products were 61% higher than in April 2022 and 71% up on the same month in 2019.

> **S&P Markit / CIPS UK:** Manufacturing PMI score of 47.1 in May 2023, representing a four-month low and remaining in contraction (less than the 50.0 no change point), as has been the case for the past 10 consecutive months. Estimates indicated the value to drop to 46.9, but this did not materialise.

> **World Steel Association:** Global steel production in May 2023 amounted to 161.6 million tonnes (Mt) – see Figure 2 – comparing against 170.5 Mt in the same position last year. Total year-to-date production is down 1.2% and equated to 786.0 Mt, with Asia and Oceania accounting for almost 75% of the total balance for 2023.

Strengths

> **Resilience in steel-consuming construction markets:** Despite a decrease of 0.6% in April 2023, construction output is up 1.6% on the previous quarter. Fiscal stimulus has underpinned large-scale infrastructure projects – including the likes of HS2, Hinkley Point and Thames Tideway – and is further enhanced by the government's £100bn spending commitment across 2022-2025. The resurgence of commercial work has also been much welcomed. For instance, the rebound in UK warehousing demand (a key steel-using sub-sector of construction), which according to Savills rose to its highest point since Q2.

> **Signs of recovery in the automotive market:** Data from SMMT suggests a bounce-back in 2023 with continual improvements in UK production noted for four consecutive months, despite remaining 31.9% down on the same position in 2019. This is further supported by year-to-date car registrations for the same period and new light vehicle sales, which rose by 17% in June. A key component underlying this expansion is the market of electric vehicles (EV), which use three times the amount of metals (predominantly copper) when compared to internal combustion engine (ICE) vehicles. According to Statista, this market has a forecasted compound annual growth rate (CAGR) of 10.1% across 2023-2028, thereby representing a pool for steel's future growth potential.

> **Buoyant pipelines for long-term renewable energy projects:** UK government boasts a pipeline of more than 100 offshore energy projects, which typically consume anywhere between 40 and 150 metric tonnes of steel per megawatt (MW) produced.

> **Enhanced protection from cheap carbon-intensive steel imports:** European producers have historically faced an inequitable burden of carbon costs compared to their developing peers. The announcement of an EU carbon border adjustment mechanism (CBAM) therefore represents positive steps to resolving this disparity by recalibrating the price of carbon intensive goods entering the trade block. For the UK, discussions around decarbonisation policies remain ongoing, after the consultation period closed on the 22nd of June 2023. With UK Emission Trading Scheme (UK ETS) compliance costs estimated at £120m last year and forecasts of non-EU product flooding the UK market, it is hoped an equivalent UK policy can be agreed to level the playing field with the country's biggest trade partner.

> **The future potential of green steel:** Substantial growth potential, with McKinsey & Company forecasting the market to grow tenfold over the period to 2033. Initial indications suggest demand for the category will outstrip supply, providing agile producers with the promise of higher margins.

Challenges

> **Elevated operation costs:** Following the geopolitical events between Russia and Ukraine, UK and European producers have faced excessive energy costs, with these ultimately leading to production cutbacks across the continent. Whilst ONS data suggests that this trend has subsided from 2022 (see Figure 3), costs remain above pre-pandemic norms and continue to hinder sentiment across the industry. An important advancement over the course of 2023 will be the lapse of China's zero-tolerance approach to COVID-19. With S&P Global forecasting Chinese gas demand to rise by 7%, conversations around energy rationing in Europe may re-spark as we approach colder winter months. On a more positive note, business sentiment did improve in June 2023, with the ONS Business Insights and Conditions Survey indicating energy costs are no longer the greatest concern to UK businesses.

> **Prolonged real estate slowdown in China:** With the sector accounting for approximately 25% of GDP, the continued downturn and slow recovery of construction within the country possess a risk of excess steel supply across Europe. Positive moves have however been made throughout the past 12 months to protect domestic industry through the extension of safeguards on reinforcement, heavy plate and cold-rolled flat steel.

> **Cost of green transition:** Increasing pressure from the domestic steel industry to fund the transition to electric-arc furnaces (EAF). To date, the UK government has pledged a combined £600m to British Steel and Tata Steel (subject to jobs being protected), which falls substantially below the estimated expenditure required to undertake this conversion. With UK public sector net debt pushing £2.57tn and estimated to have exceeded GDP for the first time in 62 years, it is reasonable to question the magnitude and feasibility of this funding at a public level. This poses particular risk to the UK steel industry at a time when the US has unveiled its Inflation Reduction Act (IRA), which subsidises the movement to a greener economy.

> **Impact of monetary-focused government policy:** With multiple interest rate increases seen throughout the world's major economies, a global recession remains very much on the cards for 2023. The UK bank rate was raised to 5% in June 2023, following the Fed rate hike the previous month. For an industry heavily reliant on receivable and stock financing and estimated to see spiking capital expenditure in the coming years (see Figure 6), this will undoubtedly create concerns around both funding affordability and availability.

> **Brexit red tape causing headaches for car manufacturers:** Whilst the automotive market shows signs of short-term recovery, question marks remain around the UK/EU Trade and Cooperation Agreement (TCA) rules of origin. Per the current agreement, policy stipulates that from January 2024 at least 45% of electric car value and 60% of electric vehicle battery components should originate from the UK/EU to avoid tariffs. The infrastructure for battery production within Europe is however currently insufficient to adhere to these requirements, which risks exiling a potential growth market for the European metals industry.

> **Restricted labour pool within manufacturing:** Many sectors are feeling the pinch in terms of human capital, but with an ageing workforce and skilled labour shortages at all levels, manufacturers are said to have reported 36% of vacancies as hard to fill (compared to the 24% industry average) according to Make UK.

Underwriting approach

> **Stable and consistent risk approach:** Each business continues to be assessed on its own financial merit, with a closer emphasis on manufacturing and fabrication supply chains.

> **Management information and regular dialogue with businesses:** The continued flow of financials and visibility outside of statutory filings via contacts held within the industry is paramount for substantial lines of credit.

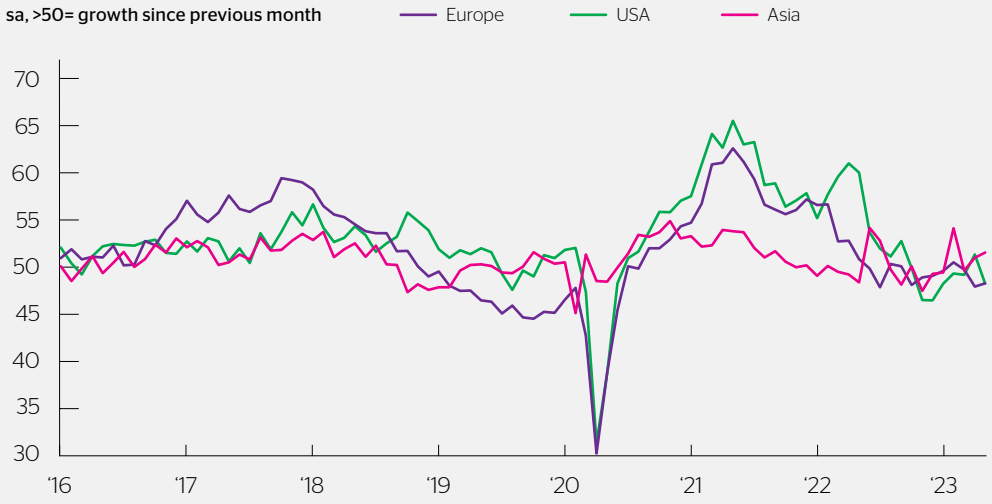
> **Focus upon funding arrangements:** Given the Metal industry's utilisation of working capital financing, an understanding on the flexibility and headroom within facilities and their covenants is crucial, particularly if prices transition to a downward trajectory, at a time when the cost of borrowing continues to rise.

Steel User Regional PMI for May 2023

S&P Global Steel User PMI samples an international base of manufacturers who classify as heavy steel users. The latest release to May posted a small increase in PMI to 50.8 and was underpinned by the Asian manufacturing market, which experienced increased output, rising new orders and reduced backlogs.

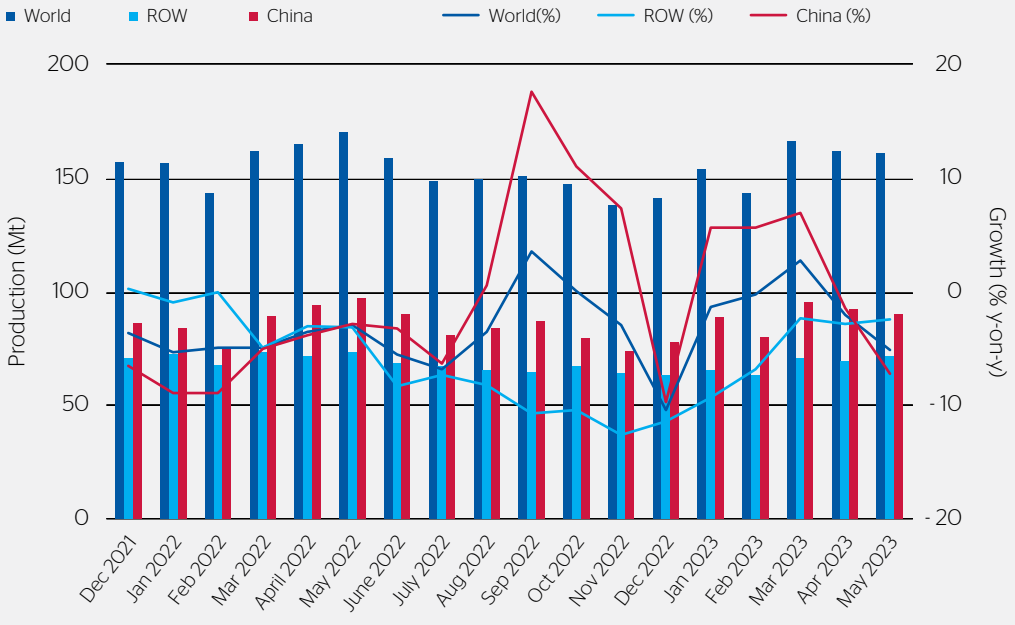
Whilst the picture in the US and Europe was somewhat weaker, vendor delivery times were said to have shortened with input price inflation easing across the board.

Figure 1: Steel Users PMI by region



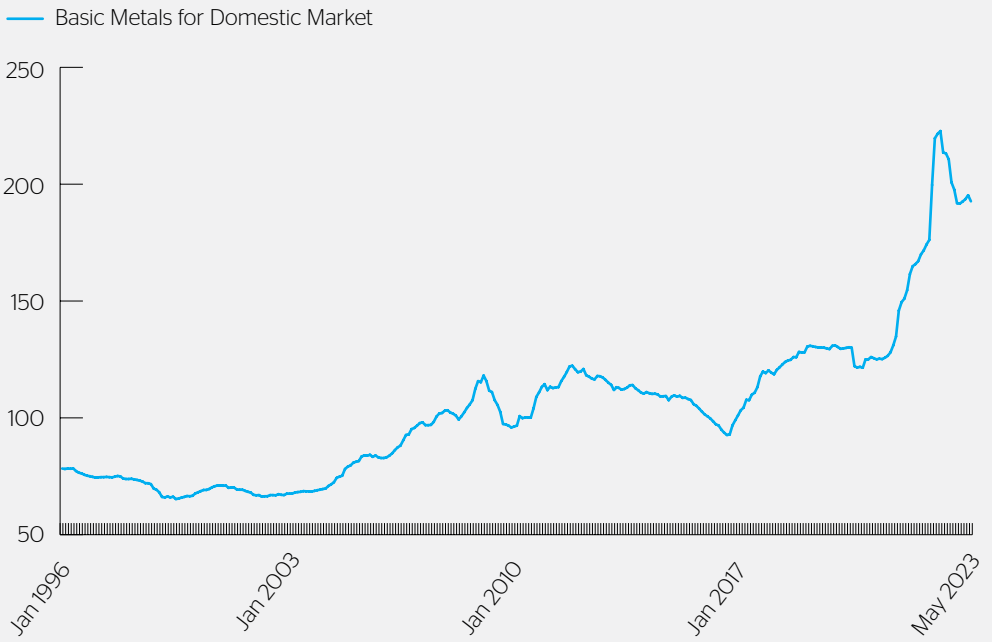
Sources: S&P Global

Figure 2: Global Crude Steel Production



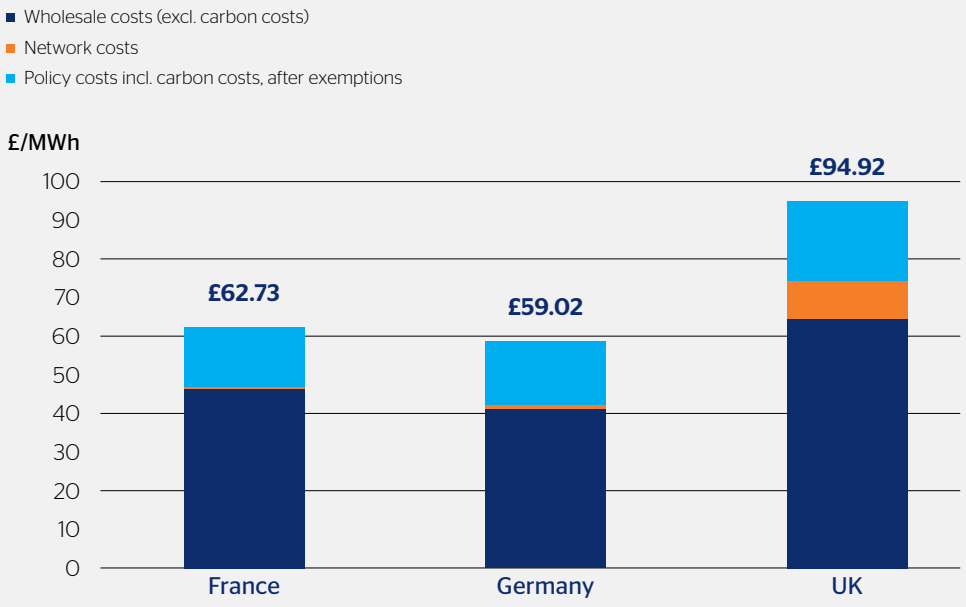
Sources: World Steel

Figure 3: Producer Price Inflation (Basic Metals for Domestic Market)



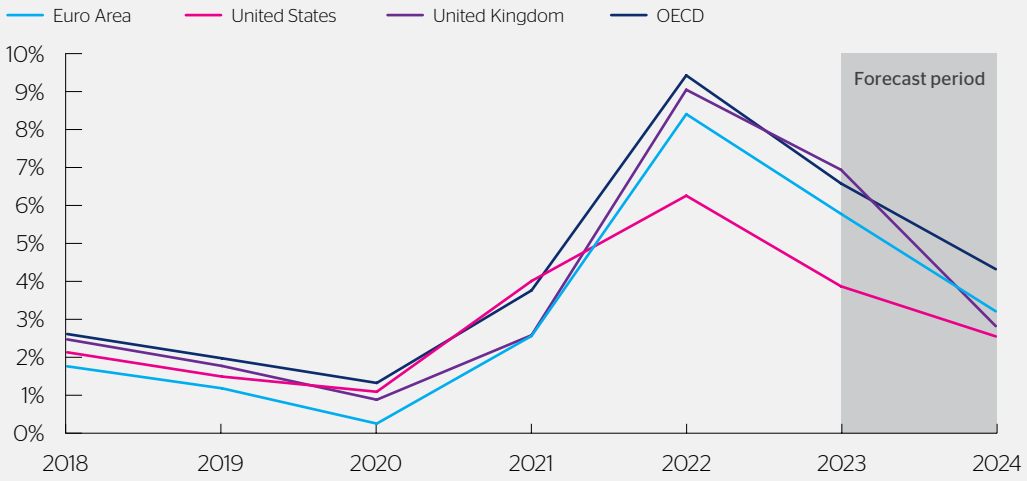
Sources: ONS

Figure 4: Steel Electricity Price Disparity 2021-2022 (UK, Germany & France)



Sources: UK Steel

Figure 5: Headline Inflation % Change (year-over-year)

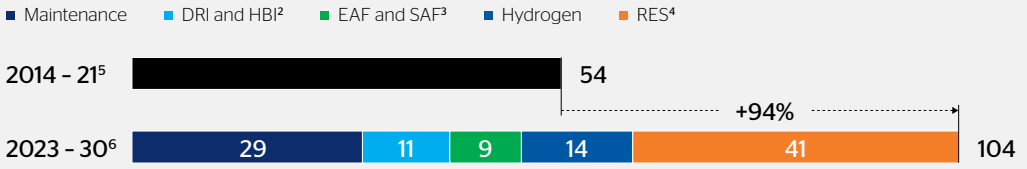


Note: Headline inflation concerns all commodities, services, and goods. Core inflation is headline inflation excluding food and energy. OECD inflation aggregate relies on different country-level definitions of inflation.

Sources: OECD Economic Outlook, June 2023

Companies have announced increased capital expenditures, mainly driven by decarbonization plans.

Figure 6: Capital Expenditures For Six Large Public Steel Companies,[1] $ Billion



[1] ArcelorMittal, Salzgitter AG, SSAB, Tata Steel, ThyssenKrupp, and U.S. Steel.
[2] Direct-reduced iron and hot-briquetted iron.
[3] Electric-arc furnace and submerged-arc furnace.
[4] Renewable-energy sources.
[5] Actual total capital expenditures. For Salzgitter, total group capital expenditures are included, which is higher than the capital expenditures of the steel business only; for ThyssenKrupp, the value is 44% of the total (ThyssenKrupp Steel Europe share in 2020-21).
[6] The following capital expenditure assumptions are being made: maintenance = $25/metric ton (t);DRI/HBI = $300/t; EAF/SAF = $300/t; electrolyzer = $1000/kW. RES ensures 90% electrolyzer capacity utilization: $3000/kW of electrolyzer capacity (a mix of wind, solar, and battery).

Sources: McKinsey & Company

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