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Do-over of a makeover

Evan Lorenz writes:

Two Mondays ago, a flurry of pink slips took down superstars on both sides of the Atlantic, including Tucker Carlson, Don Lemon and Martina Merz. If the third name doesn't ring a bell, she is the lame-duck CEO of ThyssenKrupp A.G. (TKA in Germany, TKAMY in the United States) and the subject of a bullish analysis in these pages two years ago ("Bet on the lady"). Following is a reappraisal of Europe's second-largest steel-maker.

Since we had our say in the issue dated June 11, 2021, ThyssenKrupp's stock has logged a 39.8% drop in dollar terms versus a 0.2% decline in the S&P 500 (both figures include reinvested dividends). At their current valuation, the shares are priced like an option on further portfolio rationalization, and the TKA board of directors is agitating for exactly that. In preview, we are chagrined but remain bullish on the stock (widows and orphans, please look away). We are even more constructive on safer opportunities higher up in the TKA capital structure.

ThyssenKrupp is best known for combining iron ore and coking coal in blast furnaces, but the steel division accounts for only 31% of trailing sales. Five other business units contribute the balance: material services (38% of trailing revenues), which sources, warehouses and manages inventory and raw materials for customers such as Airbus S.E. and Ford Motor Co.; automotive technologies (12%), which creates parts and systems for axles, steering assemblies, camshafts and auto bodies; industrial components (7%), which makes bearings and forged products such as crankshafts and axles; marine systems (5%), which manufacturers non-nuclear submarines and surface vessels for civilian and military use; and a hodgepodge of businesses (8%), slated for sale or closure.

While ThyssenKrupp can trace its origins back to the mid-19th century, the company as it stands today was formed in the 1999 merger of Thyssen A.G. and Fried Krupp A.G. Hoesch-Krupp. TKA's problems began a short six years later with the decision to expand steel production to the Western Hemisphere through a pair of plants in Brazil and Alabama. The housing bust of 2007–09 crimped demand in the Americas, making ThyssenKrupp's €12 billion ($13.2 billion at current exchange rates) investment a balance-sheet-encumbering bust.

The Old Continent's economic problems compounded the ones across the Atlantic. A decline in construction activity on Europe's periphery slashed steel demand to an average of 153 million tons per year in 2011–19 from an average of 188 million in 2004–08. As a result, the overleveraged industrial conglomerate found itself with persistent free-cash-flow deficits on the eve of Covid.

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The company seemed to regain its footing—or so we judged—with Merz's appointment to the top job on Oct. 1, 2019. The former chief executive of Chassis Brakes International suspended the dividend to preserve cash (a big win as the Krupp family foundation, which holds 21% of shares outstanding, relies on that income for charity work) and sold its crown jewel, the elevator division, for €17.2 billion, or 18.7 times Ebitda, in 2020.

Other dispositions followed as Merz focused corporate attention on the material services, automotive technology and industrial components. Cost cuts (headcount was reduced by just over 10,000, to 97,323, by Dec. 31, 2022), business simplification (the number of companies under the TKA umbrella shrank to 312 from 456 during her tenure) and a push to infuse some entrepreneurial spirit in the subsidiaries duly followed.

Merz accomplished these things despite lockdowns, supply-chain snarls, the war in Ukraine and last year's surge in energy prices. New-auto sales in the European Union had averaged 15.1 million units in 2017–18, but microchip shortages in each of the past three years pushed the average below 10 million. As ThyssenKrupp derives 28% of total sales from the auto sector, the damage was extensive.

Last year's commodity-price surge afforded some relief. In the fiscal year ended Sept. 30, 2022, adjusted operating profits more than doubled, to €2.1 billion, highest since 2008, despite the divestiture of the elevator unit. Material services (€837 million in adjusted operating profit last year) and steel (€1.2 billion) provided the lift.

But Merz stopped short when Russia invaded Ukraine. Mothballs enveloped the plans to separate the steel unit and publicly list a portion of Nucera, the global leader in making hydrogen from renewable energy. TKA holds a 66% stake in Nucera, which, according to early 2022 press reports, could be worth as much as €6 billion compared with ThyssenKrupp's current market cap of €4 billion.

Those delays cost Merz her job. One year ago, the company extended her contract through May 2028. On March

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31, Reuters reported that the labor representatives who compose one-half of ThyssenKrupp's board declared Merz's turnaround a failure: "The board has been lacking an overall concept for months," the internal memo concluded. "Nothing has moved since last autumn and time has again been lost unnecessarily. This is not acceptable."

For better or worse, the inflationary impulse that buoyed last year's results is receding, and the company has guided for adjusted operating earnings to subside to a level similar to fiscal 2021's. On top of this, it appears that industrial activity is downshifting in major economies worldwide, not excluding the 20 member states of the eurozone. Yes, S&P Global's Flash Eurozone Composite Purchasing Managers' Index for April rose to 54.4, an 11-month high, from 53.7 in March, thanks to a jump in the services PMI to 56.6, a one-year high, from 55. However, the manufacturing PMI slumped to 45.5, a 35-month low, from 47.3 in March.

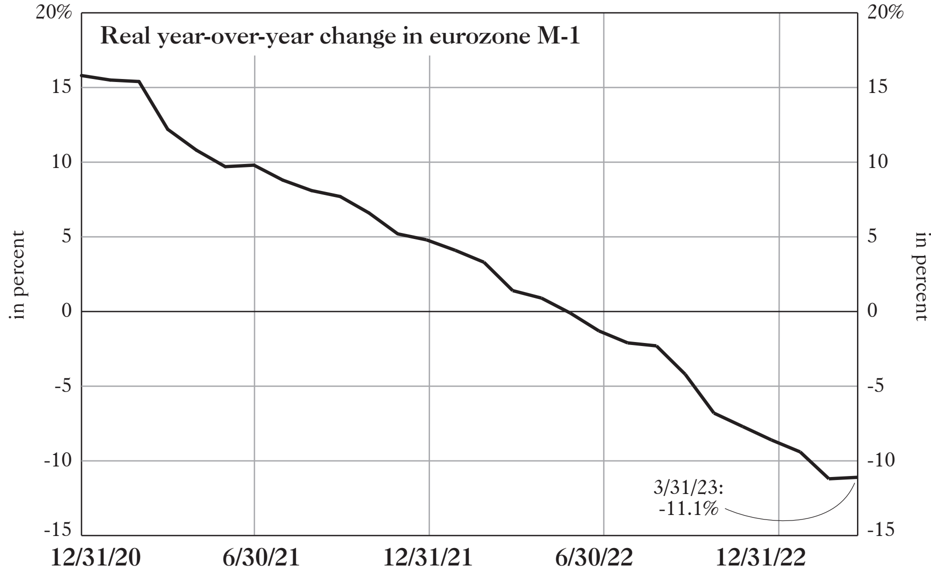
"That's more of a statistical bounce," Aaran Param, head of asset allocation at macroeconomic research firm Variant Perception, tells me about the composite PMI. "These are just surveys, and they are really measuring direction rather than magnitude. A lot of the survey's questions are, 'Do you expect conditions to be better or worse relative to the past few months?' Things are better, of course, because your starting point was absolutely terrible, with concerns about [the possible] deindustrialization in Europe due to the energy crisis.

"Hard data still look pretty terrible," Param continues. "One of the best leading indicators for growth in the eurozone is real M-1, effectively narrow money growth adjusted for inflation. It's negative double digits at the moment across the eurozone, and, in individual countries, it looks terrible."

Export orders fell 25.7% year over year in March for Taiwan. In April, South Korean exports slumped by 14.2% year over year. These export-dependent nations are the bellwethers of global trade. "In the U.S., relative to our base plan," United Parcel Service, Inc. CEO Carol Tome lamented on the April 25 earnings call, "volume was higher than we expected in January, close to our plan in February and moved significantly lower than our plan in March, as retail sales contracted and we saw a shift in consumer spending."

"Indeed, with consumer demand for

Recession in its wake?



source: The Bloomberg

discretionary-goods purchases drying up around the world, manufacturing remains under pressure," Lakshman Achuthan, co-founder of the Economic Cycle Research Institute, advises via email. "This is also why we see trucking demand fall off a cliff in the U.S.: The American Trucking Association's monthly index fell 5.4% in March, the largest monthly drop since April 2020, at the start of the pandemic."

"That said, we do see some green shoots," Achuthan continues. "Our research indicates that the pace of decline in manufacturing will ease in the coming months. That would still be consistent with recession in the U.S. and Europe."

To add to the cautionary tale, ThyssenKrupp is in investment mode, with capital expenditures regularly topping depreciation charges, as it spends to comply with European green mandates. On the drawing board today: a €2 billion investment in a steel plant that uses hydrogen to produce more environmentally friendly steel. Government subsidies are expected to reduce the bill substantially, but converting all its mills to this technology could cost more than €7 billion before state inducements.

At year end, ThyssenKrupp's balance sheet showed €7.2 billion in cash and €3.9 billion in debt—and a €5.7 billion pension obligation, primarily tied to workers in the German steel business. The pension liability inflates the net debt balance to €2.5 billion, or 1.4 times the guesstimate for Ebitda in fiscal year 2023, which places TKA near the top of junk (Ba3/double-B), according to the rating agencies.

Rising rates take some of the sting out of those liabilities. ThyssenKrupp uses double-A corporate bond yields to discount estimated future payments to its retirees. For the purpose of German obligations, the discount rate increased to 3.8% on Dec. 31, 2022 from 1% a year earlier, which catalyzed a €2 billion year-over-year decline in pension obligations.

The Street is understandably noncommittal on TKA, with four buys, eight holds and one sell. Over the past 12 months, insiders have bought 62,672 shares at a cost of €418,766 with no executives selling.

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Which brings us to the valuation of ThyssenKrupp: The stock is cheap despite Street estimates, which pencil in a 59% year-over-year decline in fiscal 2023 operating income. Including the pension deficit in enterprise value (that is, net debt plus market capitalization), TKA trades at 3.6 times estimated 2023 Ebitda and 11.3 times this year's earnings.

Then, too, the fiscal year ending Sept. 30 is likely to mark a return to positive free cash flow, even if Europe tips into a recession. From Sept. 30, 2021 through Dec. 31, 2022, working capital bulged by €2.6 billion, to €9.8 billion, thanks to the commodity boom. As prices cool this year, so, management expects, will the

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working-capital buildup. Analysts pencil in free cash flow of €377 million in 2023 from a deficit of €476 million last year. Restoration of the dividend program in February, to a rate of €0.15 per share, indicating a 2.3% yield, suggests that management is confident about the return to cash generation.

On June 1, Miguel Ángel López Borrego is expected to succeed Merz as chief executive. Prior to joining TKA, Borrego was the interim CEO at German engineering firm Norma Group S.E.; before that he was the head of Siemens A.G. business in Spain. While it may take the new broom a few months to start sweeping in earnest, we know that the board wants action.

On that note, the *Financial Times* reported on March 31 that ThyssenKrupp has revived plans to sell the marine-systems unit on which bids are soon expected. In the 12 months ended Dec. 31, 2022, the unit generated €2 billion in sales and boasts, as of last report, a €13.1 billion order backlog. European defense contractors BAE Systems plc, Rheinmetall A.G. and Saab A.B. trade at an average of 1.7 times enterprise value to sales. If TKA can sell its defense unit at just 1 times sales, the €2 billion in proceeds would equal 50% of the current market cap. Consider that marine services contributes just 5% of trailing sales.

An April 26 Bloomberg report broke news that Emirates Steel Arkan, the Abu Dhabi state-backed metal-maker, is pursuing a potential investment in ThyssenKrupp's steel division. Metal produced in the United Arab Emirates with renewable power would be shipped to Europe, where ThyssenKrupp would fashion it into final products.

Such an arrangement would be a boon for TKA. First, any investment would allow the company to reduce the steel unit's pension liabilities. Second, by sourcing steel made with renewable energy from Arkan, ThyssenKrupp would significantly reduce the amount of capital expenditures needed to meet the European Union's green mandates.

Of course, there is no guarantee that ThyssenKrupp and Arkan will sign an agreement, and Arkan is not the only suitor. Bloomberg reports expressions of interest in the TKA steel unit from Mumbai-based JSW Steel Ltd. and the Luxembourg-headquartered private equity firm CVC Capital Partners.

Then there's Nucera, the green hydrogen producer. While the unit may not be worth the €6 billion that starry-eyed bulls assigned it at the peak of the everything bubble last year, the business claimed, as of Sept. 30, 2022, a €1.5 billion backlog of work.

"Interest in this business has escalated with the passage of the Inflation Reduction Act (IRA) and, in March, Nucera held talks in the U.S. about several potential green hydrogen projects 'with very concrete timelines,'" Steven Grey, CEO and eponym of Grey Value Management, LLC, which holds a position in TKA, advises by email. "ThyssenKrupp Nucera already has a U.S. presence in Houston servicing customers of its chlor-alkali technologies, and De Nora [TKA's joint venture partner in Nucera] also has a production site in the U.S. Note that the Hydrogen Production Tax Credit—a key feature of the IRA—provides a 10-year federal tax credit of up to $3 per kilogram for clean hydrogen produced after 2022 from facilities that begin construction prior to 2033. That $3 credit per kg is sufficient to make projects that would otherwise be losers materially profitable."

Investors who attach a higher value to safety than to equity option value may consider the dollar-denominated senior unsecured TKA 4⅛s of Jan. 26, 2026, which are priced at $92.90 for a yield to maturity of 7.07%. Rated double-B, the 4⅛s offer a pickup of 43 basis points over similarly rated dollar-pay bonds.

Barring a deep sea of red ink between now and that maturity date, ThyssenKrupp has the financial wherewithal to pay off the $100 million of the 4⅛s that are currently outstanding. From now through Sept. 30, 2026, €3.3 billion of debt will mature compared with €7.2 billion in cash and €1.5 billion in available credit lines.

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ThyssenKrupp A.G. at a glance
all figures in € millions except per share data

	TTM*	FY22**	FY21	FY20	FY19
sales	€41,135	€41,140	€34,015	€28,899	€34,036
adj. operating income	1,938	2,062	796	(860)	802
net income	1,096	1,120	(25)	9,592	(260)
earnings per share	1.77	1.82	(0.18)	15.40	(0.49)
shares outstanding	622.5	622.5	622.5	622.5	622.5
cash	7,160	7,638	8,974	11,547	3,706
debt	3,912	3,981	5,424	6,502	7,415
pension obligations	5,728	5,812	7,896	8,560	8,947
total assets	36,104	36,811	37,492	36,490	36,474

*Twelve months ended Dec. 31, 2022
**Fiscal year ends Sept. 30

source: company reports

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