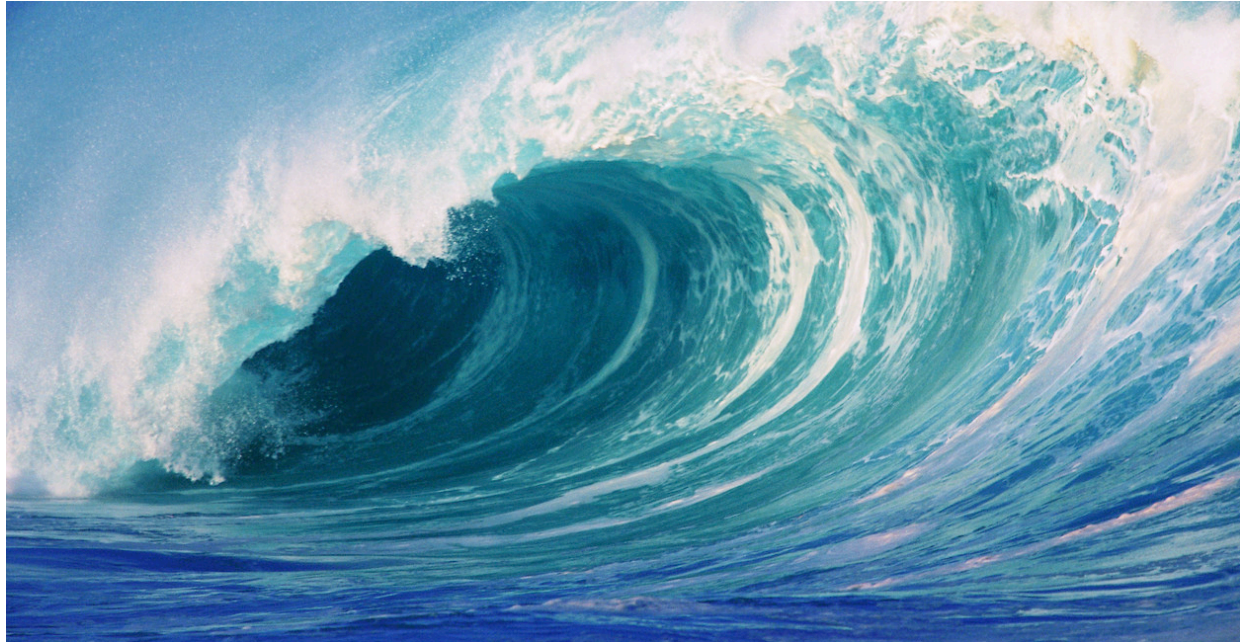


Consolidation wave

Global metals outlook

A three-part series on the future of the global metals industry



The worldwide economic downturn has slowed the rapid rate of consolidation the global metals industry has seen in the past few years, with mergers and acquisitions (M&A) activity grinding almost to a halt. Companies are tightening their belts, conserving their cash, and generally taking a wait-and-see approach to acquisitions. Yet today's market might present unprecedented opportunity for buying up critical assets at bargain prices. To learn more about the state of M&A in the global metals industry, Deloitte Touche Tohmatsu's ("Deloitte") Global Manufacturing Industry Group asked Daniel T. Schweller, global metals M&A leader, to talk about what the future holds—and if it includes a wave of consolidation.

Outlook at a glance

- Acquirers are trying to gauge when the industry hits bottom before making acquisitions.
- BRIC countries are among the top geographic regions for metal deals.
- Buyers with solid cash positions are looking to purchase smaller, non-core or distressed assets.

Q: How has the global financial crisis affected industry consolidation?

Dan: The financial crisis has significantly slowed down the pace of consolidation (see Figure 1) in most geographies with the exception of China, whose internal consolidation activity is, in part, being driven by the central government's plan to consolidate its capacity. The crisis has impacted valuations, trade finance, M&A credit—all of

which leads to companies withdrawing from external activities and focusing on leveraging the operations they currently own. And deals take longer to do—much longer. The negotiating process has lengthened—the uncertain market is making people cautious. We are seeing deals take months, rather than weeks, with both sides having many more issues to discuss prior to commencing a full-blown process.

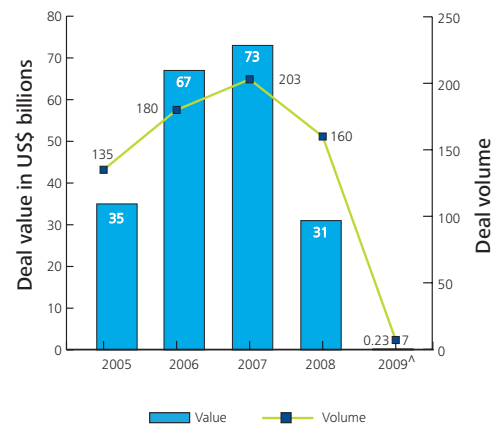
Q: Are there deals still happening or has the tap completely turned off, so to speak?

Dan: There are still deals happening, but potential acquirers are trying to gauge when the industry hits the bottom of the “trough” before they get back into the M&A arena. Many companies still have strong cash positions, so buying assets at lower valuations may be very tempting—and perhaps opportunistic plays for distressed assets may be the first activity level to return. I also expect to initially see smaller deals for viable assets as industry players trade “non-core” facilities. If a large deal were to be announced, I would think it would be a stock-for-stock deal—assuming both parties’ stock prices have declined in parity during the downturn. But I think smaller cash deals will be more prevalent.

Q: What can we expect in the short and the long run in terms of consolidation?

Dan: In the very short term, I believe we will see less focus on deals and a much greater focus on achieving synergies from past deals. As a byproduct of the synergy process, and in part, due to the need for many companies to generate cash, I also expect to see more sales of smaller, non-core steel activities in the US\$100 to US\$500

Figure 1: Global steel industry M&A deal volumes—2005 to March 2009



Source: Mergermarket accessed on 03/17/09.
^A 2009 covers deals between 01/01/09 – 03/17/09

steel industry is slowly consolidating, but still a fragmented market with the top 15 players controlling 36 percent of the global production in 2008. (See Figure 2). The industry has already seen the benefits of consolidation—achieving economies of scale and increasing negotiating power, for example. Joint ventures and alliances will continue to be popular. I expect to see more cross-border transactions as regional consolidation has already made significant progress. In terms of the big question, “When?”—the general consensus would indicate that within the next few years M&A activity should return to normal, but not likely during the next year or so. And since steel transactions have not been prone to the wild leverage seen in other industries, I see no reason to hedge that future deals will be different than those in the past.

Q: Will there be continued activity in China?

Dan: China has been an exciting market for consolidation these days. We have seen news of the Handan Steel and Tangshan Steel merger that created Hebei Iron and Steel, which, at production of 32 million tonnes in 2007, is now the largest player in China, eclipsing Baosteel, who produced roughly 30 million tonnes during that period¹. And the leader board could change again soon. Last November, two leading steel companies in eastern China’s Shandong province—Shandong Iron and Steel Group [Shangang] and Rizhao Iron and

“Will steel companies ramp up production too quickly and overproduce in an attempt to capture as much volume as possible? Or will they act rationally and gradually bring back production as demand dictates?”

million category. This tends to happen during every downturn, and, considering the flurry of large acquisition activity in recent years, the smaller deals should emerge in the near term. We may also see some distressed companies looking for partners to maintain viability. In the long run, the business case for further consolidation in the steel industry is still compelling. The global

¹ “Merger of 3 firms to create China’s largest steel maker” China Daily, 30 December 2008.

Steel [Rigang] signed a letter of intent², which, if completed, would create China's largest steel company based on 2007 combined production of over 34 million tons³. Shandong itself is the product of the merger of Laiwu Steel and Jinan Steel⁴. Though one can argue the central government has been leading the process and most of the recent deals were begun months ago when markets were better, no one can dispute that the Chinese steel M&A market is still very exciting.

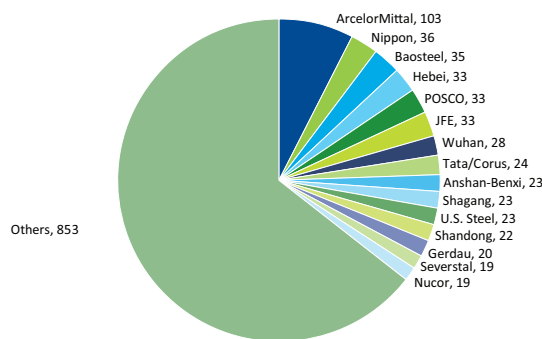
But then there are some who say that the initial mergers in the Chinese market were non-substantive. By that, I mean that two or more steel companies in the same province were merged under a common holding company but the mergers resulted in little to no significant operational changes or synergy. Recently, though, I have read reports that consolidation is beginning to achieve operational synergies. The central government has mandated that most of the small capacity blast furnaces be closed by 2010⁵. Tangshan has reportedly announced the closure of two 400 cubic-meter blast furnaces and one 450 cubic-meter furnace, providing an example of capacity rationalization to achieve operational synergies. And more are likely on the horizon.

In terms of foreign investment in China, there is still significant interest. China is still the largest untapped market. But in the near term, the most likely acceptable transactions from the central government's perspective will be smaller, non-controlling equity positions.

Q: Do you see any other countries where M&A activity will rebound?

Dan: I think we will continue to see interest in the BRIC countries—Brazil, Russia, India, and China. These would be among the top geographic regions for metal deals. I believe Asia and the

Figure 2: Top 15 global steel players
Steel production 2008 in million tonnes



Source: SBB, World Steel Association, Iron and Steel Statistics Bureau, 23 March 2009

United States were two of the top M&A activity zones last year, but the strengthening of the U.S. dollar may stem U.S. activity for a while. Turning to the raw material sector, no geography has seen more activity than Australia with its vast iron ore and bauxite reserves. And with the retreat in pricing this year, copper reserves in Chile and the United States may attract attention.

Q: Will U.S. steel mills attract foreign buyers?

Dan: I think so, though the U.S. dollar has regained some of its strength and that makes assets more expensive for international buyers. But the United States is still a great steel market and should attract aspiring global steel players. However, I suspect that the BRIC countries may be higher on the list of focus, given the greater growth prospects in those regions.

“I think one should always look for the opportunities where others see obstacles.”

² “RPT-China’s Rizhao, Shandong Steel agree to consolidate” Reuters, 5 November 2008.
³ “Top Steel Producers 2007,” World Steel Association.org.
⁴ “Shandong Group to build new plant, eyes Rizhao Steel,” Steel Business Briefing, 7 November 2008.
⁵ “News analysis: China’s steel industry benefits from stimulus, support plan,” Chinaview.cn, 22 January 2009.
⁶ “Tangshan Steel closes two 450 cubic meters BF,” Steelguru, 17 September 2008.



Q: Do you think consolidation will see an upswing again? If so, when?

Dan: Consolidation should inevitably regain its steam. I think once there is better visibility as to when the steel markets recover, M&A activity will return. There are a few schools of thought about recovery—ranging anywhere from mid-2009 to 2011. Regardless of the timing, in my mind there are two significant enabling actions required. One is that the service centers and other customers will have sufficient trade financing capacity and forecast demand to make meaningful purchases. The second will be a true test of the consolidation process: will steel companies ramp up production too quickly and overproduce in an attempt to capture as much volume as possible—perhaps flooding domestic and international recovering markets with imports? Or will they act rationally and gradually bring back production as demand dictates, adding upward pressure on pricing. It will be interesting to observe what happens.

Q: What about financing for M&A, considering the current situation in the credit markets?

Dan: There's no doubt that M&A financing markets must recover for there to be a steel M&A recovery. But in the meantime, I believe we will see some opportunistic buyers with solid cash positions chasing non-core and distressed assets. I think we will see both geographical and vertical plays, gaining new footprints and integrating both forward and backwards in the supply chain. For example, many suspect that there will be further consolidation in the long products sector in Mexico. Many producers have been rumored to be evaluating the acquisition of raw material suppliers to avoid the raw material price hikes encountered over the past few years. Also, in North America, where a lot of international investors have made significant investments in production capacity, there may be further acquisition by mills of steel distribution centers to match the common business model in Europe. Severstal, with its acquisition of Esmark, acquired not only production capacity, but also several service centers that were part of the Esmark business⁷. Will others follow suit? Still others are using the downturn to secure raw materials now to mitigate the price increases incurred during the past year.

Q: Do international barriers dampen cross-border M&A activity?

Dan: There are a number of barriers that impact the ease of executing M&A deals globally—cross holdings and increased “friendly” holdings—this is seen in South Korea and Japan as steel producers hold shares of other producers and have asked their customers, such as automakers, to increase their holdings, which can help them thwart an unwanted takeover attempt. Then there are large family-controlled businesses and issues such as minority blocking rights and government ownership and regulation. Some of these barriers are easier to address than others, but as they are minimized, deal activity should increase.

“In the long run, the business case for further consolidation in the steel industry is still compelling.”

⁷ “Severstal announces tender offer to acquire Esmark Incorporated,” Reuters, 30 May 2008.

Q: How might they be minimized in the future?

Dan: Some obstacles—such as friendly cross-holdings—have developed over time, so it will likely also take a while to eliminate. And many regulatory obstacles will be addressed by global marketplace pressure on countries that have protectionist policies. However, these same countries typically see the steel industry as vital to their national defense interests, so the pace of change may be slow. Take for example the Rio Tinto/Chinalco situation right now. There is strong opposition in Australia, citing “national interest”—many politicians don’t want to see China owning such a large stake in such a prominent Australian company. In fact, the government is looking into if state-owned entities should invest in Australian companies at all⁸. So, unfortunately, there don’t appear to be many quick fixes to some of these barriers.

Q: What about cultural issues and integration?

Dan: It’s true—cultural barriers are a difficult challenge. And it isn’t limited to different cultures in different countries, but includes corporate culture. It’s actually become one of the bigger unforeseen challenges in steel transactions. Acquirers spend significant efforts assessing the strategic, operational, and financial value of target assets only to find that the biggest challenge is managing cultural integration. I think we may see more focus on addressing this and management integration earlier in the process in future transactions.

Q: Do you see any upside to the economic downturn and how M&A activity is approached?

Dan: I think one should always look for the opportunities where others see obstacles. For example, in this economic downturn, I believe the companies that have strong cash positions will be afforded a unique opportunity to position themselves for growth by acquiring weaker competitors, customers, or suppliers at lower valuations. Look at the various iron ore assets that have been in the news lately. Seeing the lower valuations of these assets in today’s economy, companies are locking in a low-cost supply of ore that will benefit them through the next business cycle. These are the type of deals that are indicative of companies trying to use the economic weakness in today’s market to gain a competitive advantage for the future.

⁸ “Rio names new chairman as Chinalco row escalates,” Reuters, 17 March 2009.



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