Debt in the steel sector
Signs of distress in the steel sector are increasing as we see several steelmakers on the verge of bankruptcy and seeking to divest assets to reduce debt. Debt in the steel sector has reached record highs – net debt of the top 30 steelmakers is over US$150b, and debt in the Chinese steel sector is estimated to be around US$500b.¹

The average net debt of the top 30 steel companies rose significantly from 2008 to 2013. In 2014, raw material prices fell, bringing some relief to margins and an opportunity for steelmakers to pay down some debt. As a result, we saw the total net debt of the top 30 steel companies decline by 8.1% to US$173.4b.\(^2\)

This was a short-lived relief as the pressure of excess capacity, rapidly cooling demand in China and the stronger position of steel customers led to a fall of over 30% in steel prices in 2015. Lower prices and weaker demand mean steelmakers have not gained all the possible benefits from ongoing debt restructuring and the implementation of cost and efficiency measures.

While average net debt has decreased slightly on increased free cash flow, better capex discipline and in some cases asset disposals, the gap between Earnings before interest, taxes, depreciation, and amortization (EBITDA) and net debt indicates rising debt in the sector (top 30 steelmakers).

\(^2\) EY analysis of data from S&P Capital IQ

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*Source: Data from S&P Capital IQ, EY analysis*
Steel companies have taken on an increasing amount of debt as they sought to capture or sustain market share. China, in particular, has added about 1,075mt of capacity since 2000 and, in 2015, there was a gap of 419mt between production and capacity.3

As a result, the global steel sector currently has about 700mt of excess production capacity and low capacity utilization (approximately 70%), which indicate that there is at least 15% of capacity4, built at an investment of US$300b–US$350b5 that could be closed.

Weaker economic conditions and a rebalancing of the Chinese economy have resulted in a decline in the global and Chinese steel demand (by 3% and 5.4%, respectively, in 2015).6 Consequently, margins have shrunk and with a limited free cash flow, companies have turned to taking loans to finance their operations. As a result, leverage has steadily increased since 2008. We have also seen an increase in total debt as a percentage of total company assets, indicating that assets financed through debt have steadily increased.

Total debt as a percentage of total company assets (average of the top 30 companies)

Source: Data from S&P Capital IQ; EY analysis

3. EY analysis, UBS, OECD, World Steel Association.
4. EY analysis; UBS, OECD, World Steel Association.
5. As a rule of thumb, it takes US$1b to construct 1 million tonnes of integrated steel capacity.
We have also seen short-term debt, as a percentage of total debt, remain above 20% since 2011. This indicates that companies are facing issues in raising capital for long-term investments or are using debt for their operational activities. Both of these scenarios don’t bode well for the long-term sustainability and viability of the steel sector. The risk is that financing operations through short-term debt will put companies under pressure as short-term lenders may stop refinancing or increase lending rates in the event of increased volatility or a slowdown in the economy.

Debt structure (average of the top 30 companies)

Source: Data from S&P Capital IQ; EY analysis
Regional and corporate variations in distress

Steel companies in certain regions are experiencing more distress than others. For example:

- **In the US and Europe**, steel companies have been able to improve their debt situation by decreasing their capital expenditure. Stronger economic growth in both the US and Europe has also resulted in growing domestic steel demand.

- **In Brazil**, a weaker economy has resulted in a decline in domestic consumption.

- **Several players have struggled with profitability** as oil and gas capital expenditure collapsed. US Steel Corp, the oil country tubular goods (OCTG) producer in North America, has cut production and laid off a large number of employees as demand for tubular steel declined.

- **Some companies have battled higher energy costs**, e.g., Tata Steel was considering either divesting its loss-making UK operations or merging these assets into a strategic joint venture because of higher energy and related costs, making it uncompetitive in the global market.

- **Vertically integrated players have suffered a decline in profits** in their mining divisions as prices for coal and iron ore have fallen substantially since 2014.
Indian steelmakers’ debt has increased significantly as they invested in new capacity to capture rising demand.

Russian and Japanese steelmakers have been able to significantly reduce their debt owing to an increase in profitability from exports on the back of depreciation in domestic currency.

Chinese continues to reel under the pressure of excess production.

Source: Data from S&P Capital IQ; EY analysis
Unlocking long-term value: strategies to reduce debt and release cash

While many steelmakers already have a firm control over productivity and working capital, there is an increasing need to repair balance sheets. Steel companies are adopting several strategies to manage their debt, strengthen balance sheets and increase cash generation, as follows.

Alternative financing: Although large companies like Tata Steel are able to restructure debt at more favorable terms and pricing relative to the earlier debt contracts, small- and medium-sized companies are finding it difficult to obtain reasonable terms and conditions. As a result, some companies are alternative financing such as strategic partners who can invest in their operations, thereby reducing their debt and avoiding default on their loans through financial institutions.

Portfolio strategy: Some steel companies may have portfolios that are no longer aligned with their current strategies. Undertaking regular and rigorous portfolio reviews is vital in determining the highest-performing investment projects and identifying where to focus capital. The embedded optionality and capital intensity of individual assets are the key determinants in deciding what assets form the optimal portfolio to achieve growth aspirations.

Projects previously considered core may become best suited for divestment if growth opportunities are limited and do not fit with the new strategic direction of a company. Several steelmakers have been focusing on divesting non-core assets. For example, JSPL is in the process of selling its 1,000 megawatt power plant as part of its strategy to divest power assets as a means to safeguard its core steel assets.

Through regular portfolio reviews, companies may also decide to diversify into higher margin businesses, e.g., Korean steelmakers have diversified into energy, construction and agriculture to offset falling returns in the steel sector.

Unlocking cash flows: A tighter control on costs is essential. We suggest that companies take a PE

8. “Jindal may be set for a deal on Chhattisgarh power plant,” Mint, 22 March 2016.
mindset when evaluating where costs can be taken out of the business. Cost reduction measures need to be sustainable, but it is vital that such measures do not contribute to value erosion. A strong cash position is critical to ensuring a rapid response when market conditions recover, e.g., U.S. Steel Corp. has saved US$1.4b in costs over the last two years through its Carnegie Way improvement program and is maintaining a strong cash position.10

Companies can also look to identify potential activities that can provide a competitive advantage. For example, POSCO’s FINEX steelmaking technology is a market differentiator, which it now plans to sell aggressively to other steel producers. In a recent deal, POSCO has transferred this technology and equipment to Mesco Steel in India in exchange for a 26% minority share in the project.11

While the Chinese Government plans to rationalize the domestic sector and will remove 100mt–150mt of capacity by 2020, it is still unlikely to make a meaningful dent in excess capacity and this poses a risk to the industry for the foreseeable future.12 In addition, as capacity is increasing in other parts of the world, an annual average capacity reduction of 20mt–30mt from China will not bring any long-term solution.

Governments are trying to find regional solutions in tandem with their domestic steel industry by providing solutions like imposing safeguard or import duties on imported steel and providing financial assistance. However, these measures will only help steelmakers if they can maintain viable businesses.

The size of some of these steelmaking companies is large and their closure or bankruptcy could have serious consequences in terms of direct job losses and impact on financial institutions. On the other hand, continued financial incentives in domestic markets are likely to delay the critical structural changes required in the overall global steel sector.

As noted in EY’s Global Steel 2015-16, globalization is no longer a matter of choice; steel businesses’ long-term success depends on it. The businesses that ride the next wave of growth will be those that understand the trends and refine their strategies, business models and portfolios according to a truly global mindset. Ultimately, it’s never been more important for steel producers to find the right balance between globalization and customization.

12. “China to cut steel capacity by 100-150 mln tonnes in 5 years,” Xinhua China Economic Information Service, 5 February 2016.
How EY’s Global Mining & Metals Network can help your business

With increasingly positive sentiment in the sector, miners are focused on restoring balance sheet strength and liquidity in preparation for growth. The sector’s key opportunity is still productivity. Although many have made productivity improvements, the critical next wave of gains needs a strong focus on loss elimination, with digital being a key enabler.

EY has significant experience in assisting companies to evaluate and implement strategic initiatives, with deep sector knowledge to support you on finance initiatives, such as portfolio optimization and capital planning, and through to operational improvement programs, such as productivity and digital enablement.

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