Metals update Autumn 2022

Sector overview

As we head into the final quarter of 2022, we reflect on a year for metal markets that has been unpredictable and volatile.

Steel prices have been on a positive trajectory for most of the year, and as a result, stockholders, mills, and traders have benefitted which resulted in strong margin generation during the early parts of the year. As we move through H2, the landscape has somewhat changed and challenges across both upstream and downstream supply chains are now starting to impact the sector, as well as many others.

High energy prices and the widespread increase in overall supply chain costs are now eroding margins and dampening end user demand which has led to a cut in production levels across the sector. Despite the UK Government's pledge to support businesses with energy price caps throughout the winter period, those switching to, or currently on variable rates, will experience sizeable price inflation compared to previous years; a challenge for a sector that incorporates a number of high energy using manufacturing businesses.

We note that slow payments and insolvencies have gained momentum across this sector compared to what was a relatively benign risk environment last year. Adverse payment incidents that are reported direct to QBE are up 6% (Q3) compared to the same period last year. Due to the inflationary pressures, increasing interest rates and weakening global demand, we expect this trajectory to steepen throughout 2022 and beyond.

Economic data

- **ONS** – monthly production output fell by 1.8% between July and August 2022 and is now 0.9% below February 2020, which was the last month of "normal" trading conditions prior to the COVID-19 pandemic. The manufacture of basic metals and metal products contributed negative 0.24 percentage points (with growth falling by 2.8%).
- **Worldsteel** – global steel production was approximately 5% lower in the first half of 2022 compared to the first half of 2021.
- **Gazette** – total company insolvencies in Q2 2022 increased by 13% from Q1 2022 and by 81% from the same quarter in the previous year. Overall company insolvencies in September 2022 were 11% higher when compared to September 2019 (pre-pandemic) and 16% higher than insolvencies recorded in September 2021.
- **S&P Markit / CIPS UK** – Manufacturing PMI score of 48.4 was posted in September 2022, pointing to a second successive month of deterioration in the sector's business conditions.

Made possible QBE

Metals – Market Review

In Q1 2022, the Russian invasion of Ukraine began. Noting that Europe has historically depended on ca 30% of gas imports from the region, plus ca 40% of semi-finished steel imports (amongst other raw materials/commodities), the impact of the conflict on the metals market has been swift and far reaching. For example, in March, the prices of re-bar and heavy plate steel doubled within a matter of weeks, and we also saw the LME suspend the trading of Nickel.

Since then, markets have experienced a steady decline in the price of global iron ore amid weak activity in China, mainly due to the sharp deterioration in the real estate market and COVID-19 related lockdown disruption. During the summer, the Chinese government also announced the creation of a centrally controlled iron-ore purchasing group to place further downward pressure on iron ore prices.

The summer period was also characterised by large volumes of cheap Russian semi-finished steel products flooding the markets in countries such as Turkey. The resulting impact was a further knock to iron ore and scrap prices as producers turned to rolling semi-finished steel rather than utilising raw materials in the production process.

Despite all the above, outsell prices from steel mills picked up significantly in summer across Europe (particularly in August for the UK) given the eye-watering peaks seen for gas and electricity prices. Energy price volatility has meant some assets are unfeasible to run, leading to producers taking the decision to significantly curtail production.

Coking coal prices continue to be high versus pre-pandemic levels. They softened considerably from Q2 have since rallied again in October.

UK energy prices have dropped from the extreme highs seen in summer, partly due to Government's introduction of an energy cap in addition to better than expected progress made on German gas storage in preparation for winter. Energy prices do, however, remain high compared to this time last year.

The reduction in freight rates eased the costs of steel imports into the UK. This has been partially offset by a weaker British Pound in addition to port congestion owing to escalating strike action at Liverpool and Felixstowe.

The UK safeguards for the remaining 5 steel products were also extended in the summer. On one hand, this offers welcomed protection for UK steel producers, yet on the other, it means higher costs for UK manufacturers versus overseas competition.

Weakening demand in the UK economy would logically point towards some softening in prices, though the direction of travel is highly uncertain given the extensive range of variables influencing supply, demand and pricing.

Strengths & opportunities

- **Construction output slowing, but steel-consuming subsectors remains busy.** Overall output has begun to contract since summer, though we note demand continues to be positive for certain subsectors, especially infrastructure projects such as HS2 or Hinkley Point. Steel purchasing from civil engineering has been identified as a strong growth sector for FY22 by Eurofer. The outlook for energy projects continues to be healthy too as economies look to reduce reliance on imports and traditional energy sources – for example, Dogger Wind Bank is a project that will require 200 turbines weighing 2.8k tonnes each, which are predominantly made of steel. Shed builds and data centres also continue to be busy end markets for steel.
- **Spreads and profit margins for stockholders, mills, and traders over the last 18 months have been strong.** This has given many businesses the opportunity to increase investment, bolster balance sheets and reduce debt levels in preparation for a recession and a potential decline in metal prices.
- **Growing demand for "green" steel presents new opportunities for the supply chain.** The focus from corporate firms for ESG-friendly supply chains is intensifying and this will continue to gain momentum going forwards. Customers are typically willing to accept longer lead times and higher prices for these products.

Challenges

- **Ongoing headwinds for constructional steel, with fixed-price contracts biting.** Delivering a profitable contract on time has become exceptionally difficult this year amid price volatility and general inflationary pressures. Price rises increase working capital requirements for businesses which puts pressure on liquidity. Given the speed of price growth we are seeing a spike in the volume of disputed contracts which is in turn slowing the payment process for supply chains.
- **Growing borrowing costs.** The impact will be varied for metal industries. Many businesses are already carrying high debt levels due to COVID-19, and for many, debt will be far more difficult to service as growing interest payments squeeze cash flow. Funding availability may decline, as lender's risk increases and deals become too complex to price due to market volatility.
- **Semiconductor supply constraints continue to thwart recovery in the Automotive market.** The automotive market is a key consumer of metals. Overall registrations in the UK for September 2022 (the most popular month for new registrations) were still 34.4% below pre-pandemic levels, despite a 4.6% month-on-month increase (SMMT).
- **Energy price volatility in the face of softening demand.** This has effectively rendered production in many locations across Europe unfeasible, leading to manufacturers and metal producers scaling back production, or in some cases closing. ArcelorMittal's recently decided to pull production in Spain and Germany which is indicative of the challenges that the market faces. Overall, 3mt of stainless steel capacity was removed from the market as of the end of August. Many larger manufacturing businesses have fixed price energy contracts that will expire in October, which will cause margins to deteriorate if the cost is not passed on. The pricing outlook here remains highly uncertain as Europe monitors the capacity constraints caused by the damage to the Nordstream pipeline.
- **The structural shift to less carbon intensive methods of production.** Steel Orbis and Wood Mackenzie recently suggested that electric-arc furnaces (EAF's) are forecasted to account for 48% of steel production by 2050, up from 30% last year, with hydrogen methods expected to commence from 2027 onwards, accounting for 10% by 2050. Clearly this will require significant UK industry investment as key players such as Tata and British Steel look to negotiate funding deals with the UK Government to assist.

Iron Ore Prices

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

LME Steel Scrap CF (Turkey Platts) – Closing Prices Graph

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

UK Gas Prices

SOURCE - https://tradingeconomics.com/commodity/uk-natural-gas

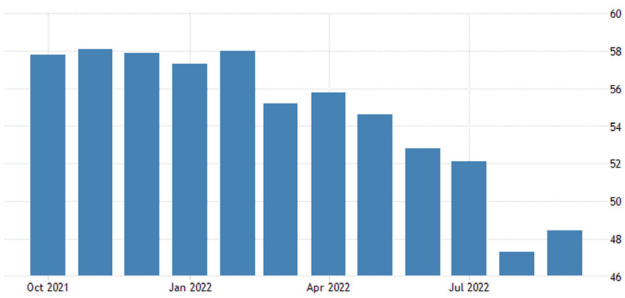
Underwriting approach

- **Case by case underwriting stance.** Each buyer continues to be reviewed on their own merits. Attention focused on the processes that feed into construction and engineering end markets.
- **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 positively underwrite. We hold strong relationships and regular dialogue with senior contacts throughout the sector and work closely with businesses to enable a stable underwriting approach.

Coking Coal Futures

SOURCE - https://uk.investing.com/commodities/coking-coal-futures

The S&P Global/CIPS UK Manufacturing PMI (September 2022)



A score of >50 denotes growth, <50 denotes a contraction.

SOURCE - https://tradingeconomics.com/united-kingdom/manufacturing-pmi#:~:text=End%20of%20Q3-,The%20S%26P%20Global%2FCIPS%20UK%20Manufacturing%20PMI%20was%20revised%20slightly,in%20the%20sector%27s%20business%20conditions.

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