What are some of the critical challenges/issues facing the metals industry?

The industry has come under increased scrutiny due to trends in metals prices and their impact to operating margins. Headwinds, notably slowing activity in China, the strong dollar, and supply/demand dynamics, all have had a negative impact on company operating performance.

Imports continue to be a big issue. The impact that trade cases will have on import volumes and pricing is unclear.

There is heightened focus on preserving vendor relationships.

What is your near-term outlook on the economy?

I don’t see a threat of a recession in the near-term. The near-term outlook on the economy is stable, even if there is more disruption with China. Many of our middle market borrowers, while they may be sourcing overseas, are domestically focused. They are selling into North America so they are performing a little bit better.

The energy crisis is actually benefiting some manufacturers. Lower energy prices are improving their cost structure.

What is your near-term outlook on pricing?

Visibility is limited. Over the last 18 months, we have seen periods where prices appear to stabilize, but any increases fail to stick because of the supply and demand imbalance. Excess supply is continuing to drive prices down.

Metals prices haven’t reached a bottom. There is probably more downside risk because of the supply and demand imbalance, which will continue to make it more challenging. You could see prices decline over the next six to nine months. At the end of the day, there needs to be more distress and some capacity taken out of the market to see some stabilization.

What is your near-term outlook on end market demand?

End market demand is stable. Aerospace has probably seen the most growth given projected demand for aircraft, particularly from the emerging economies. Automotive has been a consistent business for many metal suppliers. Auto production in North America may be close to reaching a peak, but I don’t expect demand to fall off particularly given the average age of vehicles on the road. Construction was slower to rebound but is now seeing increased activity.
Companíes are focusing on their core end markets. If they are heavily invested in automotive, they are trying to solidify their customer relationships and lock into multi-year platforms. Companies with a significant concentration in oil and gas are looking to reduce their exposure. Some are exiting the sector.

**How are companies performing in the current environment?**

Metals companies are hunkered down. They know this is the worst environment they’ve ever seen—worse than the 2008/2009 time period for many of them. They are conserving cash and have cut capex levels pretty dramatically. They are trying to adjust their business models and take costs out where they can because of the uncertain future.

Middle market companies have made a number of operational improvements. They’ve reduced inventory levels and improved their inventory turns. Some have consolidated facilities. They have rationalized SKU’s, exited unprofitable customer relationships, and reduced headcount, in some cases by 30 to 40 percent. Some (not many) have been hedging.

There will always be costs to cut, but at some point you start digging into the bone. Some companies are at their limit and to survive will either have to support the business with additional capital or bring in a partner to help weather the storm.

**What are some of the primary concerns that lenders have with metals companies in the current environment?**

The two primary concerns for a lender looking at a metals company today are, does the business have enough liquidity to operate, and is it generating enough cash to cover fixed charges. For a number of metals companies, earnings have declined significantly and debt levels are higher. Do owners have the resources needed to support the company if a negative trend continues?

Liquidity is tighter today than ever before. The challenge will be when the market improves; a lot of these companies that are overlevered are not going to have the liquidity to grow. Some will need additional capital to support the business, maybe by bringing in other investors, or will look to sell.

**What do you see as the challenges and opportunities from a financing perspective?**

Today, lenders have to be creative to come up with a solution that adds value to a company. In some cases, we’ve increased our advance rates, lent on certain assets that were not in the borrowing base before, provided more flexibility in the covenant structure, or revisited how inventory is valued to provide additional liquidity. It comes down to the strength of the management team and their level of commitment to the business.
The lender wants to find a solution to support a viable business and good customer relationship—but it’s a two-way street. Lenders are operating in a regulated environment and need to find a solution that meets everyone’s needs—client, bank, and external regulators.

We are seeing some pressure on covenants. For lenders, those situations can present refinancing opportunities. A number of credit facilities have moved to asset based structures where there is a working capital facility and at most one covenant, which is a fixed charge covenant.

It is critical to begin discussions early with your lender to understand the causes for performance problems or liquidity issues and to address any potential financial covenant/availability issues on a real-time basis.

**Is the role of the “relationship lender” more meaningful today?**

The role of the relationship lender has taken on even greater importance in the current environment. Companies need to partner with a lender that understands the volatility associated with the industry and is willing to work with them through challenging periods.

For a lender with an interest in staying in the metals space, it is a good time to cautiously take some risks where appropriate. It is an environment where bank credit groups can be more vocal. BMO Harris Bank has deep ties and commitments to the metals industry. We have been gradually growing our market share by adding new customers as lenders have exited, in some cases 20-, 30-year relationships. In our view, if you help a company find a solution now, you are going to be their lender for a long time. We are up to that challenge, and we are trying to provide more creative solutions that add value to our customers.

**Please comment on trends in pricing and leverage**

Pricing is dependent on the credit profile. Competitive dynamics in the broader ABL market have driven pricing below L+200 for quality credits. We are seeing a firming of spreads on metals facilities with a 25-50 basis point upward bias due to current market conditions. It becomes more about flexibility in structure (e.g., higher advance rates, flexibility in covenant structure) and who you want as your partner going forward. Ultimately, it depends on how many lenders you need to get a deal done. Often the last lender in the deal can dictate terms.
Metals companies that are providing more value-added services are able to charge a higher premium, and if they are hedging, they are profitable even in this environment. Those companies are going to receive a better interest rate package from lenders.

Total leverage is increasingly being scrutinized by bank credit groups and regulators. Cash flow declines are forcing leverage to higher levels. There are concerns on meeting financial covenants—fixed charge coverage test or other covenants (i.e., tangible net worth, minimum EBITDA, leverage). It is forcing certain ABL lenders not in the metals space to exit the industry.

Have you observed any significant changes in either action or mood of lenders?

There is more revolver-driven debt being provided by ABL lenders in the form of working capital lines.

ABL lenders are reducing their term exposure on metals deals which is reflective of the tightening credit profile. Maturity dates have tightened, in some cases, from five years to three year deals.

Advance rates on inventory are 85-90 percent of net orderly liquidation values for inventory. We have seen lenders ratchet back advance rates by 5 or 10 percent because they perceive metals companies to be tougher credits.

What is your outlook on credit availability?

There is no shortage of competition. We might see two to four lenders competing on every deal. However, there are fewer capital providers lending into the metals industry which has led to some stabilization in pricing.

I don't anticipate credit tightening more unless there are bankruptcies and lenders take significant write offs. There are a handful of lenders that are hunkered down, and in certain situations, what they are doing today is all they can do. I see it in borrowing bases where availability is very tight.

What impact will consolidation have on the industry going forward?

Companies in a stronger liquidity position might view the current market as a buying opportunity but are using whatever cash they have cautiously.

The bulk of consolidation this year is going to come from distressed situations, particularly in the service center and scrap markets. We are now starting to see some bankruptcies involving public and private companies, and as long as this environment remains challenging, I think there will be more.
Some of the larger players have moved away from commodity metals and into fabrication through acquisitions. Alcoa recently announced it is separating its value-add and upstream businesses into two companies to improve returns to shareholders. There will be some consolidation as companies look to move down market into higher value-added products and services.

Some operators are going to require additional capital to grow. There might be more situations where a business owner brings in a partner in a minority recapitalization. Private equity can really fill that void.

Observations on valuation trends you are seeing in the marketplace

Valuations are flat to down. A company that is providing more of a value-added product or service and generating higher EBITDA margins will be able to attract a reasonable valuation. Commodity-driven businesses are trading at net book value.

This is an environment where companies really need sound advice from a trusted advisor. Many wait and become indecisive which is never a benefit.