

# GRANT'S

## INTEREST RATE OBSERVER®

Vol. 37, No.13b

233 Broadway, New York, New York 10279 • www.grantspub.com

JUNE 28, 2019

### 172 years young

Idled blast furnaces, softening worldwide business activity and a 41% plunge in hot-rolled-steel prices constitute the news backdrop for a bullish analysis of the largest and oldest iron-ore miner in America. Cleveland-Cliffs, Inc. (CLF on the New York Stock Exchange), founded in 1847, is the apple of our eye.

Midwesterners of a certain age will remember the Cleveland-Cliffs iron-ore freighters that regally chugged between Lake Superior and Lake Erie. Twenty-first-century investors may have a different set of associations with Cliffs, starting with the five-year swoon in its share price, to \$1.26 in January 2016 from \$101 in July 2011, and the seemingly certain rendezvous with bankruptcy that never happened.

Today, revitalized Cleveland-Cliffs is profitably mining iron ore, converting that ore into pellets and selling those pellets to Midwestern steel makers. It's generating free cash, paying a dividend, liquidating debt, repurchasing shares and building a new hot-briquetted-iron plant in Toledo, Ohio, which, if all goes according to plan, will drive the growth of tomorrow's earnings.

Not everyone is persuaded by the bull story, even when properly fleshed out with facts and figures and colorful quotations, as we now set out to do. Not counting the stock sold to hedge long positions in a CLF convertible bond, fully 10% of Cliffs shares are sold short.

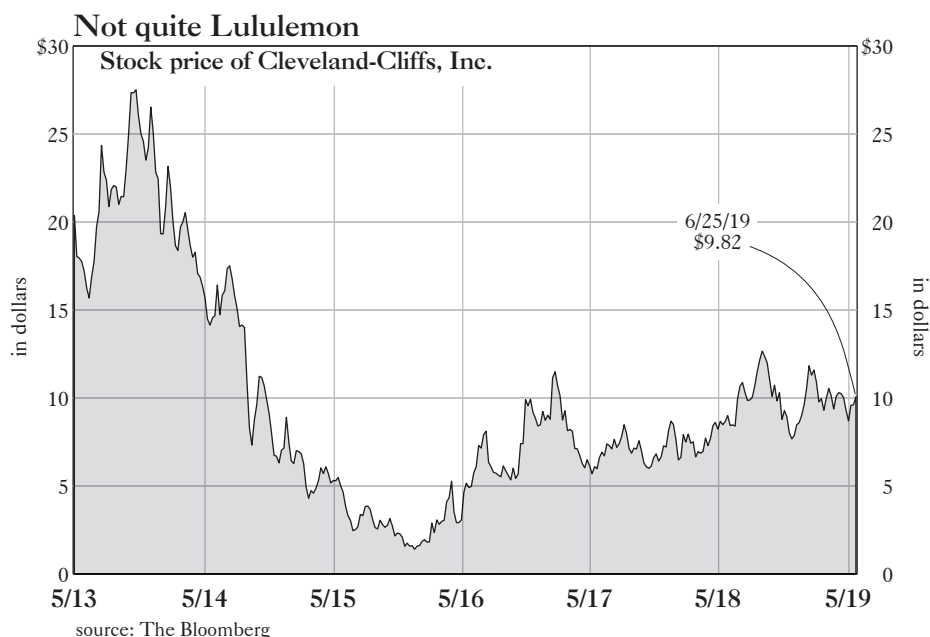
You can imagine the bearish case. A recession would do the price of iron ore no good. American car sales are weak as it is—not a happy sign for steel de-

mand. Then, too, operational risks attach to any major corporate building project, even one bossed by the demonstrably competent and hyper-confident president, chairman and CEO, 61-year-old Lourenço Gonçalves.

Mr. Market seems to see it the bears' way. Though the share price has climbed by eightfold from the 2016 bottom, today's valuation is fit for a generic, leveraged cyclical business at the peak of the economic cycle. At \$10 or so, CLF changes hands at 5.6 times estimated 2019 earnings, or 5.9 times enterprise value divided by adjusted earnings before interest, taxes, depreciation and amortization. The Cliffs 6½s of 2040 (rated single-B-minus, with \$298.4 million outstanding) trade at 87⅞ for a yield-to-worst of 7.5%.

We won't quarrel with the macro-economic arguments—really, who knows? However, we judge, Cleveland-Cliffs is in a position to ride out a recession and to continue to prosper in the absence of one. And anything but generic are the company's pricing power, regulatory edge and irreplaceable geographical advantages.

Singular, too, is Gonçalves. A poor boy in a poor country, he was educated at the Instituto Militar de Engenharia, the Brazilian MIT (or, perhaps, MIT is America's IME, as the latter, in Rio de Janeiro, is older and arguably more selective than the former, with an admission rate of 1.8% versus MIT's 6.7%). While holding senior executive positions in the big Brazilian steel maker, Companhia Siderúrgica Nacional,



Gonçalves grew tired of the kind of life one led in his then-thoroughly corrupt country; bodyguards were de rigueur, even to accompany one's spouse on a visit to the grocery store. He emigrated to the United States, worked his way up in the executive ranks of the metals industry, at length heading Metals USA, where he made enough money to afford the luxury of early retirement.

"I retired for six months," Gonçalves tells colleague Fabiano Santin. "I was investing my money and doing nothing. And I'm very good at the first one and very bad at the second one."

Reading 10-K reports in his abundant leisure, Gonçalves found his next opportunity in the then-overdiversified, capital-misallocating, money-losing Cleveland-Cliffs. The un-retiring Gonçalves presented himself to the board as the man to lead the company out of the wilderness. Ignored, he spent \$1.5 million buying Cliffs shares and partnered with the activists at Casablanca Capital, L.P. to force a change in governance from the outside. In 2014, the outsiders came in.

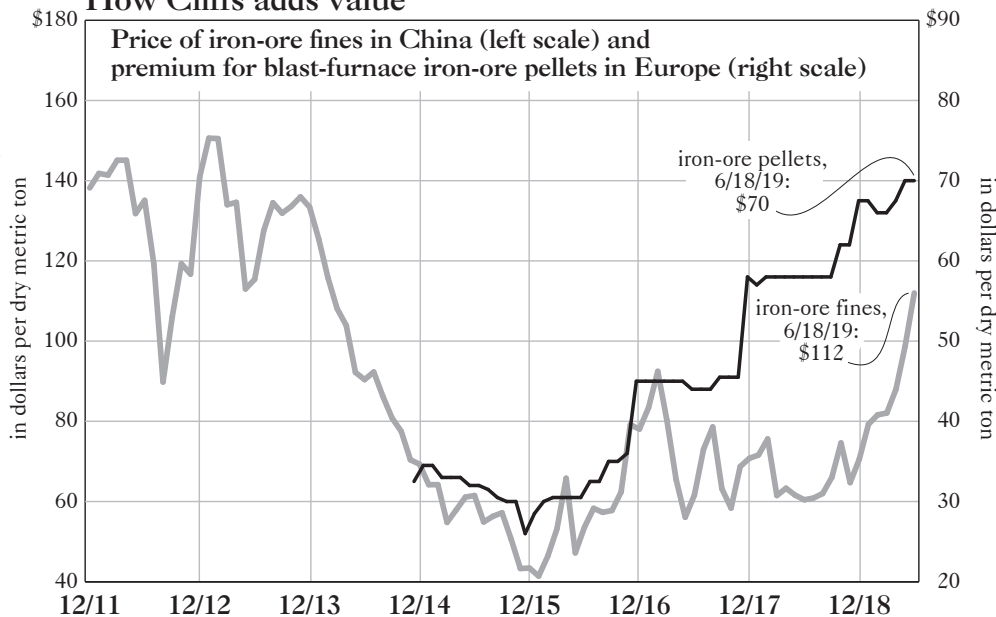
By the time the new CEO had finished slashing costs, selling overseas assets, repurchasing \$1.5 billion of debt for pennies on the dollar, renegotiating supply contracts, etc., the shares had touched their aforementioned nadir, but the old company had won new life.

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Not just a miner, Cleveland-Cliffs also manufactures and sells iron-ore pellets—they look like irregular musket balls—for use in making steel. The company's mines and factories are strategically situated near the Great Lakes steel mills, which explains the pellets' cost advantage.

Recent dam disasters in Brazil, coupled with environmentally-attuned regulatory policies, have conspired to create a shortage of pellets, a happy circumstance for the low-cost producer. But pellets, which blast furnaces consume, have no place in the electric-arc-furnace method of making steel. To serve that growing segment of the business is the reason why Cliffs is expanding in Toledo. The new plant, expected to be operational a year from now, will make hot-briquetted iron, a substitute for scrap metal as an input to EAFs.

## How Cliffs adds value



sources: S&P Global Platts, the Bloomberg

In 2018, Cleveland-Cliffs made \$2.3 billion in revenue, \$766 million in adjusted Ebitda and \$564.7 million in net income (excluding non-recurrent gains). Except for a \$613 million cash drain in 2012, when Gonçalves's predecessors decided to lay out \$1.1 billion for ill-conceived non-core assets, and the \$43 million burned in the atypical turnaround year of 2015, Cliffs has generated free cash flow annually since 2004.

Blast furnaces, the legacy steel-making technology, make molten iron by combining iron ore, coke and limestone. It's a dirty, un-green process, with the ore taking the form of a dusty material called "fines." Pellets are cleaner, and therefore more valuable, than fines. Of this high-quality product Cliffs is a high-quality producer.

In 2018, the Cliffs mines boasted an annual production capacity of 27.4 million tons of iron-ore pellets, representing 54.8% of total U.S. pellet-making potential (vs. 39.4% for U.S. Steel Corp. and 5.8% for ArcelorMittal USA, LLC). Four company mines, one in Michigan and three in Minnesota, feed the nearby pellet plants; railways lug the little iron balls to water-borne transportation, and thence to final customers.

Only three customers furnished 95% of Cliffs's 2018 revenues: ArcelorMittal USA (57%), AK Steel Corp. (25%) and Algoma Steel, Inc. (13%). Mitigating the risk inherent in such a concen-

tration is the strategic importance of pellets to steel-making—it's as critical as flour to bread-making. When Algoma's former parent went through bankruptcy in 2016, Cliffs kept cashing its customers' checks. It's a comforting story to recall while perusing AK Steel's B-rated balance sheet.

Cliffs's customers sign on for an average of six years. Pellet prices are indexed to the cost of seaborne iron ore, to domestic hot-rolled-steel prices, to various inflation indices and to the premium of iron-ore pellets over non-pelletized fines. Management aims to protect against falling prices without giving away too much potential for upside appreciation. And because customers agree to take a certain volume of material, come what may, Cliffs was able to sell 16.4 million tons of pellets in unprosperous 2009 and 17.3 million in troubled 2015—figures within hailing distance, at least, of the roughly 20 million projected for this year.

For now, though, Gonçalves's top problem isn't the next recession but a localized Toledo boom. "The biggest thing for us now is hiring people: carpenters, electricians, welders, things like that," he tells Santin. "Because the economy is so good and non-residential construction is [just] as good right now, these people are being allocated to these other projects."

As for customer demand, said the CEO at the Goldman Sachs Global Metals & Mining Conference in No-

vember, "Even though we haven't built a blast furnace in this country since 1979, we still have more blast furnaces than I can supply from Cleveland-Cliffs. We still have in Canada some blast furnaces that can only survive importing pellets because I don't have [pellets] for everybody."

Every business seeks a figurative competitive moat. Situated by the Great Lakes, Cliffs can claim a literal one. Thanks to the Jones Act of 1920 and other restrictions on navigation in that region, an offshore vendor pays \$40 to \$45 a ton to transport pellets through the Saint Lawrence Seaway; Cliffs pays just \$5 to \$10. Cargoes originating in Brazil face another \$10 per ton to reach the United States, those from Australia another \$20 per ton, according to estimates by S&P Global Platts.

Vale S.A., for instance, efficient as it is, produces iron-ore pellets for \$60 a ton. That would equate to \$110 a ton after landing in the Midwest. Cliffs makes and delivers pellets for \$65 a ton—and sold them for \$106 a ton in 2018.

Production of global seaborne iron ore (fines, lump and pellets) stood at 1.5 billion tons in 2018, and fines closed the year trading at \$73 a ton, despite relatively soft demand from Europe and China. On Jan. 25, the collapse of one of Vale's Brazilian tailings dams killed more than 300 people and cut the company's iron-ore output by 93 million tons (that's 6% of the world's total, or twice the amount American miners produce in one year). Although Vale just restarted 30 million tons of production, the disaster tightened the market, and the price of iron ore subsequently surged by 53%, to \$112 a ton.

On June 19, Rio Tinto Ltd. announced it had suffered "operational" problems in Australia and cut estimates for 2019 iron-ore volumes by about 10 million tons. Inventory at Chinese ports has been dropping by about three million tons per week since early April, to 109 million on June 16, compared with a one-year average of 132 million.

The seaborne market that delivered 155 million tons of pellets in 2015 has shrunk by 40 million, or 26%, on account of both the January dam collapse and an earlier Brazilian earthworks failure, that of the Mariana dam, in 2015. The Atlantic iron-ore, blast-furnace

pellet premium to powdery fines delivered in China has accordingly risen to \$70 a ton from \$30 at the end of 2015, according to S&P Global Platts.

If, today, Cliffs had the spare capacity, it could sell pellets in Europe at an all-in cost of about \$120 a ton, compared with the currently quoted price of \$180. It follows, then, that Cliffs could still profitably sell pellets abroad if demand dried up at home (and if—an admittedly improbable scenario—that hypothetical withering of American demand were not part and parcel of a global downturn).

Blast furnaces are slowly going the way of the 5% investment-grade bond yield. In the past 30 years, the percentage of domestic steel produced by electric arc furnaces has climbed to two-thirds from one-third. And while blast furnaces need iron ore (preferably in the shape of pellets), EAFs chiefly consume recycled scrap.

"The EAFs are limited from a quality standpoint because of that source of iron that's scrap," Paul Finan, director of investor relations at Cleveland-Cliffs, tells Santin. "Because of the impurity of scrap, and the fact that it is recycled steel, it's not going to be as pure, it's not going to be as foldable, as formable, as steel that comes from a blast furnace, so what will help [EAFs] with their quality is substituting some of that scrap with a metallic, with something like HBI."

Because domestic American production of hot-briquetted iron is currently concentrated in the southern states, adds Finan, Midwestern EAFs import that feedstock from Brazil or purchase pig iron, an alternative raw material, from Russia and Ukraine.

Not the kind to ignore handwriting on the wall, Gonçalves and his team in 2017 committed to build the Toledo HBI plant. When up and running in 2020, the new facility is expected to turn out 1.9 million tons of briquettes a year, in the process consuming some of the iron-ore pellets that Cliffs would otherwise have sold to its steel-making clientele. In so doing, Cliffs would effectively be aggravating the existing pellet shortage (should that shortage persist).

Think of Nucor Corp., the Charlotte, N.C.-based EAF steelmaker, Gonçalves bids Santin, specifically of the company's HBI plant in Louisiana which sources iron-ore pellets from

around the world. Necessarily, the little balls vary in size and chemical composition. "Our HBI plant in Toledo will only get pellets from Cliffs's Minnesota Northshore mine. So it's a single-ore body with a single-pellet plant producing a very narrow spec."

"Aside from participating in the growing EAF market for higher-quality steel," Santin relates, "based on current low prices, Cliffs is expected to see gross profits of about \$110 a ton on HBI, compared with \$40 a ton on standard pellets. That's \$209 million in gross profits on 1.9 million tons of briquettes, compared with the \$112 million on 2.8 million tons of iron-ore pellets that could be sold to blast furnaces."

As of March 31, Cliffs showed debt of \$2.3 billion (including \$244 million in pension liabilities and \$316 million in deep-in-the-money convertibles due 2025) and carried \$547 million in cash (including a \$117 million tax refund received after that statement date). Undrawn bank lines totaled \$240 million and working capital \$300 million (excluding the aforementioned cash); no bond falls due prior to 2024.

Giving advance credit for the expected receipt of \$123 million in tax refunds by 2022, you arrive at net debt of \$1.66 billion, or 2.2 times 2019 estimated adjusted Ebitda. And \$2.3 billion in deferred tax assets suggests that Cliffs won't be paying corporate income tax for many a moon.

Quarterly dividend payments resumed in October after a lapse of 15 fiscal quarters; at today's share price, the yield is 2.4%. Since late November, Cliffs has repurchased \$171 million's worth of stock and is authorized to buy another \$129 million's worth. According to Gonçalves, stock buybacks are a priority at these prices, with debt reduction as the second-best use of cash. The CEO says he intends to apply free cash flow to reducing net debt to \$1 billion over the next few years. Barring exogenous surprises, the stars are aligned for a free cash-flow yield of 11% in 2020, according to consensus estimates.

The sell side lines up with eight buys, four holds and one sell—a perhaps predictable realignment from the 2016 low, when the analysts weighed in with one buy, seven holds and seven sells. Gonçalves, who purchased \$94,000 worth of stock this month,

is the 14<sup>th</sup>-largest Cliffs shareholder, with a stake of \$32 million, of which \$23 million derive from corporate grants and the balance from his personal checking account.

On Feb. 8, the man from Brazil looked into the CNBC cameras and remarked on the disparity between the valuation of his stock (six times) and Lululemon Athletica, Inc.'s (23 times): "People are more jazzed about

athleisure than iron ore," said the anchor, Sara Eisen, to which Gonçalves replied, "Yes, but we're a lot more strategic, a lot more important in the long run, and we've been around for 172 years. In 100 years, Cleveland-Cliffs will be here and people will be using other brands of yoga pants."

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