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STEEL SECTOR CREDIT BULLETIN ISSUE 7

NASS

The voice of steel distribution

What a difference a mere six months can make! Looking back over our last Bulletin, written in March, it seems, at least at first sight, that one could be writing about two different economies. Then, we were looking at PMI indices that were all in negative territory, economic growth remained elusive (with the possibility of a triple-dip recession) and the Deputy Governor of the Bank of England was musing on the possibility of reducing MLR further- in fact to a negative figure, in order to force the banks to get money out into the real economy.

Since then, we have witnessed two successive quarters of reasonably strong growth amounting to around 1% of GDP, expectations of even higher growth in Q3and a succession of upward revisions by most economic forecasters for 2013 as a whole. On the back of this slew of positive data (wouldn't it be nice if the steel industry could share in some of the good news!) one could be forgiven for thinking that all was rosy in the garden, that the UK economy was, at long last, in the process of undergoing a significant and sustained recovery. It is, of course, quite possible that such is the case, but that would be to ignore a number of factors which should give us all pause for thought. A few of these are outlined below.

First, despite the excitement in the City (and elsewhere) created by the latest data, UK GDP is *still* around 3% below its pre-recession peak of some 66 months ago. Had the country's long-term growth potential continued throughout that period, GDP would today have been some 13% higher. Actual performance compares unfavourably not only with almost all other major economies, including most members of the Eurozone, but also with *all* other major recessions of the last one hundred years.

Second, whilst all key indices currently point northwards (eg the manufacturing sector is reporting healthy increases in both output & order intake, including from our key trading partner, the EU) this improvement is not being reflected in future employment intentions, meaning that current levels of un/ underemployment are likely to remain with us for some time. This, combined with the UK's ongoing internal devaluation (i.e. declining real wages), will act as a dampener to future domestic consumption.

Third, there is evidence to suggest that the increase in private consumption seen in recent months has been (at least in part) financed by individuals either reducing their savings (the UK savings ratio has fallen to worryingly low levels) or taking on increased debt, perhaps triggered by a 'feel-good' factor associated with rising house prices - a 'wealth' effect.

The housing market has, of course, received a major external boost from the Government's Help to Buy Scheme. Quite why the economy needs rising house prices at a time of falling real wages or indeed why the housing market should be singled out for special government assistance is open to question, especially when SME businesses are still having such difficulty in accessing competitively-priced finance (net bank lending to this type of business continues to fall). One worry is, of course, that in the medium term we may be headed for another debt-fuelled asset bubble and all the consequences that flow therefrom.

Fourth, although the recent improvement in exports to the Eurozone is especially welcome, as is the improvement in the Balance of Payments in Q2, note does need to be taken of the very latest figures which show a large fall in sales to emerging economies, some of which are showing signs of weakening performance.

Finally, business investment fell 8.5% year on year in Q2.

Overall, it would seem to be much too early to start putting the flags out in celebration. Whilst any positive news is always to be embraced, there are plenty of warning bells still waiting to ring, arising from a variety of internal & external factors. In addition, the issues outlined above, when taken together, point to the real possibility that the current apparent recovery may yet prove to be unsustainable in the medium to longer term. One can only wait and see.

Finally, my personal thanks to Colin Sanders and Tom Bryant for their interesting contributions.

Phil Grey
Director

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QBE

Difficult times remain in the UK with steel sales generally flat and steel prices remaining stubbornly depressed with little signs of improvement in the short term largely due to the soft market demand.

The major cause for concern remains the construction sector where despite the general perceived recovery in the overall UK economy, construction output remains generally flat with the 1.4% rise in Q2 2013 offsetting the 1.8% decline in Q1. To put this into perspective, construction output has fallen 10% relative to Q1 2011. It is worth noting that the sub sector with the largest recent increase in output is house building, which is not a heavy user of steel highlighting the challenging nature of supplying volume to the construction sector. A number of large and well established companies in this sector have also gone into administration or insolvency highlighting the need for continued vigilance and information sharing.

It is worth noting however that the ONS stated that the estimated GDP for the UK economy grew by 0.6% in Q2 2013, this followed an increase of 0.3% for Q1 2013. With regard to steel intensive industries, the automotive sector has shown remarkable resilience to the recent economic malaise by posting output for August 2013 up 16.2% against the same time in 2012. This has been fuelled not only by domestic demand (SMMT state new car registrations show 18 months of consecutive rises realised, with the new car market growing 10.9% in August 2013) but also by the increase in global exports. In line with this trend the yellow goods market remains robust with strong international demand fuelling the sector. Manufacturing data in the UK as a whole appears positive with a 2% increase in output in June 2013 relative to June 2012.

Economic conditions in the Eurozone continue to be difficult however, as with the UK we are seeing resurgence with a 0.3% growth in Q2 2013 following 6 consecutive declines. Hopefully this will continue to give some much needed impetus to our own export economy.

While the latest information is suggesting we are well on our way to recovery it must be tempered by the fact that real pay increases for the consumers that drive the UK economy remain well below inflation leading to a continued reduction in disposable incomes. Whether the recent improvement in output and GDP growth can be maintained at a sustainable level leading to a robust recovery remains to be seen.

At QBE we continue to grow and support our metals & engineering portfolio. With many of our clients strong in the oil & gas, off-shore, white goods, automotive, aerospace and yellow goods sectors that are all performing encouragingly, we remain open for further opportunities and continue to demonstrate the characteristics we have established in the UK:- market-leading response times, direct client access to sector-specialist underwriters, risk decisions taken by experienced underwriters who are client-facing, risk underwriters meeting and managing their buyer exposures, senior commercial underwriters supporting specialist brokers only with no direct sales-force.

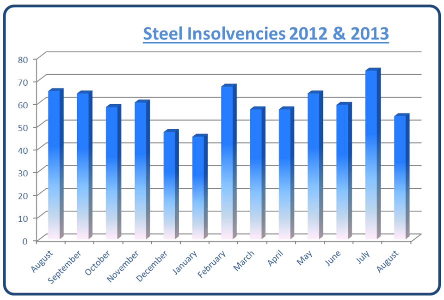
GRAYDON
open in business

A case of “As you were”

As we enter the final quarter of 2013, it’s really a case of “As you were”. The situation in the steel sector appears no better than in 2012 but, dare I say it, no worse either.

I read today that UK manufacturing is booming, as reported by the PMI index, but once again this does not appear to be reflected amongst our steel clients, or in other sectors for that matter. What is apparent from talking to our steel client base is that it has been quiet in trading terms in the last few months. Also apparent is the fact that buyers are paying slower and extending payments beyond terms like never before.

There are some positives in the UK economy but these are few and far between. House construction and motor manufacturing have reported positive trading figures, though these are exceptions to the rule. The same cannot be said for commercial construction or retail. Government austerity continues, and will do so for some considerable time to come. Best guess, and it is a guess, is that sustained growth will not appear before 2015. In the meantime, it is a case of working hard to maintain any sort of growth, but at the same time not allowing slow (or slower) payments to erode what thin margins already prevail.



Funding (or a lack of it) from major lenders continues to hamper business growth in all sectors and alternative sources are expensive. These second and third tier lenders continue to grow on the back of desperate borrowers charging horrendous levels of interest. The phrase “Zombie” can be attributed to a number of concerns. These are companies which are effectively limping along, just about covering debt payments, but with little or no prospect of turning around their fortunes or prospects and it’s usually a matter of when, and not if, before the plug is pulled and ultimately failure follows, particularly when there is little chance of obtaining additional and affordable finance from an alternative source. 0.5% base rates have no bearing where borrowers are concerned.

In 2012 the Chancellor announced a £50 billion spending programme for private sector building projects to boost growth. Clearly, this is not nearly enough to kick start the construction sector. More is needed but austerity remains the government’s prime measure to combat a lack of growth in the UK and a debt mountain which is likely to take years, possibly decades, to bring down to a manageable level.

There seems little prospect of a major and sustained price hike in steel, which is very much needed for both producers and distributors, and particularly for the producers who have been recording sizeable losses in most cases and which, in the long term, is unsustainable.

Some good news? Well, insolvency levels are down (see graph, left) and this will hopefully continue but beware complacency. The end of the recession (whenever that may be) will bring added problems initially as, traditionally, insolvencies rise as a recession ends. Why? Usually it’s down to companies over-extending themselves, and it’s also likely that this will be accompanied by a rise in interest rates, thus borrowing costing even more.

If ever a sector “cut its cloth accordingly” then it is steel. I would again reiterate my comments of 2012. Steel is a very robust and resilient sector, and owners and directors alike should take huge credit for this and their continued commitment and responsible attitude in ensuring their companies survive until the situation turns around.

I know I’m repeating comments of the past but credit managers and finance directors must remain vigilant. Keep getting the most up to date financial information and all round knowledge of your buyers to avoid bad debts and slow payments. Question any delay and change in payment patterns, and make yourself a nuisance if need be. Why should you be an alternative bank to your buyers? Correct—you shouldn’t! KYC it’s called, and you should “know your customer” better than ever before. Make getting management and draft accounts a habit, not just a one off. In most cases, your customers need you as much as you need them and they need to continuously prove they are still creditworthy, or at least more creditworthy than previously. Working with your sales team is more essential than ever as they will know as much, if not more, about your buyer than you will. Oh, and remind your sales team (again) that a good sale is one that pays on time.

Tough times still and tough times ahead, but I’m encouraged by the spirit and drive of our steel clients and the sector as a whole. The fight must continue because good times will return…...eventually.

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