Issue 5

October 2012

STEEL SECTOR CREDIT BULLETIN ISSUE 5

The voice of steel distribution

"A chronic condition of subnormal activity for a considerable period without any marked tendency either towards recovery or towards complete collapse."

John Maynard Keynes—definition of economic depression.

Is 2012 to be a 'year of two halves' for the UK, a dismal first half followed by signs of economic resurgence in the second? Following the (predictable?) fall into double-dip recession in Q2, early indications would suggest not. Whilst, for example, the CIPS manufacturing data for August showed a strong bounce back, this was from very low levels recorded in July - the two months combined suggest no material progress. In fact, so weak are the overall data that the OECD has been moved to predict that, for 2012 as a whole, the UK economy will contract by some 0.7% - this following a figure of plus 0.5% forecast only three months ago.

Early this month (September), the Government unveiled the long-expected plans which it hopes will bring growth back to the UK economy, absent which reducing public borrowing is likely to prove almost impossible. The key proposals are all, however, supply-side measures which will have little, if any, effect on the UK's low level of aggregate demand, which requires measures to improve it in the short & medium terms.

Among the measures announced was the creation of a state-backed bank with a remit to lend long to established high-growth industries. This is, arguably, a long overdue positive move, though there are question marks; for example, over the demand for funding given the wariness of so many businesses to borrow at all and over how the bank will be funded. A further potentially positive measure is the allocation of £10bn of government guarantees which may help housebuilders begin to address our chronic housing shortage - provided, of course, the support is correctly targeted.

As noted above, however, neither of these proposals addresses the fragility of domestic demand. With public sector spending cuts set to continue (indeed increase), the threat of unemployment ever-present & private debt paydown still on-going, consumer confidence & spending is likely to remain subdued, a situation likely to be reinforced by the continued fall in real wages. Furthermore, unless business confidence improves (problematic until aggregate demand improves) and results in the unlocking of the cash mountains sat in UK plc's accounts, the British economy is likely to remain flat, the problem compounded by the on-going Eurozone crisis and signs of softening growth elsewhere e.g. China, India & Brazil.

Interestingly (and happily), the macroeconomic data are not necessarily reflective of experience across all sectors of activity. Whilst construction & banking are undoubtedly significant drags on overall UK economic performance, other sectors are doing well. In that context it seems right to mention, in particular, the continuing excellent performance of the automotive industry, especially Tata's JLR, and to highlight the latest significant investment announcements of Honda & Toyota.

Overall, at the time of writing, the UK economic situation remains mixed at best. Despite the uncertainties, however, the credit insurance market remains *relatively* benign, though there have been signs this year that a cusp may have been reached. Premium rates, for example, have been showing some signs of hardening - tied to this, all insurers are reporting year-on-year increases in claims values, though as far as the major steel-consuming sectors are concerned, these remain largely construction related. With regard to risk appetite, this remains generally positive, though increased credit limit review activity experienced in 2012 reflects insurers' concerns going forward, such as the continuing upward trends in overdues reporting & incidence of requests for support for repayment plans.

For this issue of the Credit Bulletin, we welcome Euler Hermes as our insurer contributor, who provide us with some useful insight into their recent steel–related experiences and thoughts for the future.

As ever, thanks also go to Graydon UK for their customary thought-provoking contribution.

EULER HERMES

Our knowledge serving your success

2012 has been a challenging year for most with both prices and demand very unpredictable and we have seen the difficulties that companies have had setting forecasts. Quite a few companies have changed their year end budget mid-year as both prices and demand have been nowhere near expectations. Our own experience across the steel consuming sectors show quite contrasting views shared by clients.

For the majority of clients supplying into the automotive sector, the level of activity has exceeded expectations this year. 2011 was very much a rebalancing of the supply chain from the Far East to local suppliers and those with spare manufacturing capacity in the UK have quickly found they are back in demand with UK based OEM's. A phrase sometimes mentioned is 'best cost, not low cost' and UK based suppliers are back in favour. The positive trend has continued into 2012, and for the first 7 months to 2012 the UK Automotive Sector has continued to perform well. Output was up 15% for the year to end July 2012, with 875,998 vehicles produced in the UK A key factor driving this sectors performance (no pun intended) are the high level of export sales into high growth markets such as China. Almost 80% of cars built in the UK are exported. Euler Hermes UK exposure to the sector rose by 30% in 2011 on the previous year. For the first 7 months of 2012 our UK Automotive exposure rose a further 15.5%. Other parts of the EU are not seeing such a positive outlook and overall European automobile production is expected to drop by 1 million units in 2012 to 19 million.

The Construction sector has seen more than 5,500 companies fail in the past two years, and last month more grim news was reported that construction activity had reached its lowest level for three years with no sign of this slide abating. Our underwriting stance has needed to be robust with more companies being contacted for quarterly management accounts, and a detailed breakdown on their secured order book. It is probably not surprising that suicidal bidding where firms take on work at loss-making rates now appears more common. We continue to see severe signs of distress with an increase in overdue payments and repayment plans being reported. Much of the current pain has been felt by subcontractors being squeezed by the larger players. A large number of payment delays we see reported are caused by a subcontractor not being able to pay until they have been paid, very much a ‘hand to mouth’ existence for some. Our construction claims account for about one fifth of our overall claims year to date.

The message we get from our steel stockholding clients is that although demand is holding up, margins remain weak. The Automotive and the Construction sector are two extremes but within any sector there will be good and bad performers. We have seen less activity with fewer credit limit applications, and Stockholders have been much more cautious with their purchasing. European mills continue to cut output in a bid to align supply and demand, and trying to raise prices to offset resulting higher unit costs. We would expect to see demand improve in Q4 this year, on the back of restocking after the summer shutdowns, but our own experience by mid September is that the month has got off to a slow start.

Market sentiment remains mixed with business confidence throughout Europe remaining poor with no real improvement seeming likely in the short term. EU apparent steel demand is forecast to contract 3% to 5% in 2012, more than previously expected, due to the region's lacklustre economic prospects.

Our Metals Team are always accessible and through constant dialogue with our clients and their customers we can respond quickly to credit limit requests. This includes clients’ trading across coil, long products, plate, and scrap. Over the past year we have met with 23 NASS members in either a client or buyer capacity. The feedback provides invaluable background to the credit decision. We are currently writing £480m of credit limits on NASS members, and we enjoy the constant dialogue with the sector and their willingness to share information.

At Euler Hermes UK we have been proud of our long term commitment to the steel industry and our historic association with the stockholding community. Our ability to get close to our clients’ customers, and really understand their businesses remains vitally important. Overall, we will continue to operate with a cautious approach but will continue to support the members of NASS as well as the industry as a whole.

For further information contact Shannon Murphy, Metals Risk Underwriting Manager on 0207 860 2764

Sources: UK automotive output – SMMT (Society of Motor Manufacturers & Traders)
Construction failures last 2 years – PWC   All other information is our own.

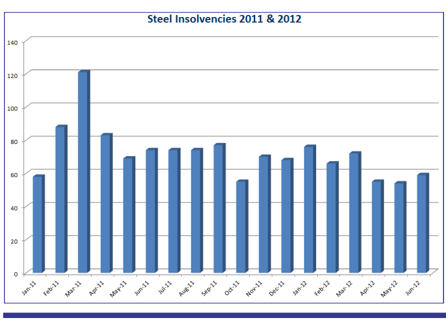
GRAYDON
credit risk intelligence

NO RESPITE IN 2012…… SO FAR!

We still operate in troubled times with no respite in sight. What is noticeable, however, is how robust and resilient the steel sector is. This owes much to the directors and shareholders of companies in this sector who continue to show great commitment and responsibility in trading through what has been the very worst recession in living memory.

Prices on all products show no signs of sustained increase. Iron Ore is down and China is cutting back on production. According to our Steel client base, there is massive oversupply and trading is, at best, quiet. It is hoped that the price malaise will reverse in the near future and a need to replenish stock will take place sooner rather than later.

Can it get worse? There is a possibility, but Insolvency statistics seem to indicate a consistent level of business failures for this year so far but, overall, are down on the corresponding periods of last year (see graph below) in the traditional area of “metal bashing”. Of equal if not greater concern is the area of new Incorporations. As recent as 2010 and 2011 the number of newly formed companies in the area of engineering, fabrication etc. ran into three figures but there has been a steady decline in the numbers since August last year, and this has turned into a trickle since the turn of the year. The reason? One, I would suggest, is a lack of affordable finance in the market. One advantage of this is that less “phoenix” companies are also being formed, but it’s a small crumb of comfort and overall it adds up to a shrinking marketplace, something the industry doesn’t need on top of all the other pressures being experienced.



There are some positives though - the automotive sector in the UK is buoyant but this is an exception and is very much tempered by construction in particular, which continues to decline greatly.

Recently, David Cameron, the Prime Minister indicated the possibility of austerity measures continuing for the remainder of the decade and possibly beyond. Is this the answer? Debatable, particularly if job creation and reduction in unemployment is important to the government as well as attempting to ignite growth in the UK economy. Construction is an example where a controlled spending programme could help reverse the current trend. This course of action could also have a positive effect on the private sector and the Chancellor, George Osborne, has just announced that the government is to underwrite some £50bn. of private sector building projects which need finance in an effort to boost growth

Existing operations remain at the mercy of the major lenders in the UK but despite incentives being promoted by the government, lenders remain reluctant to provide continued support at times and, in the area of new business start ups, even less so. The alternative is second and third tier lenders which can prove costly and this has a further impact on margins. This ultimately puts further pressure on a business’ long term growth and, in the extreme, survival.

Without teaching my grandmother to suck eggs, credit managers (and their sales teams) must remain vigilant. Continue to question your Credit Information Supplier, your Credit Insurer and your Credit Insurance Broker. Get the most up to date picture on a business as is possible, and make it a habit to get management and draft accounts. You will never eradicate bad debts entirely (unless you trade on a cash basis) but at the very least minimise these by taking every possible step to know your customers and prospects inside and out. Let’s face it, they need your services as much as you need their custom and, after all, it has never been more difficult setting up new lines of credit with worries about taking on a competitor’s poor payer and potential bad debt.

I know I’m repeating myself again and again but the message remains the same: “credit where credit is due”.

Oh, and finally, a message for your sales team: “a good sale is one which pays.... on time!”

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nass
The voice of steel distribution

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