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AK Steel treading a fine line amid industry challenges

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AK Steel Holding Corp (AKS), a prominent US steelmaker that derives 90% of its revenue domestically, saw its financial performance in Q3 2017 deteriorating to precarious levels due to a combination of an unstable industry environment and disastrous strategic management. In a brief comparison of Net Debt/EBITDA against some of its peers (see Table 1), AKS is shown to have the largest financial leverage among them all, suggesting that it may be the most vulnerable to the adverse industry conditions ongoing for the past few quarters.

	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017
AK Steel (X)	4.45	3.53	3.13	2.68	4.11
Nucor Corp (X)	1.25	1.05	1.10	1.09	1.08
Steel Dynamics Inc. (X)	2.62	1.48	1.13	1.19	1.17
Commercial Metals Co (X)	2.04	2.54	2.58	2.99	2.52
Carpenter Technology Group (X)	4.11	1.08	1.17	2.52	2.29

Table 1: Peer-to-Peer comparison of Net Debt/EBITDA, a financial leverage metric. *Source: Bloomberg*

	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017
Net Income (USD mn)	50.90	75.20	51.90	66.70	-8.40
Cash, Cash Equiv. & STI (USD mn)	57.50	173.20	185.70	136.30	69.30
Current Liabilities (USD mn)	934.40	865.30	1,037.00	927.00	1,004.40
EBITDA/Interest Expense (X)	4.69	1.21	4.44	4.43	2.72

Table 2: Financial Data for AK Steel Holding Corp (AKS). *Source: Bloomberg*

From an industry perspective, domestic steel companies have been suffering for quite some time due to the massive cheap foreign steel imports to the US. Ever since President Trump took office, he has announced several measures to cut unprofitable investments and renegotiate trade deals that are inflicting current account deficits to the US. This includes the Section 232 review on the US steel industry urged by steel companies on whether these steel imports threaten national security. Unfortunately, the review seemed to have stalled over months owing to pressures from domestic steel-using manufacturers, which argue that tariffs and bans on steel imports would hurt their export competitiveness. Another aspect to consider would be the detrimental implications on US trades with its strongest allies, such as Canada, South Korea and Brazil, which happen to be major exporters of steel to the US. Moreover, even if the tariffs and bans on steel imports would eventually be rolled out, these foreign steel exporters would have managed to get more of their steel products into the US so as to cash in at the expense of US steel companies before any results from the Section 232 investigation are announced. US steel imports have shot up by 241% between Q2 2009 and Q2 2017 and 26% more in H1 2017 as compared to H1 2016. Imports have also captured an increasing share of demand as shown by the increase in import penetration from 28.5%% in H1 2016 to 33.5% in H1 2017. The competition from foreign steel imports could be the reason behind the worsening profitability in AKS.

AKS' financial standing is also not in good shape. Its current liabilities in Q3 2017 stand at USD 1bn, which compares with its current Cash, Cash Equivalents & Short Term Investments of only USD 69.3mn, indicating an inability to meet all of its upcoming commitments should any adverse events arise on short notice. On the company's long-term obligations, AKS recently announced new offerings of its senior notes, which prompted more concerns on its already highly leveraged position (see Table 1) and its decreasing ability to pay off its debts measured by EBITDA/Interest Expense (see Table 2).

To counteract the weak yet competitive steel industry, AKS acquired Precision Partners Holdings Co, a manufacturing and engineering services company, in hopes to expand AKS' product offerings, streamline its supply chain processes by producing closer to consumers and possibly acquire technologies that would add value to its current product offerings to boost profit. AKS sees the acquisition as a good move to diversify given the fact that its steel is not as competitive relative to its peers. AKS buys iron ore and coal and smelt them into steel whereas other steel companies (such as Nucor Corp. and Steel Dynamics Inc.) use mini-mills to melt scrap steel with electric furnaces and then tinkering with the carbon content, which improves the quality of the steel produced.

Industry-wide developments are not the only problem AKS faces. AKS' minimum exposure to the iron ore spot market turns out to be a double-edged sword that is putting pressures on the company. AKS depends considerably on fixed iron contract pricing to guarantee its stable income flow. While this pricing policy gives AKS an upper edge against its competitors in the event of a market upturn, the recent low iron ore spot price coupled with AKS' conservative approach on striking iron ore price contracts turned against its favor.

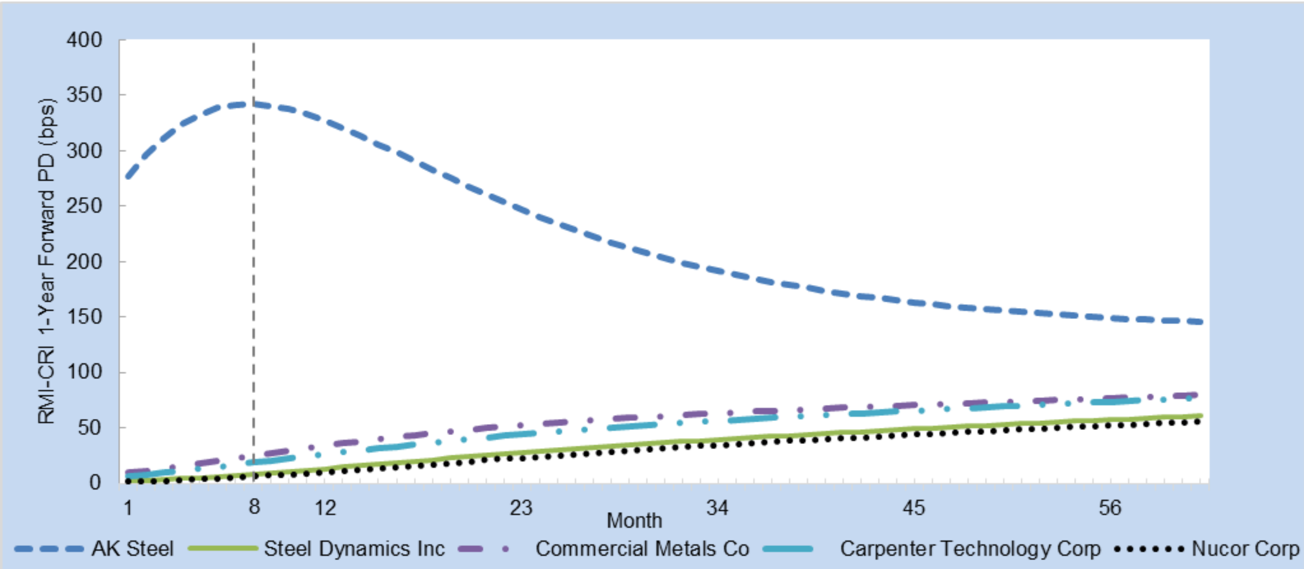

Figure 1: RMI-CRI Forward 1-year PD term structure for AK Steel Holding Corp and other similar US steel companies with the market information on Nov 9, 2017. *Source: RMI-CRI*

From Figure 1, we observe that AKS has the highest RMI-CRI 1-Year Forward Probability of Default (PD) compared to other similar US steel companies over the period. Intuitively, the Forward PD computes the credit risk of the firm on a future period, which works like a forward interest rate. For instance, the 3-month Forward 1-year PD is the probability that the firm defaults during the period from 3 months onwards to 1 year plus 3 months, conditional on the firm surviving the next 3 months. The AKS' curve shows that the Forward 1-year PD gradually steepens with time to peak at around 8 months and then declines afterwards, suggesting that based on the market information on Nov 9, AKS faces relatively higher default probabilities over the next 20 months vis-a-vis other times. Adverse industry effects magnify for AKS due to its highly leveraged position compared to its peers. The increase in AKS' forward PD measure likely indicates the heightened risk associated with the delay in the Section 232 review on the US steel industry.

AKS is treading on thin ice as any major setbacks to the steel industry will likely impact the company the most due to its highly leveraged financial position. At its current state, the company should better not engage in unproductive and risky activities that could introduce more headwinds to its delicate standing on the industry. At the same time, the company should focus more on revamping its business model and possibly improve its product offerings in order to keep up with the rapid changes that could render the steel industry obsolete in the future.

Credit News

Kenya Airways restructures in debt-for-equity swap

Nov 13. Kenya Airways finalized the terms of debt-for-equity on November 13 which will make the lossmaking airline almost 90% owned by the Kenyan government and a group of 11 local banks. The minority shareholders appear to be the big loser in the deal, as Air-France-KLM's ownership dropped to 7.8% from 26.7% and shares owned by other shareholders will be diluted down to 5.2% from 43.5%. Kenya Airways has suffered five years of losses, including a KES 26.2bn loss in 2015/2016, the biggest in Kenyan corporate history. The restructuring deal stabilizes the balance sheet, increase the equity on the balance sheet and downshifts the interest payments. The finance minister of the company insisted the deal was not a bailout but an investment, for the government expects a return once the company returns profitability and expects to retain its stake for up to a decade. (FT)

Riskiest countries are selling debt at record rate

Nov 13. Buoyed by the global economic growth and investors' search for yield, the world's riskiest countries are issuing debt at a record rate. Junk-rated emerging market sovereigns have raised UDS 75bn in syndicated bonds so far this year, a 50% increase year on year based on Dealogic, a data provider. Non-investment grade issuance has made up 40% of the new debt syndicated in emerging markets (EM) so far in 2017. EM's local currency-denominated sovereign debt has returned 10.4% this year, making it one of the best-performing assets globally in 2017. However, these bonds are likely to be traded less often and thus command an illiquidity premium and that have attracted institutional investors and private clients to hold to maturity. Analysts also warned that sovereigns with poor credit ratings might struggle to refinance their debt when it matures. (FT)

Venezuela's Maduro dismisses default possibility on eve of debt talks

Nov 13. Prior to meeting creditors on Nov 13, the Venezuelan government has declared that the country would not default on its debt as the President plans to renegotiate financing terms with its bondholders. Venezuela owes China USD 28bn and Russia USD 8bn and the economic recession has left the country with little reserves. Inflation is forecast to exceed 2000% due to widespread food shortages and a collapse in the bolivar currency. US sanctions prevent American banks from investing in newly issued Venezuelan sovereign bonds, making it practically impossible for the country to refinance its debt. (Reuters)

Catastrophes wipe USD 35bn from insurers' profits

Nov 13. A string of natural catastrophes this year have wiped more than USD 35bn from insurers' profits, according to a Financial Times analysis of third-quarter results. Worse still, insurers have stated that the final cost is likely to be larger, with estimates suggesting that the industry is facing more than USD 110bn of insured losses from natural catastrophes. Such rising costs could in turn push up premiums, which is welcome news for insurers, as commercial insurance and reinsurance have suffered from years of falling rates, due to excess capacity and a lack of big claims. While some analysts argue that price rises will not occur in non-loss affected areas, others argue that price rises will be more widespread. In addition, the reaction of the burgeoning market for insurance-linked securities would also influence premiums—premiums have a better chance of rising if the recent spate of disasters and associated losses on the securities scare investors away. (FT)

After their own debt binge, Europe loan collectors seen at risk

Nov 10. Analysts in Europe are calling out against the unsustainable business model of European loan collectors. Companies like Arrow Global Group and Lowell Group Ltd purchase overdue debt using borrowed money instead of earnings. These debt purchasers took advantage of low borrowing costs in Europe but their growth are believed to be unsustainable should debt costs increase. Hedge funds were reported to take short positions on these loan collectors, with the total combined shorts amounting to nearly 20% of available shares. However, bonds offered by debt collectors remain popular among investors. Optimistic investors are expecting these companies to refinance their bonds and cut debt next year. (Bloomberg)

Four Seasons' largest creditor rejects proposed debt-restructuring plan

Nov 8. Four Seasons' largest creditor has rejected a proposed restructuring plan of multi-million pound debt, leading to a bruising fight with its private-equity owner. The UK's largest care provider has declared that it would default on its debt next month because of a failed deal with bondholders. Currently, the company is saddled with a high-interest debt of GBP 525mn. Compared with Four Seasons' initial debt restructuring plan, its creditor, H/2 Capital, has launched a proposal that argues for a much higher debt reduction of GBP 247mn, a lower leverage ratio of 46% and lower interest rate payment of 7%. Under the proposal, H/2 also suggested Baroness Margaret Ford as the new chair of board to replace Robbie Barr. Four Seasons said it welcomed the proposals to ensure the long-term stability of the group. In addition, an industry insider regarded the new plan as a positive step for the company. (FT)

Noble group loses key bank support as DBS cuts lending (Bloomberg)

Teen fashion retailer Styles For Less files for bankruptcy (CNBC)

Takata creditors seek USD 30bn, far more than it can pay - court filing (Reuters)

Regulatory Updates

RBI questions dealings under liberalised remittance scheme on laundering suspicion

Nov 13. Amid concerns about tax havens and black money, the Reserve Bank of India (RBI) is scrutinizing dealings under the Liberalized Remittance Scheme (LRS) that allows resident Indians to invest a maximum USD 250,000 abroad a year. Many have been asked to explain transactions in offshore unlisted companies set up under the LRS, loans to such companies, use of properties purchased abroad, and flow of funds from such companies back to India. A few MNC banks have even requested for an undertaking from customers that money remitted to a foreign currency account opened abroad under LRS would not be deployed in onwards overseas investments. This is due to the possibility of transactions involving money laundering are often routed through Foreign Currency Accounts created under the LRS. These measures were implemented in response to strategies adopted by individuals or companies to invest in companies overseas in lower tax jurisdictions with the objective to shift profits. (The Economic Times)

China widens foreign access to its giant financial sector

Nov 10. As part of China's efforts to become a major finance hub, the country is raising foreign ownership limits in its financial firms. Limit on foreign ownership in joint venture firms will be raised from 49% to 51%. Western governments and businesses welcomed the move as they had hoped to see the removal of investment barriers in China. The size of the Chinese market is a big lure for foreign investment banks even though their joint ventures had been making an average loss of RMB 21mn loss over the past decade. Despite the relaxation, certain industry watchers claimed that the changes are too small and too late to effect significant reactions from the market. Capital control and other restrictions still make it difficult for foreign firms to compete against their Chinese counterparts. (Reuters)

Norway sovereign wealth fund wants forex traders to restore trust (FT)

Greece's Tsipras says debt relief discussion to follow review (Reuters)

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