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CALIBRE GROUP

Steel: Fasten Your Seatbelts - A Bumpy Ride Ahead

Expect lots of volatility in 2019, as Washington gridlock, changing policies and Federal Reserve decisions will play a huge role

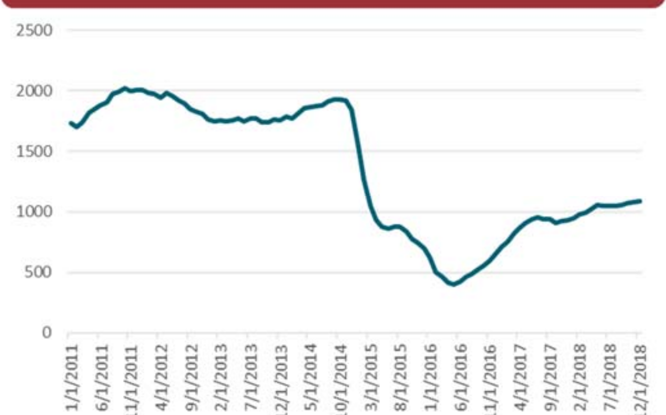
SUMMARY

2018 was a wild ride for the steel industry as prices for the first two-and-a-half quarters of the year were on a straight shot up, driven almost entirely by Section 232 tariffs of 25% on steel imports and tough trade talk. Demand fundamentals in 2018 were solid, as companies had more to spend due to tax cuts, had more incentive to spend on capital investments due to changes allowing for immediate expensing of capital investments, and individuals benefitted from a declining unemployment rate, and slight improvements in wage growth. However, there was no significant uptick in demand that would have resulted in the price movements experienced in 2018. Rig counts increased in 2018 from 2017 levels, but are still well below levels prior to 2015. Domestic vehicle production remained solid, but was roughly in-line with 2017 levels. Construction activity in the US was strong in 2018, but roughly in-line with 2017 levels as measured by the Dodge new construction index for both residential and non-residential construction activity. The only possible explanation for the significant increase in prices in 2018 was that it was not demand driven, but rather almost entirely driven by a reduction in available supply due to the tariffs.

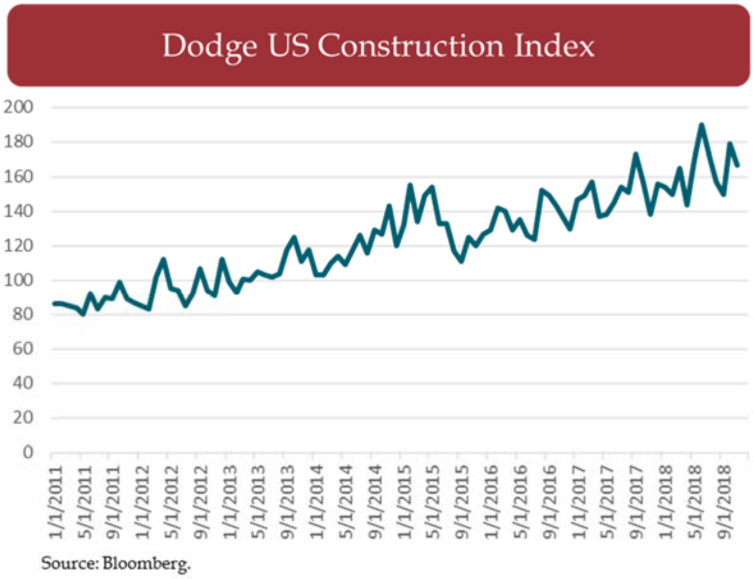
US Annualized Auto & Light Truck Assemblies *(Millions)*

Source: Bloomberg.

US Oil & Gas Rotary Rig Count



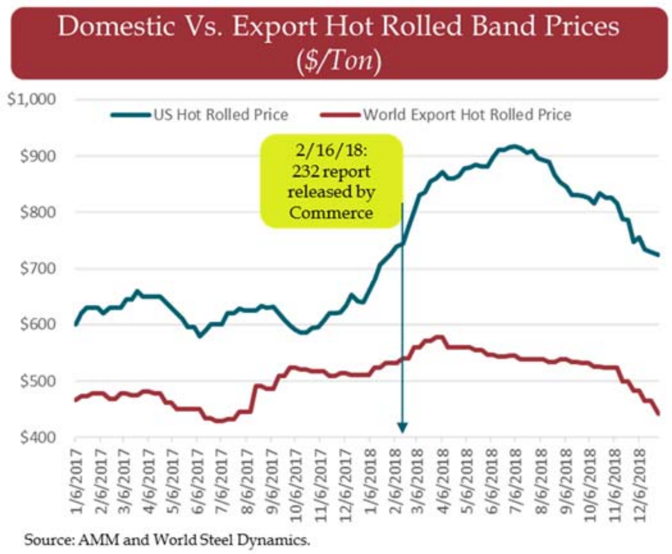
Source: Bloomberg.

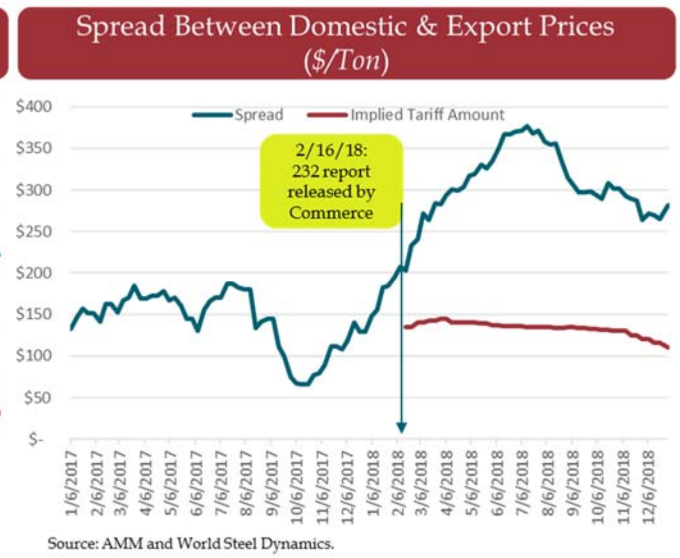


The relatively solid economic fundamentals of the US economy, coupled with trade disputes and rising domestic interest rates, led to a strengthening of the US dollar in 2018, which is usually correlated with weak commodity prices. However, steel prices increased despite a stronger dollar. This can mainly be attributed to tariffs, and protectionist domestic policies, which threw many normal correlating factors askew.

Despite steel tariffs of only 25%, prices increased by more than 25% (using as a starting point prices as of April 2017 when President Trump initially asked Commerce to begin a national security investigation of steel imports under Section 232) as supply chains needed to adjust, uncertainty abounded, lead times extended, and producers and "sellers" took advantage of the situation. As was predictable, by the middle of the third quarter these "excess" prices began to dissipate, with steel prices beginning to normalize, declining by approximately $200/ton from peak. There was an estimated 4.4 million tons of capacity restarted in 2018, numerous tariff exemptions were granted, trade deals between nations were reached with expectations that more trade deals were ahead, and the short squeeze that initially took place began to wear out. While protectionist policies and threats still linger, the benefit of those policies have been fully priced in, and barring unforeseen new protectionist policies, changes in steel prices are only headed in one direction by the end of 2019…down.

It should be noted that domestic steel prices are at a premium to world export prices by significantly more than 25%. Even before President Trump asked Commerce to investigate steel imports via Section 232, domestic steel prices traded at a premium to world export prices. This was due to transportation costs, and anti-dumping and countervailing duties on certain countries that were previously in place. In 2017 that domestic-export spread averaged $142/ton. When adjusting for the 25% tariff currently in place, the spread is currently at $171/ton over the implied tariff. So there is still some room to the downside for prices even if demand stays flat and tariffs remain unchanged.





TIME TO PULL THE TRIGGER

With 2018 as a backdrop, we believe 2019 will be a year marked by further volatility in steel prices driven by fiscal and monetary policy. Government policy was the most important factor in 2018 supply-demand dynamics. We believe that trend will continue in 2019. As such, we believe that owners of steel assets who are considering a monetization event, should do so before it's too late. Governmental policy is never static and seems to change at the whims of policician's desires, so holding out in the hopes of further governmental support is a risky proposition. 2018 was a good year for most steel producers and service centers, as the rising prices led to expansions in metal margins, while solid economic fundamentals prevented a deterioration in volumes. We anticipate that 2019 will see financial performance decline from 2018 levels, as metal margins compress, wage and benefit inflation continues, and certain sectors of the economy begin to show cracks in their foundations due to higher interest rates as Central Banks around the world scale back dovish policies. New capacity coming online in 2019 will also put downward pressure on prices. Consequently, if owners have the opportunity to sell on 2018 financial performance they should take advantage of it before "normalization" kicks in.

FED RATES & BALANCE SHEETS

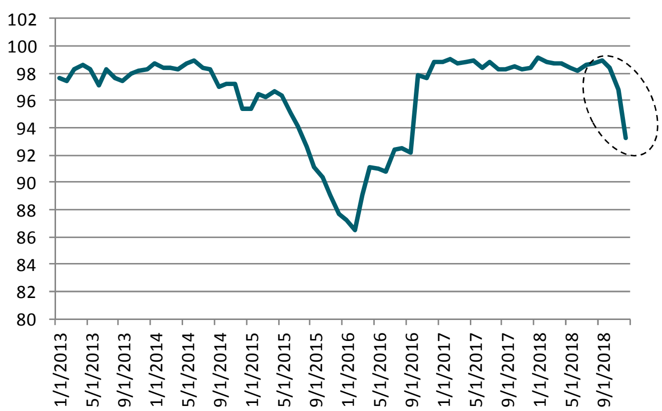
The Federal Reserve raised rates seven times in the past two years, and the Fed has stated they expect there will be another two in 2019 (economic data depending). In addition to hiking rates, the Fed will also continue shrinking its balance sheet by $50 billion per month in 2019. These two factors in a vacuum should lead to higher interest rates in 2019. What do higher rates mean for the steel industry?

First, higher domestic rates would generally lead to a stronger dollar, which places downward pricing pressure on steel prices. Second, as rates rise, all companies with floating rate debt, as well as companies with near-term debt maturities, will face higher interest expense costs. This will divert company's resources from potentially steel intensive capital investments to debt service instead, which will put a damper on demand. In some cases this will be further exacerbated by new tax rules limiting interest deductibility for tax purposes (30% of EBITDA). Third, rising rates are bad for many steel end markets. When rates rise, industries where financing is important, such as automotive and construction, are negatively impacted. Mortgage and automotive loan availability and affordability are key drivers in consumer purchasing decisions, and higher rates and less access to credit correspond to lower home and automotive purchases.

Restrictive Fed policies are meant to slow inflation, and cool down economic growth. So if the Fed continues to tighten, that will be a burden on domestic steel demand.

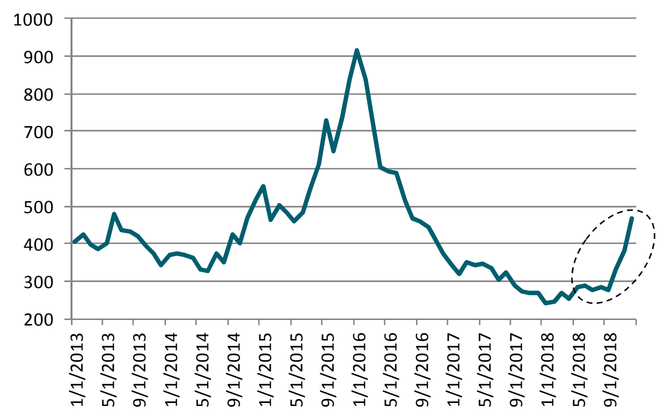
Rates have already started moving up, with leveraged loan prices declining (prices are inversely related to yields). The decline in loan prices is noteworthy because they indicate a repricing of credit. Interest rates in leveraged loans are linked to a base rate that typically moves with interest rates overall. Therefore, the decline in pricing reflects a change in the cost of capital beyond interest rates.

S&P/LSTA US Leveraged Loan Price Index



Source: Bloomberg.

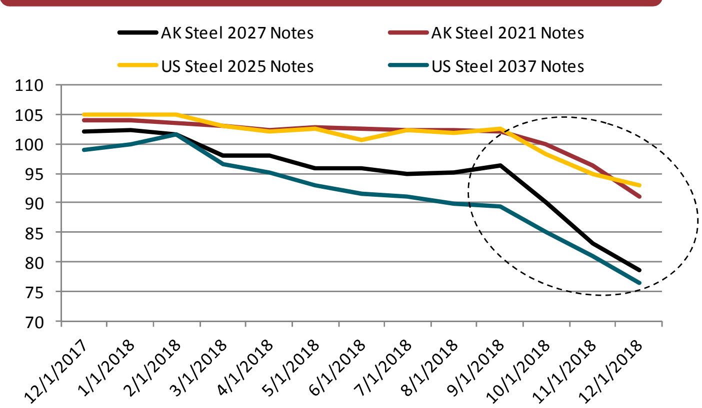
US High Yield Materials Index Spreads
(basis points)



Source: Bloomberg.

Spreads within the high yield industrials sector have also begun to widen, but still remain lower than levels seen in 2015 and 2016. However, when spreads widened in 2015 and 2016 that was during a period of continuing accommodative Fed policies, which is very different than the current environment. Steel companies such as AK Steel and US Steel are already experiencing a significant weakening in bond prices, with those company's bonds down 10+% in the last six months. We expect spreads to continue to widen and credit to get tighter.

Select Steel Company Bond Prices



Source: Bloomberg.

GOVERNMENTAL POLICY UNCERTAINTY

The current political environment is one where uncertainty abounds. However, there are some potential bright spots for the steel industry. With respect to supply, if the administration maintains its tough stance on trade, and keeps tariffs and/or quotas in place, supply will remain constricted and provide an "artificially high" floor on steel prices. However, such policies may have a detrimental impact on long-term steel demand, as higher costs will eventually trickle through to the consumer and lead to lower consumer purchasing power. Separately, manufacturers may import manufactured components rather than produce them here with high-cost steel.

With respect to governmental impact on demand, talks of a big infrastructure spending bill continue, but so far nothing has been done. A $1 trillion infrastructure spending bill would be a nice boon for the steel industry, especially since it will likely be coupled with Buy American provisions promoting domestic steel. In addition to infrastructure spending, if Congress decides to approve the USMCA (new NAFTA) trade deal between the US, Mexico and Canada, that will also benefit steel demand. The USMCA increased the regional vehicle content requirement for duty-free shipments on vehicles and light trucks from 62.5% to 75% (and from 60% to 70% on heavy trucks). The USMCA also added a provision requiring that vehicle producer's source 70% of their steel and aluminum purchases from North America, a requirement that previously did not exist in NAFTA. Taken as a whole, these provisions should help increase steel demand.

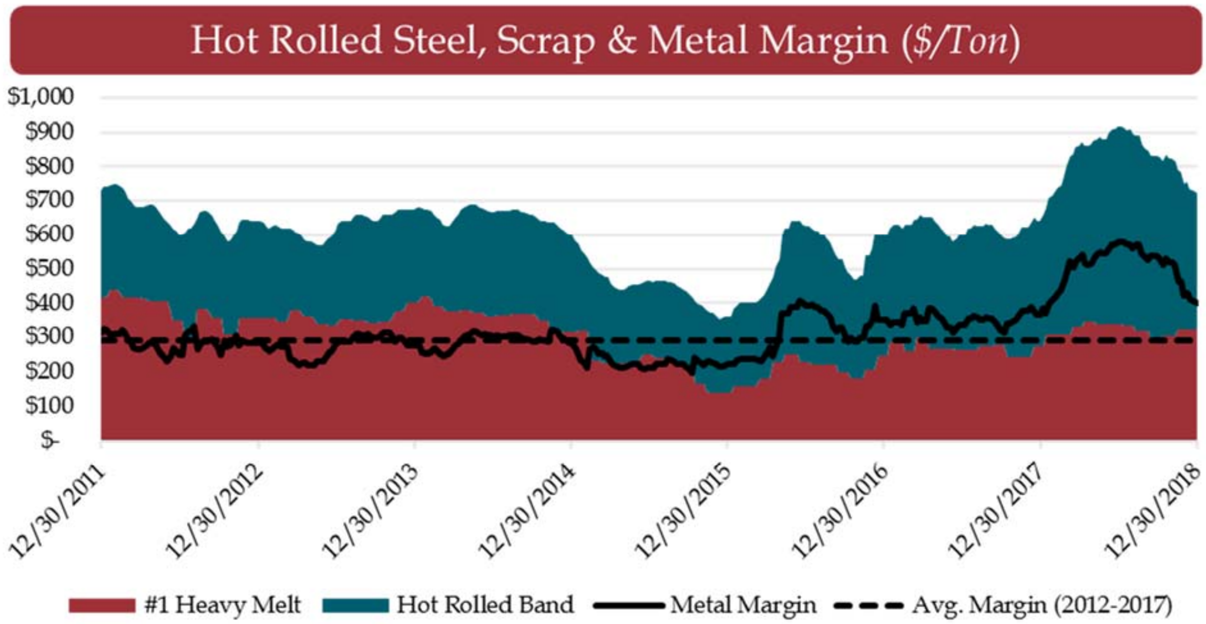
While there are certainly some potential positives for the steel industry that could come from government policies/initiatives, as with anything government related, there is no guarantee anything gets done especially now with a divided Congress, which is why uncertainty abounds…and uncertainty leads to volatility.

CHINA EFFECT

Another potential concern for the steel industry is China. Chinese economic growth has remained strong by relative standards, but is beginning to slow. China's significant economic growth over the last decade has been fueled in part by debt. According to Bloomberg, the country has $34 trillion of public and private debt, with borrowing having quadrupled in the last seven years by some estimates. This high debt burden could have a substantial negative impact on global growth, as the Chinese may have to rein in public works projects and consumption to better manage the growing debt burden, which could negatively impact demand. Although remote, another potential concern is a domestic credit crisis in China. In order to ease their burden of a slowing domestic economy and attain much needed foreign currency, they will increase the amount of steel and aluminum they dump into the export market, driving down prices even further. Calibre doesn't expect any imminent credit crisis issues to arise out of China in 2019, but it is a variable that deserves close monitoring, because the results of such a crisis would be impactful to the US and global steel industry.

SPREAD NORMALIZATION

During the 2018 run-up in hot rolled steel prices, spreads between hot rolled band and scrap widened to levels well above long-term averages. The long-term average spread between hot-rolled band and #1 heavy melt scrap has been ~$300/ton, but in 2018 spreads widened to levels as high as ~$580/ton. Midway through the third quarter of 2018, those spreads began contracting as hot-rolled prices declined while scrap remained relatively flat, with spreads ending the year at ~$400/ton. Despite those declines, spreads are still ~$100/ton above the average leaving more room to the downside for hot-rolled prices. As such, we expect material spreads to continue to fall back in-line with historical averages, driven by declines in hot-rolled prices, so long as no unforeseen incremental domestic protectionist policies are implemented in 2019.



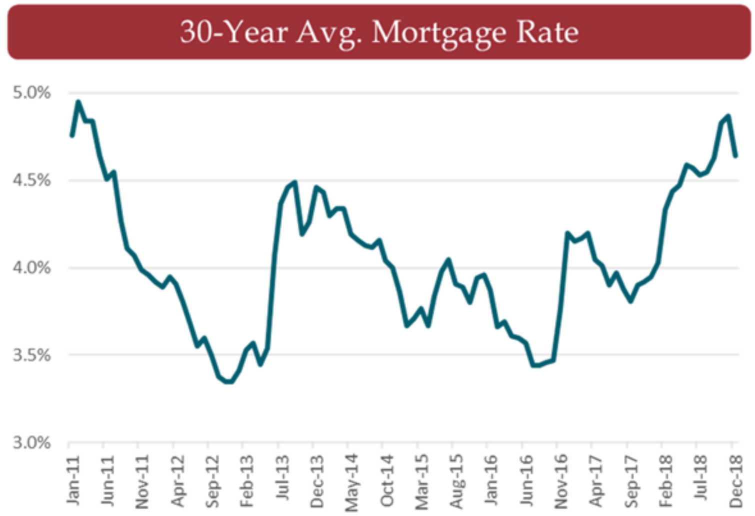
Source: AMM.

While high steel to scrap spreads are particularly good for the mini mills, a sustained period of high steel to scrap spreads can pressure processor's margins, particularly those with higher yield losses. This results in higher dollar yield loss costs that are not as offset due to relatively low scrap prices. So while the expected decline in 2019 spreads will compress steel producer's margins, that may not be all bad news for certain steel processors.

MANUFACTURING OUTLOOK

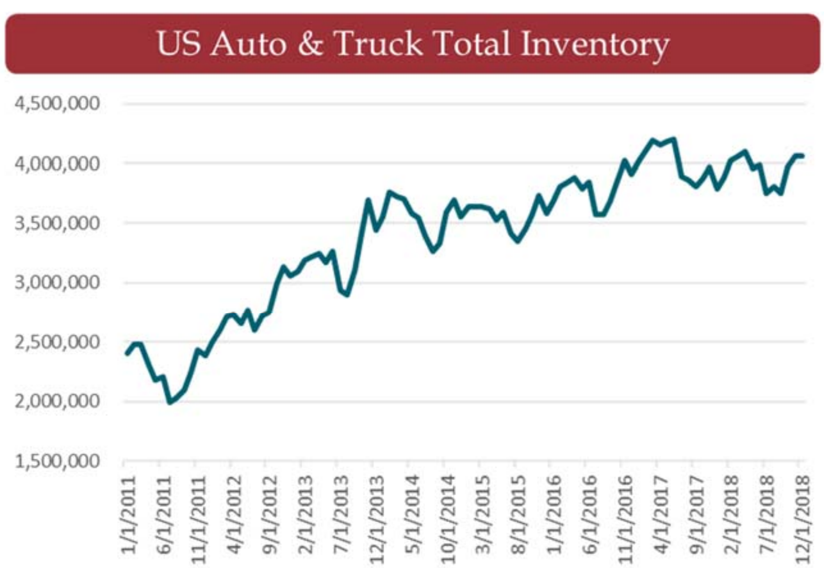
Manufacturing activity remained solid in 2018 (roughly in-line with 2017 activity) as pro-business initiatives took hold, from deregulation and favorable tax policies having been implemented. However, in the fourth quarter of 2018 certain concerns began to emerge. The stock market, which is a forward looking metric, had its first annual decline since 2008, as prices plummeted in the fourth quarter. European, British and Japanese markets all experienced double digit declines in 2018, with investors becoming more skeptical of future growth prospects. Sustained declining stock markets typically sap consumer wealth and confidence, which negatively impact big ticket item purchases.

Mortgage rates rose to their highest levels since the first quarter of 2011, as Fed tightening continued. Even if the Fed moderates its interest rate increases, the shrinking of its balance sheet, comprised of Treasuries and mortgage-backed securities, will have an adverse affect on mortgage costs. While mortgage rates declined in December 2018 from October and November levels, fourth quarter 2018 30-year mortgage rates were still at their highest levels since the first quarter of 2011. These higher rates will start to reverberate through the housing market, and we expect home sales to weaken in 2019.



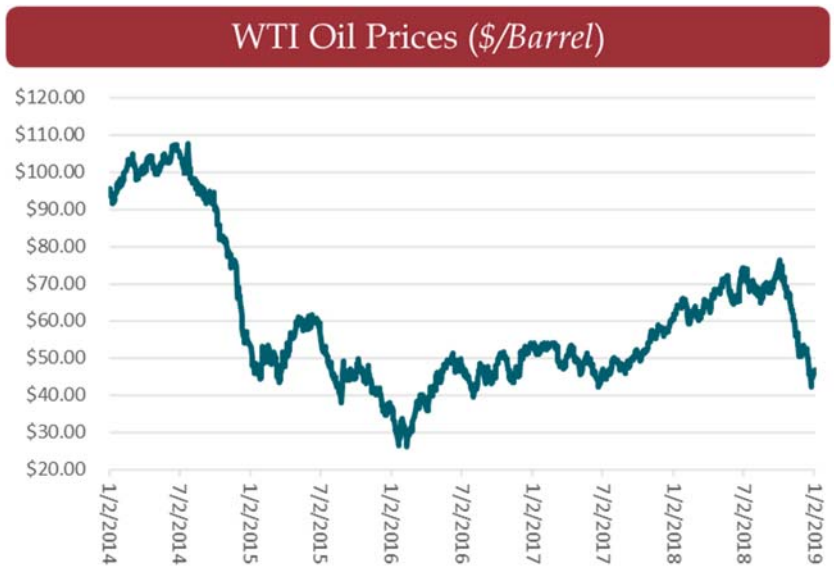
Source: Freddie Mac.

There are some positive dynamics for steel demand in the automotive sector as certain policies such as the USMCA's regional vehicle content and steel content requirements potentially get implemented. Also, if the President does begin slapping higher tariffs on vehicle imports, that could provide a short-term boon for domestic steel demand. However, we expect auto sale contractions in 2019 as higher financing costs, coupled with lower incentives, take their toll on demand. A continuing demographic shift brought on by an aging population will also have adverse effects on auto demand, although we anticipate that is a longer-term issue, not a 2019 concern. The National Automobile Dealers Association estimates that sales will dip below 17 million vehicles in 2019, for the first time since 2014. Additionally, over the last several years there has been a buildup in auto and truck inventories in the US, which will adversely impact auto production and steel demand, particularly in a contracting auto sales environmental where that glut of inventory will need to be worked through. Steel demand from autos will also continue to experience some negative demand trends as a result of the continuation of light-weighting, whereby substitute materials continue to displace steel.



Source: Bloomberg.

While oil and gas prices had been climbing consistently since the middle of 2017, in the fourth quarter of 2018 they experienced a precipitous decline, erasing all of the gains over the prior 18 months. Given current pricing levels, we believe it will be difficult for producers to continue drilling at the rates they have been. Numerous producers, such as Diamondback Energy, Parsley Energy, and Centennial Resource Development have recently stated that they plan to operate fewer drilling rigs and/or lower production plans in 2019. We expect that rising interest costs for several of these leveraged energy companies, coupled with low energy prices, will put a damper on OCTG demand, as energy companies are forced to scale back drilling activity. The last time prices were at a sustained mid-$40/barrel was the first half of 2017 when rig counts averaged ~835 rigs, which is approximately ~250 rigs less than the current rig count.



Source: Bloomberg.

COMPANY LIQUIDITY NEEDS TO BE A FOCUS

In a declining price environment, EBITDA will likely be negatively impacted by a contraction in metal margins, with a concurrent short-term increase in cash flow as working capital contracts. However, once that one-time cash inflow takes place, companies will be left with lower working capital accounts and reduced borrowing bases.

If there is significant price volatility in 2019 banks might get nervous regarding the value of their underlying collateral. This could be more acute for companies that speculate on inventory. Lower of cost or market write-downs can squeeze liquidity. Most banks are not experts in steel collateral, and having been burned as recently as 2015, banks may get nervous if inventory write-down charges were to occur. Given that credit availability is governed by accounts receivable and inventory amounts, and the advance rates applied to those amounts are dictated by banks, banks may begin lowering advance rates or increasing reserves. This would further exacerbate any liquidity constraints. We saw this in 2015-2016 when banks lowered inventory advance rates after being burned by a run-up and “crash” of steel prices moving from 2014 into 2015.

In an environment where volumes contract in addition to prices, banks will become even more nervous, and almost certainly will focus on downside protection. Banks will start monitoring companies with much greater vigor, restricting the ability to spend, and forcing companies to manage cash not profitability. They may also "encourage" actions that can create a self-fulfilling prophecy, where they force liquidation of inventory at a more rapid rate than normal, which lowers prices even further, which in turn negatively impacts liquidity, creating a spiraling cycle. Under the most dire circumstances, banks will insist on having strategic consultants hired for oversight. These consultants are not cheap, and are paid for by the company. Management will no longer have control over bank accounts, as strategic consultants need to sign off on all actions. Autonomy disappears.

In a slowing economic environment with rising financing costs, some customers may run into liquidity issues, and will view suppliers as a source of cheap unsecured liquidity. So, in addition to inventory issues, customers may begin delaying payments, creating an increase in ineligible accounts receivable which lowers the borrowing base, and subsequent liquidity.

In a declining price and volume environment it is critical to maintain a constant, disciplined focus on working capital levels (inventory levels, monitoring customer financial situations and managing accounts receivable). Maintaining a strong relationship with lenders by communicating issues quickly and candidly will be essential to avoiding the death spiral of decreased liquidity, expensive consultants and lost autonomy.

IN CLOSING

Calibre believes 2019 will be a year where policy decisions in Washington will be a major driving force behind performance. Given the uncertainty behind Fed and Congressional actions, and changing/conflicting policy positions, we expect the year to be a volatile one. We believe current spreads between domestic and export prices, the current wider than average material spread between hot rolled and scrap prices, a further strengthening of the dollar, and higher rates adversely impacting steel demand, will all contribute to steel prices declining in 2019. There will be some volatility in prices due to uncertainty and some positive economic news (employment, wage growth, etc.), but by the second half of the year we anticipate steel prices declining from current levels, and volumes beginning to erode. Those companies with leveraged balance sheets, those lacking working capital discipline, and those with tight liquidity will run into serious issues. It should be noted that it is certainly possible that the Fed tightens less than expected, that a large infrastructure spending bill gets passed, and that protectionist policies ramp up…but if those things don't happen, we see a slowdown in demand and further price declines. Right now the only thing keeping hot rolled band prices above $700/ton is President Trump.

We recommend that steel service centers buy what you expect to sell and not try to speculate on price movements, and to strengthen your balance sheets as much as possible. If an attractive monetization opportunity presents itself, we recommend strongly considering it, because there is more risk to the downside than upside in 2019.

CALIBRE SELECT INVESTMENT BANKING ASSIGNMENTS

Greenfield Capital Raise Rebar Manufacturer Ongoing	Raising Growth Capital Steel Pipe & Plate Manufacturer Ongoing	Adviser to the Seller Aluminum Scrap Processor Ongoing	Management Consultant Midwest-Based Steel Processor Ongoing	Advised Creditors On Restructuring Of Specialty Steel Holdings November 2017	Investment Banking Services HAYWARD TYLER September 2017
Advised Buyer On Acquisition ESSINTIAL August 2017	Investment Banking Services RYERSON May 2017	Chief Restructuring Officer Strategic Consultant HI-TEMP SPECIALTY METALS INC May 2016 – January 2017	Advisor on Acquisition MSC Material Sciences Corporation December 2016	Strategic Consultant Pennsylvania Scrap Processor February – April 2016	Investment Banking Services Heidtman Steel March 2016
Advisor on Strategic Projects for the Company COLT DEFENSE November 2014 – February 2015	Advisor to the Debtor Sale of Assets Chapter 11 363 Sale ORMET July 2014	Advisor to the Seller Mountain States Carbon, LLC June 2014	Labor Advisor to Debtor ORMET December 2013	Advised Aurora Capital On the sale of Miami Valley Steel Service July 2013	Advised Official Unsecured Creditors Committee Chapter 11 LYON Workspace Products April 2013
Advised Debtor Sale of Assets Chapter 11 363 Sale RG STEEL, LLC August 2012	Advised PE Sponsor Sale of Company & Subsidiary Spin-off New Star Metals August 2012	$1,200,000,000 Advised Seller on Sale of Assets to RG Steel Severstal March 2011	Advised Seller NSG Has been Acquired by AURORA RESURGENCE June 2010	Advised Buyer ESMARK Has been Acquired by Severstal August 2008	Advised Buyer WCI STEEL Has been Acquired by Severstal May 2008
$110,000,000 Short-term Financing ESMARK April 2008	$200,000,000 Capital Raise for Merger ESMARK November 2007	$39,000,000 Acquisition Capital ASI Alton Steel Inc August 2007	$46,500,000 Convertible Debt Raise FRONTERA RESOURCES May 2007	Advised Buyer Independent Steel Has been Acquired by ESMARK August 2006	$50,000,000 Term B Financing WINNER STEEL, INC. March 2006
Advised Buyer PRG Premier Resource Group Has been Acquired by ESMARK January 2006	Advised Buyer North American Steel Has been Acquired by ESMARK December 2005	$140,000,000 Acquisition Capital Sheffield Steel Products, Inc. July 2005	Advised Buyer Miami Valley Steel Service Has been Acquired by ESMARK May 2005	Advised Buyer US Metal & Supply Has been Acquired by ESMARK March 2005	Advised Buyer TriWestern Metal Has been Acquired by ESMARK January 2005
		Advised Buyer Century Steel Has been Acquired by ESMARK January 2005	$1,100,000,000 Acquisition Capital Severstal December 2004		

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