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INVESTMENT NOTE **XX MAY 2015**

HERMES: ORE HITS THE FLOOR

Andrey Kuznetsov, Credit Analyst at Hermes Credit, gives his view on how best to play the steel meltdown.

Global steel prices have collapsed in the past year, as the value of iron ore has plunged relentlessly. For the first time since 2009, the price of iron ore on the global market fell below $50 per tonne. This represents a 75% fall from the near $200 peak reached almost four years ago. Although the iron ore and steel markets have stabilised in the past month, it's premature to talk about a sustained recovery because the Chinese economy continues to slow down. The combination of excess capacity and weak consumption in the world's second-largest economy has reduced demand, while flooding the export market.

Currency weakness in Europe and emerging markets is preserving margins

While the outlook may seem bleak and further downside is likely, it would be wrong to ignore the sector altogether. As the US dollar has strengthened, steelmakers whose operating costs are predominately in euros or in emerging market currencies have been better able to preserve margins. This is fertile ground for active managers. However, investors must assess the relative strengths of issuers, price in further risks and ultimately decide which instruments provide better value.

Shorter-dated bonds offer better relative value

One Russian name we are constructive on is Severstal. The company is rated BB+, however it has strong credit metrics that are more consistent with a BBB- rating. While its heavy exposure to Russia and Eastern Europe is a net positive, domestic steel demand is weak and additional sanctions imposed by the West could limit its ability to export into Europe – a big market for Russian steelmakers. However, and most importantly, the devaluation of the rouble has led to significant margin expansion for all Russian steel producers. Severstal's EBITDA margins have increased from the high teens in 2013 to 38% in the Q1 2015.

Evraz had a very strong 2014. Its credit profile benefits from decent scale, a low-cost base owing to the rouble's devaluation and some diversification through its US business. However, it is sitting on $6bn of gross debt and has a number of bonds maturing in 2017 and every year thereafter until 2020. In the cases of Severstal and Evraz, we perceive their shorter-dated bonds to provide better relative value given the recent bounce back in the rouble and the higher coupons on offer.

European steelmakers holding up

Steel prices in Europe have held up well in euro terms, helped again by the depreciating currency. As a result, those steelmakers that report in euros – such as Thyssenkrup, Saltzgitter and Voestapine – will generate stronger numbers, all else being equal. Another tailwind for European steelmakers comes from regulators. The European Commission has opened an anti-dumping investigation on cold rolled coils from China and Russia. Additionally, duties on cold rolled stainless steel from China and Taiwan, and on grain-oriented electrical steel from Russia, the US, Korea, China and Japan, were announced in March.

Key indicators

The key metrics to watch out for now include the level of Chinese steel production, Chinese export figures and anti-dumping cases targeting cheaper steel imports. Any enforcement of protectionist tariffs in Europe or simply lower Chinese production would be positive for the European steel sector. That said, it would be negative if introduced protectionist measures are stronger in the US or if Chinese exports continued at their rate of between 7m-10m tonnes per month. If the anti-dumping measures prove successful, however, steel producers will have one more piece of positive news to hold onto after what has been a painful 12 months.

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