Metals update Spring 2022

Sector overview

In 2022 metal prices in the U.K. and Europe have remained elevated against pre-pandemic levels. The end of March rounds off an extremely volatile period for product availability and heightened pricing which is largely down to the Russia/Ukraine conflict and energy cost inflation. Despite these challenges, demand remains strong in end markets and margins across steel service centres, traders and producers are healthy. This report touches on some pertinent headwinds that the Metals sector faces which we believe could pose a serious threat to supply chains across the industry, adversely impacting trading trends and liquidity metrics for many downstream businesses.

Economic data

- **ONS:** Despite a monthly production output increase of 0.7% in January 2022, output remain 2% down against February 2020 (the last month of "normal" trading conditions prior to the Covid-19 pandemic). Within manufacturing output, the most notable quarter-on-quarter increase (to January 2022) was a 4.6% rise in output in the basic metals and metal products segment.
- **Gazette:** 14,048 underlying company insolvencies recorded in 2021 in England and Wales, which was higher than the 12,634 in 2020, but below pre-pandemic levels. January 2022 saw a 3% rise in insolvencies versus January 2021, and February 2022 saw a 13% increase against February 2021.
- **IHS Markit/CIPS UK:** PMI score of 55.2 was posted for Manufacturing in March 2022.

Made possible
QBE

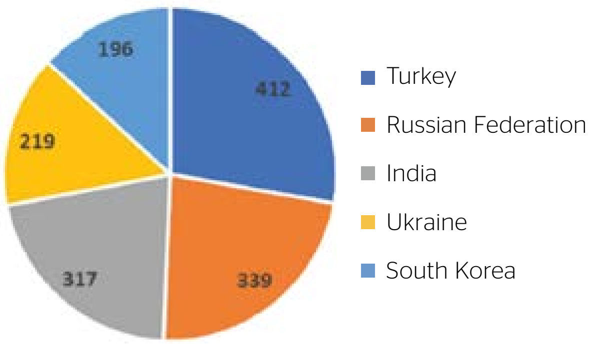
Strengths & opportunities

- **Record-breaking margins for steel service centres and traders:** The speed of material price increases has led to significant spreads and has provided an opportunity for this sector to considerably strengthen their balance sheet. Steel producers have also benefitted from this bull market.
- **Construction pipelines remain buoyant, particularly in steel hungry subsectors:**
    - **Current large-scale infrastructure projects:** The UK Government is investing heavily in infrastructure to drive economic recovery post-pandemic. HS2, Thames Tideway and Hinkley Point remain key projects in the UK.
    - **Industrial and shed builds (including logistics and data centres):** A key user of structural steel which continues to be the preferred material over concrete (90%+ market share). Consumption for structural frames in the UK increased by 16.9% last year, with further growth of c12% expected in 2022. Overall output is expected to increase beyond pre-pandemic levels in 2022 [BCSA].
    - **Energy projects:** Examples such as the Dogger Bank Wind Farm (largest offshore wind farm in the world due for completion by 2026), alongside the Government's recent energy strategy announcement suggests increased spend is forthcoming.
    - **Electric vehicle production/recycling:** Naturally the structural shift to EV's requires significant infrastructure spend and gigafactory builds are gaining traction in the UK. Recent plans include facilities in Northumberland, Coventry and a lithium-ion recycling facility in Kent.
- **The US steel and aluminium tariffs for imports from the UK have been removed:** UK steel exports to the US (the UK's 2nd largest steel export market) have fallen by over 50% since the introduction of the tariffs in 2018 [UK Steel]. The removal of US tariffs for the EU in January 2022 disadvantaged UK-domiciled exporters of steel and aluminium products, who continued to pay 25% and 15% tariffs for these materials respectively. UK-US specific tariffs have now been removed which closes the competitive gap between firms in the UK and Europe.

Challenges

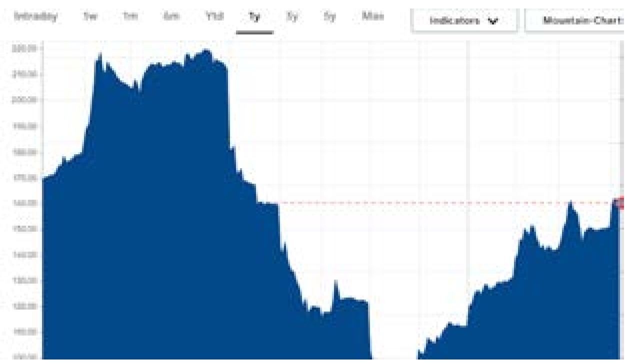
- **Fixed-price contracts continue to be the norm for Constructional Steel:** The pace of material price increases naturally creates a huge headache for contractors, particularly for products such as rebar and heavy plate which effectively doubled in price during March. Not only can contracts become loss-making quickly, paying at the higher prices requires further working capital which absorbs liquidity in the short-term. This is a particularly challenging issue for the SME market; in the main businesses are carrying higher debt levels from Covid-19, and therefore businesses may have less financial flexibility to raise the necessary capital to operate. Other headwinds within the sector include the removal of the red diesel subsidy (and increasing energy costs), material price increases and labour availability.
- **Liquidity impact from constrained supply chains:** Growing lead times and tight supply chains are a threat to manufacturers and processors in the UK, whereby the most popular form of working capital funding is receivables financing. Issues with stock availability can lead to a reduction in sales, which means less invoices to raise finance on, therefore tightening liquidity. For contractors, longer lead times also impact the ability to complete projects on time, which increases the risk of late penalties and liquidation damages.
- **Succession:** The current age demographic of management/ownership for many businesses within UK metal industries, plus favourable trading conditions, means that we are anecdotally seeing an uptick in ownership changes as individuals look to exit. Often there will be new debt/liabilities raised as a result so it is important that we understand how the new structure will impact both operational management as well as future cash flow.
- **Despite positive demand, the recovery in automotive is being derailed primarily due to the global semiconductor shortage:** Original equipment manufacturers (OEMs) are contending with cost inflation from steel, energy, and aluminium (up over 70% in the last 4-5 months). Supply chains into OEMs are typically complex and shipment delays are common which is widening lead times. To demonstrate the impact that this has, UK car registrations for March 2022 were at their lowest level since 1998; a month which normally accounts for 1/5 of vehicles sold in the UK [SMMT].

EU Finished Steel Imports By Country (11m – 2021)



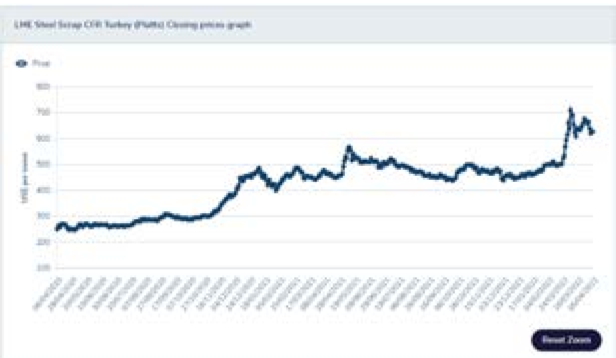
SOURCE - https://www.eurofer.eu/publications/economic-market-outlook/economic-and-steel-market-outlook-2022-2023-first-quarter/#:~:text=It%20is%20set%20to%20rebound,demand%20from%20steel%2Dusing%20sectors.

Iron Ore Price (LTM)



SOURCE - https://markets.businessinsider.com/commodities/iron-ore-price

LME Steel Scrap CFR Turkey (Platts)



SOURCE - https://www.lme.com/en/metals/ferrous/lme-steel-scrap-cfr-turkey-platts#Price+graph

Market review

- **Iron ore:** Pricing at the highest level since August 2021. Set to remain buoyant' in April, owing to the easing of Chinese Government environmental policy and growing Chinese consumption which has since been compounded by the reduction in export volumes from Russia (the 5th largest global producer).
- **Slab and billet:** The EU is heavily dependent on imports of finished steel goods. Ukraine and Russia accounted for circa 40% of imports in the first 11 months of 2021 [Eurofer].
- **Scrap:** A sharp reduction in export volumes from Ukraine and Russia via Turkey. Platts TSI Northwest Europe Rebar reached $1,230/mt ex-works in March. The increase for rebar intensifies in the UK due to limited levels of domestic production along with UK import quotas.
- **Nickel:** Russia is the largest exporter of nickel. The drop in their export volumes ultimately led to trading being suspended on the LME as prices reached over $100/t from $25/t only a week prior.
- **Energy costs:** Cost inflation has been well documented and although this directly causes surcharges in metal prices, the volatility and peak hour pricing has rendered it unfeasible to produce steel during certain hours of the day. Several mills across Europe are idle or running at low production levels, which leads to a further tightening in supply and upward pricing pressures.
- **Freight rates:** Remain very high. For example, rates from Southeast Asia rose to approximately $200/mt in mid-March, up from $160-170 just a week prior, whereas freight on the same route in December 2020 checked in closer to $45/mt.

The UK is facing additional pressure due to the reliance on imported metals, congestion at the ports and driver shortages. Therefore, it is unsurprising that we are seeing significant, and in some cases, record-breaking price hikes implemented throughout supply chains. To give additional context, the estimated cost of raw materials used by blast furnace-based mills in Europe, adjusted for consumption rates, had risen from $536/t at the start of January to $871/t at the end of March, and this is without an increase in energy costs factored in.

Underwriting approach

- **Case by case underwriting stance:** Each buyer continues to be reviewed on their own merits but a more favourable stance exists for steel stockholders/processors with more focus on challenging markets such as constructional steel and manufacturing supply chains required.
- **Information is key, particularly given the higher requirements on credit limits:** Management accounts, buyer meetings/calls, transparency over banking facilities and forward-looking information continue to cement our ability to underwrite positively.

Contacts

Ally Connolly
Senior Underwriter
Trade Credit
QBE European Operations
Level 2, 30 Fenchurch Street, London, UK. EC3M 3BD
Email: alasdair.connolly@uk.qbe.com

QBE European Operations

30 Fenchurch Street
London EC3M 3BD
tel +44 (0)20 7105 4000
QBEeurope.com

Made possible
QBE

367870/2203