Canadian steel industry on the verge of transformation, experts say

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TORONTO (CP) - Canada's steel industry is poised for more rapid change in the year ahead after clinging to the edge of its seat on a white-knuckled ride through much of 2005.

"The Canadian steel industry is going through one of the most dramatic changes of the last 50 years," according to New York-based steel consultant Michael Locker.

As 2005 drew to a close, Dofasco Inc. was the subject of a takeover battle, Stelco Inc. was finally nearing the end of its two-year restructuring and Algoma Steel was fending off an attempt by its biggest shareholder to force it into making a massive cash payout.

The industry was tossed on a sea of uncertainty in 2005 after steel prices hit all-time highs at the end of 2004, creating "a new steel era," Locker said.

"China's demand is driving the ship. Consolidation is the name of the game. Prices have a new plateau. Raw materials are much more expensive."

A few years ago, dozens of North American steelmakers were tumbling into bankruptcy proceedings. Then came China, whose rapid development has given the industry whiplash.

While steel prices have fallen since their unprecedented highs of late 2004, observers believe 2005 proved that the bottom of the price cycle has risen.

"The days of $250 US a ton steel are gone," said steel analyst Randy Cousins, of BMO Nesbitt Burns, adding it's impossible to predict steel prices for 2006. His best estimate was somewhere between $400 and $600 US per ton.

Cousins said he's never in 20 years seen so many pricing factors in such constant flux. Basically every steel input has become more expensive, he noted.

Stelco CEO Courtney Pratt said what was already a volatile industry became even more so in 2005.

"The extent and the speed of changing in pricing has been enormous and the level of unpredictability has been enormous."

Denis Turcotte, chief executive of Canada's No. 3 steelmaker, Sault Ste. Marie-based Algoma, said he believes markets will be strong going forward, but "will ebb and flow."

"In September of 2004, pricing was north of $800 a ton," said the CEO. "By August 2005, it was about $410. That's a $400 a ton drop."

But it was a far cry from historical lows. And August proved to be the bottom of the cycle, with prices rising by $100 a ton in September and remaining strong.

Turcotte hesitated to declare a "new normal" for the industry - "I would never use the word permanent to describe anything" - but he's confident the extended bull run has been based on real changes.

"If you look at the last 20 years, you constantly had demand chasing supply. You always had more supply at any point in time than you needed," he said.

"We're now in a period where it's the opposite. Supply is chasing demand because you've got a higher level of consumption globally. The net result should be higher average trend line pricing going forward."

The new pricing allowed Hamilton-based Stelco to earn $47 million in the first nine months of 2005 as it waded through the bankruptcy protection process it began in January 2004.

It also delayed restructuring negotiations.

"That huge runup in steel prices changed the nature of this restructuring from a group of people looking at concessions, to people looking at 'how do I maximize my gains from this restructuring?,' " said Pratt. "That makes it very, very difficult to get a deal done."

Stelco abandoned the hunt for concessions from its workforce and found new financing it hopes will allow it to emerge from protection in the next couple months.

As bottom lines across the industry flourished, many other steel CEOs faced new problems.

Take Algoma: New York-based Paulson & Co., which has a 19 per cent stake in the company, is trying to force a payout of hundreds of millions of dollars to shareholders and wants its board replaced.

Paulson criticized Algoma for sniffing around Stelco at the beginning of 2005. The hedge fund said Algoma wasted substantial time and money pursuing Stelco when prices were hot.

Turcotte denied that and hints that a wedding between Stelco and Algoma could still be a possibility.

"I strongly disagree with Paulson that it was the wrong thing to do," Turcotte said. "It was absolutely the right thing to do."

"We gained an understanding of what we needed to understand to position ourselves if and when it becomes of interest to us in the future. We accomplished that."

In March, Stelco tossed out its sale process after a handful of offers and began searching for new financing.

Meanwhile, Algoma put itself on the auction block, taking itself off this summer, when Turcotte said some suitors were interested but none were willing to pay enough.

"When we ran our (sale) process, within about three or four weeks, the price of steel started to drop quite aggressively," Turcotte said. "The notion of putting out $1 billion or more to do an acquisition in a falling market is something that not a lot of people are prepared to do."

Now that August appears to have hit the pricing trough, "the consolidators" have regained confidence, Turcotte said.

"I think as we go through these ebbs and flows successfully as an industry, confidence will grow and people will circle back and say 'maybe we should take another look at this.' "

Algoma has agreed to hold a shareholder meeting in March to hear Paulson's proposal.

The proxy battle would not have arisen in the absence of a healthy steel market, Turcotte said. At the end of September, Algoma had about $450 million cash on hand, even after coughing up $238 million in special dividends in August.

"You've got these huge net profit margins we've been generating, huge amounts of free cash flow," Turcotte said. "It builds up on the balance sheet at a rapid pace."

"As we've shown through our behaviour, we believe that for the time being, we should continue to focus on small investments that continue to shore-up and improve the business, as opposed to blowing our brains out on some massive billion-dollar expenditure."

This year's steel blockbuster news was the wooing of Dofasco Inc., Stelco's more profitable next-door neighbour, considered a jewel in the North American industry.

In May, the world's second-biggest steelmaker, Arcelor SA, teamed up with American giant Nucor to approach Dofasco.

The company played hard to get and on Nov. 23 Arcelor publicly announced a hostile $56-per-share bid. It's not known what happened to Nucor's interest.

Within days, Dofasco's board endorsed a $61.50-per-share white knight offer from German steel conglomerate ThyssenKrupp. Dofasco shareholders have until Jan. 10 to tender to that offer.

The interest in Dofasco created a sudden interest in the equity Stelco will issue once it emerges from court protection.

In early December, Stelco won much-needed creditor support when it changed its restructuring plan to give unsecured creditors a chance to get more of the yet-to-be-issued shares.

But some people involved with Stelco said it's only a matter of time before it's gobbled up by another steelmaker as the industry continues to consolidate.

"I predict Stelco will be bought by an international player," Locker said.

Pratt himself acknowledges the possibility.

"At some time in the future, with the consolidation trend that we're seeing, and as Stelco continues to improve and be a better performer, I would be surprised if we didn't get approaches," he said. "I think the issue is when."