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Stelco Inc.: BANKRUPTCY AND RESTRUCTURING[[1]](#footnote-1)

Professor Michael R. King and Erika Chamberlain wrote this case solely to provide material for class discussion. The author does not intend to illustrate either effective or ineffective handling of a managerial situation. The author may have disguised certain names and other identifying information to protect confidentiality.

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In late 2003, Jonathan Peters and Christine Martin, managing directors of Quantum Investors Inc. (Quantum), were reviewing the file on the Hamilton, Ontario-based steel company, Stelco Inc. (Stelco). Quantum was a Toronto-based private equity firm that specialized in distressed investing. Quantum raised its first fund in 2002, and since then Peters and Martin had been studying various restructuring opportunities as a precursor to making an investment. They were currently focused on opportunities in the North American steel industry, which was undergoing a cyclical downturn. Stelco was Canada’s largest and most diversified steel producer with fiscal 2002 sales of CA$2.8 billion.[[2]](#footnote-2) Despite being a Canadian giant, Stelco was in trouble, with a high cost structure, a unionized workforce, a large pension liability, and a deteriorating cash position. It was clear that Stelco needed to restructure to remain viable, and the company’s leadership was initiating a strategic review of all operations. The price of Stelco’s shares listed on the Toronto Stock Exchange (TSX) had declined sharply in recent months, suggesting the company was running out of time.

Peters and Martin **anticipated Stelco would file for bankruptcy imminently under the *Companies’ Creditors Arrangement Act* (CCAA)—Canada’s bankruptcy and insolvency law.**[[3]](#footnote-3)The Quantum founders needed to decide whether to take a position in Stelco. If Quantum were to take a position, Peters and Martin would need to decide which securities to purchase and the strategy to pursue with the various stakeholders to ensure a successful outcome for their investment. In particular, they needed to identify the “fulcrum” security in Stelco’s capital structure—that is, the class of securities that would most likely control both the legal process and the go-forward value proposition in a restructuring. They also needed to identify the key stakeholders in the restructuring, understand their bargaining positions, and assess the feasibility of a future exit. Peters and Martin had asked their team to look into Stelco’s financial and operating situation, its capitalization, and its assets and liabilities. With a CCAA filing imminent, they needed to make a decision soon.

****The STEEL INDUSTRY****

The North American steel industry was highly cyclical and had undergone many booms and busts over the years. The industry was in the midst of another downturn, which had seen the bankruptcy and restructuring of numerous U.S. and Canadian steel companies: LTV Steel Corporation (2000), Bethlehem Steel Corporation (2001), National Steel Corporation (2002), and Weirton Steel Corporation (2003) in the United States; and Algoma Steel (2001), Ivaco Inc. (2003), and Slater Steel Inc. (2003) in Canada. These steel companies used court-supervised restructurings to reduce their debt, labour costs, and liabilities. This turmoil also led to industry consolidation, as stronger competitors acquired struggling rivals through horizontal mergers designed to capture economies of scale and scope. International Steel Group Inc. was formed in March 2002, following the merger of bankrupt firms LTV Steel Corporation, Acme Steel Co., and Bethlehem Steel Corporation. International Steel Group Inc. had become the second-largest U.S. steel manufacturer and a price leader. These restructured steel companies re-emerged from creditor protection as leaner, more cost-efficient competitors.

However, the steel industry continued to face challenges. In the first nine months of 2003, world steel production had increased by 7.1 per cent versus the same period a year earlier, driven by higher production in Asia. This increased supply met with weak market demand, leading to declining steel prices. After peaking at US$273 per ton, the price benchmark of U.S. hot-rolled sheet steel declined to US$240–US$250 per ton in September 2003.

****ABOUT STELCO Inc.****[[4]](#footnote-4)

The Steel Company of Canada Limited was incorporated on June 8, 1910, in Hamilton, Ontario. In 1946, Stelco was unionized after a bitter and lengthy strike, with 10,000 residents of Hamilton marching in support, led by the city’s mayor. The name was changed to Stelco Inc. as of mid-1980. By 2003, Stelco was Canada’s largest steel producer with combined annual production of 5.9 million tons and 8,400 employees. (See Exhibit 1 for an overview of Stelco and its principal subsidiaries.)

Stelco operated through three segments: (1) integrated steel, (2) mini-mills, and (3) manufactured products.

The integrated steel segment was Stelco’s primary business and generated 76.3 per cent of total revenue for the nine months from January 2003 to September 2003. Integrated steel was Stelco’s least profitable business, posting negative earnings before interest, taxes, depreciation, and amortization (EBITDA) of −$71 million over this period. Stelco’s two steel-making facilities, Stelco Hamilton Works and Stelco Lake Erie Works used blast furnace technology, whereby a towering cylinder lined with heat-resistant bricks was used to smelt iron from its ore. A “blast” of hot air and gases was forced up through the iron ore, coke, and limestone that loaded the furnace. In a bid to turn itself around, Stelco had announced the integration of the Hamilton and Lake Erie operations. This integration was expected to reduce operating costs by $15 million in the first nine months of 2003 and a further $6 million in the final quarter of 2003. Stelco also planned to upgrade its hot-strip mill at Lake Erie and construct a new pickling line at Hamilton, allowing it to close higher-cost production facilities in Hamilton.

Stelco’s mini-mill segment contributed 9.6 per cent to total revenue for the first nine months of 2003. The mini-mill segment was profitable, generating positive EBITDA of $11 million in the same period. Mini-mill steelmakers used electric arc furnace technology, where scrap metal was generally 100 per cent of the input. Heat was supplied from electricity that “arced” from the graphite electrodes to the metal bath. Stelco had two principal subsidiaries, Stelco-McMaster Ltée. in Quebec and AltaSteel Ltd. in Alberta. This segment owned interests in two scrap providers, which provided a stable supply of scrap needed for steel production.

Stelco’s manufactured products segment represented 14.1 per cent of total revenue for the first nine months of 2003, and generated EBITDA of −$14 million over the same period. This segment manufactured products such as wire, pipe, tube, and grinding balls. Most of the steel used in this segment was supplied from Stelco’s two other segments, providing cost synergies.

Stelco’s main products were hot-rolled sheet (35 per cent of sales), coated sheet (20 per cent), and cold-rolled sheet (8 per cent); plate steel (4 per cent); bars and wire rod (16 per cent); and manufactured products, such as wire and wire products (7 per cent), pipe and tubular products (7 per cent), and other products (3 per cent). Stelco’s main customers were the auto sector (36 per cent of sales), steel service centres (20 per cent), the construction sector, and the oil and gas sectors. According to its *Annual Report 2002*, Stelco sold approximately half of its products on a contract basis (at fixed prices) and half on the spot market (at variable prices). Sales to the auto sector, for example, were largely based on annual contracts, providing greater predictability of cash flows. Sales to steel service centres, however, were on a spot basis and were thus more susceptible to intra-year swings in market prices for steel. Geographically, Stelco was concentrated on the North American market, with 83 per cent of sales in Canada and 15 per cent in the United States. (See Exhibit 2 for an overview of Stelco’s production by facility, its product mix, its principal customers by industry, and its sales by geography.)

In 2001, Stelco reported its first net loss in seven years: −$178 million, or a loss of −$1.74 per share (see Exhibit 3). While steel shipments remained essentially unchanged from a year earlier, Stelco’s sales decreased by 10 per cent, reflecting a lower average revenue per ton of $546 in 2001 versus $606 in 2000. This 10 per cent decline was the result of a less favourable mix of products sold, a lower level of activity in prime manufacturing markets (such as the auto sector), and depressed spot market prices caused by high levels of imported steel. While Stelco managed to reduce the average cost per ton through various cost reduction initiatives, these efforts were offset by lower semi-finished steel sales, higher average natural gas prices, and the unfavourable exchange rate of the Canadian dollar (CAD) to the U.S. dollar (USD). As a result, Stelco’s average cost per ton declined to $553 in 2001, implying an operating margin of −$7 per ton.

Stelco’s fortunes improved in 2002 due to the recovery of the North American steel market from the depressed conditions in 2001. Consumer demand for steel products picked up, but commercial demand remained weak. Spot steel prices recovered from 20-year lows due to reduced supply from U.S. mills. Stelco saw an increase in average revenue per ton to $592 as compared with its cost of $554 per ton, leading to a positive operating margin of $38 per ton. For 2002, Stelco reported a meagre profit of $3 million due to a $10 million recovery of past income taxes.

However, 2003 was turning out to be a disastrous year, with Stelco finding it difficult to compete with restructured U.S. competitors on a cost-effective basis. Stelco’s profit margins were under pressure due to industry overcapacity, cost increases for inputs (such as natural gas prices and scrap), rising employee retirement benefit costs, and an increase in the CAD relative to the USD. Despite a recent rise in steel prices, Stelco’s average revenue per ton decreased to $563 for the nine months ending September 30, 2003. At the same time, Stelco’s average cost per ton increased to $583 per ton. While some of these cost increases were offset by further expense reduction initiatives, Stelco’s operating margin was again negative, losing $19 per ton. It was clear to equity analysts and market participants that Stelco was heading for a significant loss for 2003.

Following the announcement of a second quarter loss of $82 million, Stelco’s chief executive officer (CEO), Jim Alfano, announced his retirement in July 2003 after having led the steelmaker for seven years.[[5]](#footnote-5) Fred Telmer, Stelco’s chairman and former CEO from 1991 to 1997, agreed to act as interim CEO and initiated a strategic review of the company’s business. The review included Stelco’s organizational structure, product lines, and capital expenditures, as well as the identification of non-core assets that might be candidates for a sale. The media reported:

Stelco Inc. may put almost one-third of its $2.8-billion business on the auction block to streamline the company and avoid bankruptcy court, according to a senior official. Frederick Telmer, Stelco’s recently appointed chief executive, said Thursday that the money-losing producer wants to sell its entire mini-mill and manufactured products divisions, which will shrink its operations to a pair of integrated steelworks in Hamilton and Nanticoke, Ont. [Ontario]. . . . “Everything else, I think you can say, is non-core,” Telmer said. “We have to get down to the core business.”[[6]](#footnote-6)

Stelco was unviable due to its inability to compete against lower-cost steel producers. Significantly, Stelco was overburdened with large off-balance-sheet pension liabilities. Stelco management warned that a restructuring under court-ordered protection from creditors might be required to deal with this pension issue. “Our preferred route is to achieve this outcome without a formal restructuring process,” Telmer told analysts. “Looking at the U.S. experience, certain companies were forced to enter Chapter 11 [of the U.S. *Bankruptcy Code*[[7]](#footnote-7)] to deal with this [pension cost] issue, while others were able to co-operatively work out an equitable solution with their workforce,” Telmer said. “We will have to see how things develop, but make no mistake, we must to come to terms with this significant impediment to our ability to emerge as a competitive player.”[[8]](#footnote-8)

While Stelco’s on-balance-sheet debt totalled $721 million as of the end of September 2003, the pension liabilities under Stelco’s defined benefit pension plan and other employee benefits added an additional $1.723 billion of off-balance-sheet debt. Stelco had a powerful trade union representing its workers, and it would undoubtedly fight any effort to reduce its pension claims and benefits. To make matters worse, Canada had few legal precedents to suggest how the pension plans and the labour unions would be treated in a court-supervised restructuring. Air Canada, for example, was in the process of using CCAA court protection to negotiate the reduction of its underfunded $1.5 billion pension deficit with its unions. Other well-known Canadian companies—lumber producer Doman Industries Limited and Montreal-based clothing retailer Boutiques San Francisco among them—were also seeking to shed staff and restructure debts through this process. Recent cases had reached different outcomes, with some going before the Supreme Court. The stakes were high, with one estimate placing the underfunding of corporate pension plans in Canada at $225 billion, representing 20 per cent of Canada’s gross domestic product.[[9]](#footnote-9)

It was clear that Stelco needed to take immediate action. The board candidly examined a court-supervised restructuring process to provide legal protection, while Stelco addressed its problems and developed a restructuring plan. Another option was to consider a merger or sale to a competitor. Doing nothing was not an option.

****Stelco SIZE-UP****

As with any restructuring situation, Peters and Martin knew it was vital to understand the target company in depth. The Quantum team summarized Stelco’s operating performance over the first nine months of 2003 (see Exhibit 4). Total steel shipments had been stable, but the trend in operating profitability was ominous. Stelco was operating at a loss, with costs exceeding revenues by $20 per ton. The integrated steel and manufactured products segments were operating at a loss or at break-even. Only the mini-mill segment was generating positive EBITDA. Stelco’s interest expense was rising each quarter, leading to net losses of $168 million over the first three quarters of 2003.

The Quantum team outlined Stelco’s strengths and weaknesses:

Strengths

* Integration leading to cost savings: The integration of Stelco’s operations (i.e., Stelco Hamilton Works and Stelco Lake Erie Works) was expected to generate $6 million in annual cost reductions beginning in the fourth quarter of 2003. Stelco’s Lake Erie plant was reportedly among the lowest-cost integrated steel producers in North America.
* Divestitures to reduce debt: During the most recent analyst conference call, Stelco management had disclosed they were examining divestitures to de-lever the balance sheet and refocus on core operations. The sale of AltaSteel Ltd. was being actively pursued. According to management’s disclosure, AltaSteel Ltd. generated annual EBITDA of $20 million–$25 million and carried debt of $30 million.
* Positive outlook for the auto sector: Stelco was a major supplier of steel to the auto sector, accounting for 36 per cent of Stelco’s sales. The outlook for this industry was stable, and the potential relocation of foreign auto companies to Ontario might increase demand for Stelco’s products. Stelco also had a joint partnership with JFE Steel Corporation of Japan to develop automotive sheet steel, which was favourable for sales to this sector.
* Maintenance capital expenditures (CAPEX) covered: While the maintenance CAPEX was difficult to determine, Stelco’s management claimed that CAPEX over the past five years had been sufficient to cover maintenance for the coming two years.
* Increase in cost-efficiency and productivity: Over the past five years, Stelco had reduced its steel production costs by $45 per ton by investing $850 million in upgrades, primarily at Stelco Hamilton Works and Stelco Lake Erie Works. Between 1994 and 2002, Stelco’s workforce declined by 25 per cent to the current 8,890 employees. As a result, the tons of steel produced per average employee increased by 41 per cent over this period to 579 tons in 2002. Stelco’s Lake Erie facility was one of the lowest-cost integrated steel producers in the industry.
* Access to low-cost scrap metal and iron ore: Stelco satisfied some of its scrap demand through its 50 per cent ownership of Fers et Métaux Recyclés Ltée., a processor of ferrous and non-ferrous scrap metal. This supply provided a hedge against increasing scrap prices. Stelco also owned interests in iron ore properties that provided 80 per cent of Stelco’s annual needs, with probable reserves in excess of 25 years.

Weaknesses

* Exposure to industry cyclicality and volatile steel prices: Steel production required substantial amounts of raw materials and energy, including coal, iron ore, coke, scrap, natural gas, and electricity. These costs were set in world markets, and fluctuated based on economic conditions. Stelco was particularly exposed to cyclical spot steel prices; only 50 per cent of Stelco’s sales were hedged using forward contracts.
* Exposure to currency fluctuations: Being a Canadian-headquartered company, movements in the CAD versus the USD affected Stelco’s business. Overall, Stelco’s USD costs exceeded its USD sales, making Stelco a net purchaser of an average of US$175 million per year. On the revenue side, approximately half of Stelco’s sales were priced based on spot steel prices set in USD. During its most recent conference call, Stelco stated that the company did not use foreign exchange contracts to hedge sales.
* Rise of foreign steel imports: On October 4, 2003, the Canadian government announced its decision not to implement any safeguard tariffs on foreign steel imports, which had captured a 40 per cent domestic market share.
* Lower-cost competitors: In recent years, many North American steel companies exited bankruptcy with lower debt, labour costs, and retirement and environmental obligations.[[10]](#footnote-10) These competitors were operating more efficiently, placing Stelco at an estimated per-ton cost disadvantage of US$40–US$60.
* Work stoppages and strikes: Stelco and its subsidiaries were party to nine collective agreements, and 75 per cent of employees were unionized. Labour costs represented 25 per cent of Stelco’s total operating costs. These collective agreements were negotiated at the plant level. Work stoppages and strikes orchestrated by the unions had reduced Stelco’s profitability. While Stelco’s two integrated steel-making divisions both had labour agreements in place, the Stelco Lake Erie Works agreement was up for renegotiation in July 2004.
* Deficit in pension and other benefit obligations: As of the end of the 2002 fiscal year, Stelco’s defined benefit pension plan was in a $650 million deficit position, and its other benefits obligations were in a $1.1 billion deficit position.[[11]](#footnote-11) Cash contributions to the pension plan in 2004 were expected to be in the range of $60 million–$70 million, and cash post-retirement funding added another $40 million. Similar to other Ontario corporations, Stelco’s pension liabilities were partly insured by the provincial government’s Pension Benefits Guarantee Fund. The fund had recently paid out $300 million as part of Algoma Steel’s restructuring, leaving the fund with only $222 million in assets.
* Future CAPEX requirements: Stelco required an estimated $235 million in CAPEX to upgrade the hot-strip mill at Stelco Lake Erie Works and to construct a new pickling line at Stelco Hamilton Works.

****Priority in Bankruptcy And the FulCrum Security****

The key to any restructuring was to determine (1) the intrinsic value of the assets, (2) the order of priority for the settling of the different claims in bankruptcy, and (3) the potential payout to each class of claims. The payout was based on the “waterfall”—the cascade of cash paid out to the creditors and shareholders. While in theory the order of priority in bankruptcy was clear, in practice the determination of “who gets what” was the result of intense negotiations and legal proceedings by different stakeholders (see Exhibit 5 for a stylized example of the order of priority in bankruptcy and a hypothetical waterfall, illustrating how the liquidation of a company’s assets may result in some of the liabilities and equity being eliminated.)

As an investor in distressed companies, Quantum had the objective to ensure its claims were paid out at a higher price than the cost to acquire them. To control the process, Quantum would seek to establish a “negative control” position in a given class of securities, where negative control represented more than 33 per cent of the securities issued in that class. Most companies required a supermajority of votes (i.e., 67 per cent or greater) of each class of securities separately to approve important corporate events such as a restructuring. This voting requirement was stated in the corporate charter or by-laws. Controlling more than one-third of a given class of securities would grant Quantum a veto over any restructuring options, effectively allowing it to block any proposals that harmed its interests.

Quantum’s strategy would be to acquire a negative control position in the “fulcrum security”—the class of securities that would control the restructuring process. This class of securities would be mandated by the courts to come up with a restructuring proposal, thereby putting the owners of this class of securities in control. Typically, the fulcrum security was the most senior secured claim against the bankrupt company’s assets, which was held by the bank lenders or the bondholders. These parties would nominate one of their members to chair a creditor committee that would advise the court-appointed monitor overseeing the bankruptcy process. The creditor committee would make a proposal to the court on what percentage to pay each class of creditors over a specific period of time. The creditors would then vote to accept or reject the proposal, with a supermajority required to approve it. Identifying the fulcrum security was both legally and mathematically intensive, requiring both science and judgement.

****Stelco’s capital structure and Liquidity Position****

To identify the fulcrum security, Quantum’s team needed to understand Stelco’s capital structure and the different claimants—both creditors and shareholders—at the time of filing for bankruptcy. Stelco was financed through a combination of bank debt, loans, long-term bonds, convertible debentures, and common equity (see Exhibit 6).

Bank Debt and Loans

Stelco’s bank debt consisted of various lines of credit (“revolvers”) owed by the parent company and various subsidiaries, as well as a number of term loans. Stelco had recently negotiated a $322 million revolver with a syndicate of banks to provide credit to support the company’s operations.[[12]](#footnote-12) This revolver consisted of a $295 million line of credit facility led by CIT Business Credit Canada Inc. that matured at the end of September 2004, and $27 million in lines of credit for Stelco’s subsidiaries that matured between 2003 and 2004. The revolver was secured by a first charge (or claim) on Stelco’s receivables and inventory, and a second charge on the property, plant, and equipment of Stelco and its subsidiaries. Additionally, the revolver was secured by a second pledge of the shares of certain Stelco subsidiaries and liens against their assets. The average interest rate on the revolver was 5.36 per cent. As of September 30, 2003, $178 million was drawn on the revolver. By mid-November 2003, Stelco was in the process of negotiating a one-year extension, but these negotiations were complicated by the fact that Stelco’s wholly owned Quebec subsidiary, Stelco-McMaster Ltée., was in default on its line of credit facility. The banks had given Stelco a waiver until year-end 2003 to sort out the situation. Stelco had a total of seven term loans with various banks totalling $151 million. These loans matured between November 2003 and January 2008. Two of the term loans paid floating rates of interest. The remaining loans paid fixed rates of interest ranging from a low of 6.20 per cent to a high of 7.75 per cent. In addition, Stelco had borrowed $21 million from EDS Canada Inc. to finance a 10-year enterprise computer system, with repayment commencing in October 2004.

Bonds and Debentures

Stelco had two publicly traded bonds outstanding: $125 million of 8.0 per cent senior unsecured debentures that would mature in 2006, and $150 million of 10.4 per cent senior unsecured debentures that would mature in 2009. Stelco’s bonds had a several important covenants specified in the bond indenture, including a negative pledge on fixed assets. The bonds would trigger an event of default if Stelco missed an interest payment after a 30-day period. A note to the financial statements in the company’s *Annual Report 2002* stated:

Throughout the life of the Debentures, upon the occurrence of both a designated event and a rating decline, a holder of Debentures may require the Corporation to purchase all or any portion of such holder’s Debentures unless a rating recovery has occurred. For these purposes, designated event includes significant changes in ownership, control or structure of the Corporation or membership of the Board of Directors or certain distributions of cash, property, or securities excluding regular dividends and distributions of non-redeemable and non-retractable shares of the Corporation.[[13]](#footnote-13)

In January 2002, Stelco issued $90 million of 9.50 per cent convertible unsecured subordinated debentures that matured in 2007. These debentures were convertible at any time prior to maturity into Series A common shares, at the option of the holder, at a conversion price of $4.50 per share. Stelco had the option to repay the principal amount of the debentures, at redemption or maturity, in cash or by the issuance of shares to the holder.

Common Shares

Stelco had two classes of common shares traded on the TSX: Series A (ticker: STE.A) and Series B (ticker: STE.B). Each class of common shares was voting and was convertible into one another on a share-for-share basis. The two classes ranked equally in all respects except that the dividends on the Series B could be paid by way of a stock dividend, whereas dividends on the Series A were normally payable in cash. No dividends were declared or paid in 2002 or 2003. As of September 30, 2003, Stelco had 102,017,302 Series A shares and 231,901 Series B shares issued and outstanding. Stelco shares were widely held, with no single investor owning more than 10 per cent of the voting shares.

The holders of Stelco’s common shares had experienced a decade-long roller coaster ride, as the share values rose and fell. Having started above $20.00 per share in 1990, Stelco’s shares fell below $1.00 per share by the end of the 1990–92 recession. They recovered to a peak of $14.00 per share in 1998 before declining over the next five years to a low near $2.00 per share in October 2001. The shares then rallied above $6.00 per share by April 2002, before weakening to below $1.00 by the summer of 2003.[[14]](#footnote-14) Over this period, Stelco shares generated a total return of −10.4 per cent per year, similar to the TSX Metals & Mining index but far underperforming the TSX Composite Index at +6.6 per cent per year (see Exhibit 7).

The Quantum team noted that Stelco had adopted a shareholder rights plan (i.e., a so-called “poison pill”) in December 1998. This plan gave the board of directors and the shareholders time to consider the terms of any takeover bid and to allow more time for the board to pursue, if appropriate, other options to maximize shareholder value. The rights plan would be exercisable if any investor acquired beneficial ownership of 20 per cent or more of Stelco’s outstanding voting shares. This plan remained in place as of November 2003.

Liquidity Position

The Quantum team noted that Stelco’s liquidity position was deteriorating. The company had $159 million of available liquidity as of the third quarter of 2015, consisting of $15 million in cash and $144 million of unused capacity on its revolver. But Stelco had used $71 million of available liquidity over the past nine months, with more required by year-end. Stelco was scheduled to repay $50 million in long-term debt over 2004. EBITDA for the first nine months had been negative, and the company had recorded a loss of $168 million for the first three quarters of 2003.

DECISION

Both Peters and Martin suspected Stelco would file for bankruptcy protection imminently. If Quantum wanted to get involved in the restructuring, it would need to purchase a sizable stake in one or more classes of Stelco’s securities. The choice of which security to purchase was made challenging by Stelco’s multi-layered capital structure. Unless Peters and Martin could correctly identify the fulcrum security, Quantum would not be in a position to guide the restructuring. Another complication was how to treat Stelco’s $1.7 billion of pension liabilities. Would the courts include this off-balance-sheet liability in the restructuring? If it was included, all of Stelco’s common equity and most of its on-balance-sheet creditors would be eliminated. With no rule book to follow, Peters and Martin would need to trust their business instincts and negotiating skills to influence the outcome. Of course, they could always walk away from Stelco and wait for a better opportunity to invest their capital.

Exhibit 1: Stelco Inc. and its Subsidiaries

Stelco Inc. (Canada)

* Executive Management
* Corporate Affairs
* Financial
* Information Services
* Legal
* Raw Materials and Strategic Purchasing

Wholly Owned Subsidiaries

* Stelco Hamilton Works (A Division of Stelco Inc.)
* Stelco Lake Erie Works (A Division of Stelco Inc.)
* Norambar Inc. (Quebec)
* AltaSteel Ltd. (Alberta)
* Stelwire Ltd. (Canada)
* Stelfil Ltée. (Quebec)
* Stelpipe Ltd. (Canada)
* Stelco USA, Inc. (Delaware)
* Fers et Métaux Recyclés Ltée.

Partially Owned Subsidiaries—At Least 50 per cent Ownership

* Z-Line Company (Ontario General Partnership)
* Baycoat (Ontario Limited Partnership)
* Moly-Cop Canada (Ontario General Partnership—A Partnership of AltaSteel Ltd.)
* DC Chrome Ltd. (Ontario—A Corporate Joint Venture of Stelco Inc.)
* GenAlta Recycling Inc. (Alberta—A Corporate Joint Venture of AltaSteel Ltd.)

Joint Ventures (% Owned)

Iron Ore

* Wabush Mines, Newfoundland and Labrador & Quebec (44.6)
* Hibbing Development Company, Minnesota (24.1)
* Tilden Mining Company L.C., Michigan (15)
* Ontario Iron Company, Minnesota (10)
* Hibbing Taconite Company, Minnesota (6.7)

Other

* Z-Line Company, Ontario (60)
* Baycoat, Ontario (50)
* Moly-Cop Canada, British Columbia (A Partnership of AltaSteel Ltd.) (50)
* GenAlta Recycling Inc., Alberta (A Corporate Joint Venture of AltaSteel Ltd.) (50)
* DC Chrome Ltd., Ontario (50)
* Camrose Pipe Company, Alberta (40)
* Wabush Lake Railway Company Ltd., Newfoundland and Labrador (44.6)
* Knoll Lake Minerals Ltd., Newfoundland and Labrador (26)
* Northern Land Company Ltd., Newfoundland and Labrador (22.3)
* Twin Falls Power Corporation Ltd., Newfoundland and Labrador (7.6)

Source: Stelco Inc., *Annual Information Form*, 2003.

EXHIBIT 2: Stelco inc. PRODUCTION, Product Mix, and Sales, 2002

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  | **Capacity** | **Capacity** |  |  |  |
| **Steel Production** | **Location** | **(Tons 000s)** | **(%)** | **Products** |  |  |
| **INTEGRATED STEEL SEGMENT:** | |  |  |  |  |  |
| Stelco Hamilton Works | Hamilton, ON | 2,200 | 37.5% | Hot-rolled, cold-rolled, and coated sheet; plate, bar, and rod | | |
| Stelco Lake Erie Works | Nanticoke, ON | 2,670 | 45.5% | Hot-rolled sheet | | |
| **MINI-MILL SEGMENT:** | | | | | | |
| Stelco-McMaster Ltée. (Norambar Inc.) | Contrecoeur, QC | 630 | 10.7% | Billets, merchant, and special quality bar | | |
| AltaSteel Ltd. | Edmonton, AB | 365 | 6.2% | Merchant and special quality bar | | |
|  |  | 5,865 | 100.0% |  |  |  |
|  |  |  |  |  |  |  |
|  | **2002** | **2002** |  |  | **2002 Production** | |
| **Product Mix**  **(CA$ millions)** | **Sales** | **Sales** | **Customers:** |  | **Tons (000s)** | **%** |
| Hot-Rolled Sheet | $974 | 35% | Automotive |  | 1,685 | 36% |
| Cold-Rolled Sheet | $223 | 8% | Steel Service Centres | | 936 | 20% |
| Coated Sheet | $557 | 20% | Pipe and Tubular Products | | 702 | 15% |
| Plate | $111 | 4% | Construction, Manufacturing | | 1,357 | 29% |
| Bars and Wire Rod | $445 | 16% | Total |  | 4,680 | 100% |
| Wire and Wire Products | $195 | 7% |  |  |  |  |
| Pipe and Tubular Products | $195 | 7% |  |  |  |  |
| Other | $84 | 3% |  |  |  |  |
| Total | $2,784 | 100% |  |  |  |  |
|  |  |  |  |  |  |  |
| **Geographical Sales (CA$ millions):** | |  |  |  |  |  |
| Canada | $2,317 | 83% |  |  |  |  |
| United States | $420 | 15% |  |  |  |  |
| Other | $47 | 2% |  |  |  |  |
| Total | $2,784 | 100% |  |  |  |  |

Note: ON = Ontario; QC = Quebec; AB = Alberta

Source: Stelco Inc., *Annual Report 2002*, 2002.

EXHIBIT 3: Stelco inc.’s Financial STATEMENTS, 1999–2002

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **(CA$ in millions unless otherwise specified)** | **2002** | **2001** | **2000** | **1999** |
| **Consolidated Income Statement** |  |  |  |  |
| Net sales | 2,755 | 2,561 | 2,837 | 3,101 |
| Costs | 2,576 | 2,593 | 2,638 | 2,765 |
| Depreciation of property, plant, and equipment | 138 | 132 | 149 | 142 |
| Operating earnings (loss) | 41 | (164) | 50 | 194 |
| Interest on long-term debt | 43 | 49 | 55 | 57 |
| Other interest (income) expense—net | 5 | 4 | (7) | (13) |
| Earnings (loss) from continuing operations before income taxes | (7) | (217) | 2 | 150 |
| Income taxes—recovery (expense) | 10 | 39 | 2 | (43) |
| Net earnings (loss) | 3 | (178) | 4 | 107 |
| Earnings (loss) per common share ($ per share) | $0.03 | $(1.74) | $0.04 | $1.01 |
|  |  |  |  |  |
| **Consolidated Balance Sheet** |  |  |  |  |
| Cash and cash equivalents | 67 | 41 | 45 | 176 |
| Other current assets | 1,234 | 1,060 | 1,192 | 1,147 |
| Total current assets | 1,301 | 1,101 | 1,237 | 1,323 |
| Property, plant, and equipment (net) | 1,291 | 1,299 | 1,384 | 1,386 |
| Intangible assets (net) | 38 | 13 | 0 | 0 |
| Other non-current assets | 351 | 415 | 347 | 201 |
| **Total Assets** | **2,981** | **2,828** | **2,968** | **2,910** |
|  |  |  |  |  |
| Bank indebtedness | 145 | 76 | 43 | 6 |
| Other current liabilities | 556 | 587 | 571 | 614 |
| Total current liabilities | 701 | 663 | 614 | 620 |
| Long-term debt | 419 | 456 | 508 | 576 |
| Other non-current liabilities | 845 | 892 | 851 | 258 |
| Convertible debentures | 92 | 0 | 0 | 0 |
| Common equity | 924 | 817 | 995 | 1,456 |
| **Total Liabilities and Shareholders’ Equity** | **2,981** | **2,828** | **2,968** | **2,910** |

Source: Stelco Inc., *Annual Report 2002*, 2002.

EXHIBIT 3 (Continued)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **(CA$ in millions, except as otherwise indicated)** | **2002** | **2001** | **2000** | **1999** |
| **Consolidated Statement of Cash Flows** |  |  |  |  |
| **Cash from (used for) Operations (CFO):** | **(10)** | **69** | **75** | **224** |
|  |  |  |  |  |
| Expenditures for capital assets | (48) | (73) | (148) | (222) |
| Proceeds from sale of assets | 0 | 21 | 0 | 0 |
| Other investment activities (net) | 8 | 0 | 6 | 20 |
| **Cash from (used for) Investing (CFI):** | **(40)** | **(52)** | **(142)** | **(202)** |
|  |  |  |  |  |
| Increase (reduction) in bank indebtedness | 69 | 33 | 37 | (7) |
| Net proceeds from issue of long-term debt | 11 | 19 | 1 | 168 |
| Reduction of long-term debt | (87) | (70) | (64) | (64) |
| Net proceeds from issue of convertible debentures | 87 | 0 | 0 | 0 |
| Purchase or redemption of preferred shares | 0 | 0 | 0 | (67) |
| Net proceeds from issue of common shares | 0 | 0 | 0 | 3 |
| Purchase of common shares | 0 | 0 | (26) | (8) |
| Interest paid on convertible debentures | (4) | 0 | 0 | 0 |
| Cash dividends paid | 0 | (3) | (12) | (18) |
| **Cash from (used for) Financing (CFF):** | **76** | **(21)** | **(64)** | **7** |
| Net increase (decrease) in cash and cash equivalents | 26 | (4) | (131) | 29 |
| Cash and cash equivalents at end of year | 67 | 41 | 45 | 176 |
|  |  |  |  |  |
| **Other Data** |  |  |  |  |
| Return on average capital employed (%) | 1.1 | (6.7) | 1.5 | 6.2 |
| Return on average common shareholders’ equity (%) | 0.1 | (19.7) | 0.3 | 7.3 |
| Long-term debt/equity—% of total capital | 32/68 | 39/61 | 37/63 | 31/69 |
| Dividends declared—common (millions) | 0.00 | 0.00 | 12.00 | 13.00 |
| Common shares outstanding at year-end (millions) | 102.2 | 102.2 | 102.2 | 105.5 |
| Book value per common share ($ per share) | $9.03 | $7.99 | $9.73 | $13.80 |
| Average number of employees including joint ventures | 9,749 | 10,096 | 10,811 | 11,133 |
| Number of pensioners at year-end | 12,803 | 12,276 | 12,134 | 12,019 |
| Pensions paid during the year (millions) | 181 | 167 | 156 | 145 |

Source: Stelco Inc., *Annual Report 2002*, 2002.

EXHIBIT 4: Stelco inc.’s Operating Performance, January 1 to September 30, 2003

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  |  |  |  |  | 9 months ending |
|  |  | Q1 2003 | Q2 2003 | Q3 2003 | Sep 30, 2003 |
| **Tons Shipped (000s)** |  |  |  |  |  |
|  |  |  |  |  |  |
| Integrated Steel |  | 925 | 982 | 932 | 2,839 |
| Mini-mill |  | 125 | 161 | 158 | 444 |
| Manufactured Products |  | 116 | 115 | 115 | 346 |
| Total Tons Shipped |  | 1,166 | 1,258 | 1,205 | 3,629 |
| **Average Revenue & Cost per Ton** |  |  |  |  |  |
| Integrated Steel |  | $583 | $545 | $519 | $549 |
| Mini-mill |  | $448 | $435 | $443 | $441 |
| Manufactured Products |  | $845 | $826 | $835 | $835 |
| Average Revenue per Ton |  | $594 | $556 | $539 | $563 |
| Average Cost per Ton |  | $595 | $604 | $550 | $583 |
| **EBITDA (CA$ millions)** |  |  |  |  |  |
| Integrated Steel |  | $3 | ($56) | ($18) | ($71) |
| Mini-mill |  | $2 | $4 | $5 | $11 |
| Manufactured Products |  | ($6) | ($8) | $0 | ($14) |
| Total EBITDA |  | ($1) | ($60) | ($13) | ($74) |
| **EBITDA Margin** |  |  |  |  |  |
| Integrated Steel |  | 0.6% | −10.5% | −3.7% | −4.6% |
| Mini-mill |  | 3.6% | 5.7% | 7.1% | 5.6% |
| Manufactured Products |  | −6.1% | −8.4% | 0.0% | −4.8% |
| **Income Statement & CAPEX (CA$ millions)** |  |  |  |  |  |
| EBIT |  | ($35) | ($93) | ($47) | ($175) |
| Interest Expense |  | $12 | $13 | $14 | $39 |
| Net Income (Loss) |  | ($44) | ($82) | ($42) | ($168) |
| Capital Expenditures |  | $10 | $6 | $12 | $28 |

Note: Q = quarter; EBITDA = earnings before interest, taxes, depreciation, and amortization; CAPEX = capital expenditure; EBIT = earnings before interest and taxes

Source: Estimates of Quantum Investors Inc.

EXHIBIT 5: Order of Priority in Bankruptcy and HYPOTHETICAL Waterfall

The table below illustrates the difference between the book value of a company’s assets, liabilities, and equity as recorded on the balance sheet, and its value in a bankruptcy. The liquidation value of the assets is typically significantly lower than their book value. In this example, accounts receivable are worth only 60% of their face value, inventory 75%, other current assets 20%; and property, plant, and equipment 50%. Goodwill and other intangible assets are typically worth nothing. Thus, the liquidation value of total assets is half their book value. In bankruptcy, the payout of claimants cascades from the top to the bottom similar to a waterfall. The highest priority is given to current liabilities, followed by secured creditors and then unsecured creditors. Unsecured creditors are paid in priority based on the seniority of their claim, with senior unsecured paid before subordinated. Preferred shares are repaid next, ahead of common shares, which receive any residual amount. In this hypothetical example, the proceeds of the asset sales have raised insufficient cash to repay the full amount to senior debentures, which receive 43% of par value. Holders of subordinated debentures, preferred shares, and common equity are wiped out. This scenario may be worse if the company’s off-balance-sheet obligations, such as pension liabilities, receive priority over on-balance-sheet claims.

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | Book  Value | | Liquidation Value | | Order in Priority |  | Book  Value | | Value under Waterfall | | |
| **ASSETS** | **$** | **%** | **$** | **%** |  | **LIABILITIES AND EQUITY** | **$** | **%** | | **$** | **%** | |
| Cash and Marketable Securities | 50 | 100 | 50 | 100 | 1 | Accounts Payable | 15 | 100 | | 15 | 100 | |
| Accounts Receivable | 50 | 100 | 30 | 60 | 2 | Taxes Payable | 10 | 100 | | 10 | 100 | |
| Inventory | 200 | 100 | 150 | 75 | 3 | Bank Line of Credit (Secured) | 100 | 100 | | 100 | 100 | |
| Other Current Assets | 50 | 100 | 10 | 20 | 4 | Other Current Liabilities | 15 | 100 | | 15 | 100 | |
| Property, Plant, and Equipment | 350 | 100 | 175 | 50 | 5 | Senior Secured Bonds | 100 | 100 | | 100 | 100 | |
| Goodwill and Intangibles | 125 | 100 | 0 | 0 | 6 | Term Loans (Unsecured) | 100 | 100 | | 100 | 100 | |
|  |  |  |  |  | 7 | Senior Debentures (Unsecured) | 175 | 100 | | 75 | 43 | |
|  |  |  |  |  | 8 | Subordinated Debentures (Unsecured) | 100 | 100 | | 0 | 0 | |
|  |  |  |  |  | 9 | Preferred Shares | 50 | 100 | | 0 | 0 | |
|  |  |  |  |  | 10 | Common Equity | 160 | 100 | | 0 | 0 | |
|  |  |  |  |  |  |  |  |  | |  |  | |
| **TOTAL** | **825** | **100** | **415** | **50** |  | **TOTAL** | **825** | **100** | | **415** | **50** | |
|  |  |  |  |  |  | Off-Balance-Sheet Obligations | 200 | 100 | | 0 | 0 | |

Source: Created by the case author.

EXHIBIT 6: Stelco inc.’s Capitalization and Estimated Market Value, As of September 30, 2003 (in Ca$ millions)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | Notes | Book Value | Esti-mated Market Value | % of  Face Value |
| Drawn Lines of Credit (“Revolver”) with Banks |  | 178.0 | 178.0 | 100% |
| Term Loans, Maturing 2003 to 2008 | 1 | 151.0 | 151.0 | 100% |
| Computer System Financing at 9.1% Interest due 2012 | 2 | 21.0 | 21.0 | 100% |
| $125 million 8.0% Senior Unsecured Debentures due 2006 | 3 | 125.0 | 55.6 | 44% |
| $150 million 10.4% Senior Unsecured Debentures due 2009 | 3 | 150.0 | 66.8 | 45% |
| $90 million 9.5% Convertible Subordinated Unsecured Debentures due 2007 | 4 | 96.0 | 35.8 | 37% |
| Total On-Balance-Sheet Debt |  | 721.0 | 508.2 | 70% |
|  |  |  |  |  |
| Pension Benefit Plans—Plan Deficit (Surplus) | 5 | 650.0 | 650.0 | 100% |
| Other Benefits Plan—Plan Deficit (Surplus) | 5 | 1,073.0 | 1,073.0 | 100% |
| Total Off-Balance-Sheet Debt |  | 1,723.0 | 1,723.0 | 100% |
|  |  |  |  |  |
| Total On- and Off-Balance-Sheet Debt |  | 2,444.0 | 2,231.2 | 91% |
| Less: Cash |  | 15.0 | 15.0 |  |
| Net On- and Off-Balance-Sheet Debt |  | 2,429.0 | 2,216.2 | 91% |
|  |  |  |  |  |
| Shareholders’ Equity |  |  |  |  |
| Capital Stock (Series A 102.0 million shares outstanding;  Series B 0.2 million shares outstanding) |  | 781.0 | n.a. | n.a. |
| Contributed Surplus |  | 13.0 | n.a. | n.a. |
| Retained Earnings |  | (46.0) | n.a. | n.a. |
| Total Shareholders’ Equity | 6 | 748.0 | 123.0 | 16% |

Term loans are secured by assets of Stelco’s “various subsidiaries and joint ventures” and amortize on monthly, quarterly, or semi-annual installments.

10-year contract with EDS Canada Inc. to a maximum of $47 million over term. Repayment commences in Oct 2004.

Borrower is Stelco Inc.

Borrower is Stelco Inc. Convertible into Series A shares at $4.50 per share. Stelco Inc. can pay interest and principal by the issuance of shares provided there is no Event of Default.

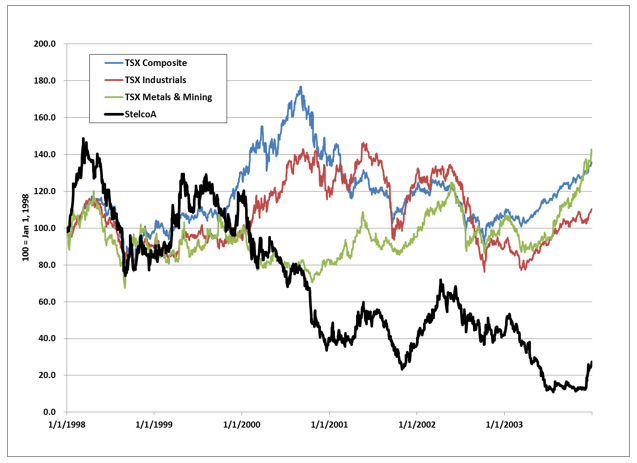
As of fiscal year ending 2002.

Based on the prices of the Series A and B shares traded on the Toronto Stock Exchange.

Note: n.a. = not available

Source: Stelco Inc. *Annual Report 2003*, 2003; Quantum Investors Inc. internal analysis.

EXHIBIT 7: Stelco inc. versus TORONTO STOCK EXCHANGE (TSX) Indices



Source: DataStream and case author’s calculations.

1. Background and research material has been provided by the case author. The completeness, interpretation, and accuracy of this information is the sole responsibility of the case author. [↑](#footnote-ref-1)
2. All currency amounts are in Canadian dollars unless noted otherwise. [↑](#footnote-ref-2)
3. Justice Laws Website, *Bankruptcy and Insolvency Act* (R.S.C., 1985, c. B-3), Government of Canada, accessed June 26, 2016, http://laws-lois.justice.gc.ca/eng/acts/b-3/; Office of the Superintendent of Bankruptcy, “Your Owe Money—Restructure Your Business through the *Companies’ Creditors Arrangement Act* (CCAA),” Government of Canada, accessed June 26, 2016, www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br03125.html. [↑](#footnote-ref-3)
4. Bruce Livesey and Nicole Mercury, “Rust Never Sleeps: Who Killed Stelco?,” *Report on Business Magazine*, *Globe and Mail*, September 29, 2016. [↑](#footnote-ref-4)
5. Stelco’s stock rose 12 per cent to $1.23 per share in heavy trading on the day following Alfano’s announced departure; Steve Erwin, “Stelco Shares Up on CEO’s Departure, but Analysts Wait for Cost-cutting Plan,” *Canadian Press*, July 29, 2003. [↑](#footnote-ref-5)
6. Peter Brieger, “Stelco–Restructuring,” *Canadian Press*, September 12, 2003. [↑](#footnote-ref-6)
7. Chapter 11 was a form of bankruptcy that involved a reorganization of a debtor’s business affairs, debts, and assets. [↑](#footnote-ref-7)
8. Steve Erwin, “Stelco Looks to Slash Labour, Pension Costs; Bankruptcy Protection Possible,” *Canadian Press*, October 22, 2003. [↑](#footnote-ref-8)
9. Julius Melnitzer, “Pensions: Corporate Powerhouses in Crisis,” *LEXPERT*,April 2004. [↑](#footnote-ref-9)
10. The U.S. Pension Benefit Guaranty Corporation (PBGC) had absorbed more than US$6 billion in pension liabilities from bankrupt U.S. steel companies. The three largest claims in the PBGC’s history were Bethlehem Steel Corporation, at US$4.3 billion; LTV Steel Corporation, at US$2.2 billion; and National Steel Corporation, at US$1.5 billion. [↑](#footnote-ref-10)
11. A defined *benefit* pension plan paid out to retirees based on a formula linked to years of service and average salary in their final years. This structure created large, long-lived liabilities for a company with aging employees. [↑](#footnote-ref-11)
12. Stelco had increased its revolver twice in 2003—a $25 million increase during the first quarter of 2003, and a $20 million increase on July 8, 2003. [↑](#footnote-ref-12)
13. Stelco Inc., *Annual Report 2002*, 2002, 39. [↑](#footnote-ref-13)
14. Douglas Goold, “Steely Resolve Needed to Cure the Troubles at Stelco,” *Globe and Mail*, August 4, 2003, accessed April 17, 2018, www.theglobeandmail.com/report-on-business/steely-resolve-needed-to-cure-the-troubles-at-stelco/article752107/. [↑](#footnote-ref-14)