AP CAPITAL RESEARCH

M&A Deal of The Week

NIPPON STEEL X U.S. STEEL

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Executive Summary

M&A DEAL OF THE WEEK

Deal Summary

- On Monday, 18th of December, Japanese Steel manufacturer Nippon Steel (TSE - 5401) announced that it had decided to acquire American Steel giant U.S. Steel (NYSE - X) for $14.9 Billion in an all-cash transaction. U.S. Steel stock rose 28% following the release of this news.
- This deal is for $55 a share, which amounts to a premium of 40% when compared to Friday's closing price of $39.51.
- The rationale behind this is that Nippon wants to increase production in the U.S. as steel prices are predicted to rise, fuelled by the increase in demand for electric vehicles.
- This deal came after U.S. Steel rebuffed an offer for $7.9 billion by industry rival Cleveland-Cliffs in August, although U.S. Steel was actively looking for a buyer.
- This deal is expected to make Nippon Steel the second-largest company in Global Steel Production.
- The deal is expected to close in Q2 or Q3 of 2024 and is expected to be accretive to EPS.

Deal Advisors

Nippon Steel:
Financial Advisor: Citibank

U.S. Steel:
Financial Advisors: Goldman Sachs, Evercore and Barclays Capital

Key Figures

- Offer Premium: 40% [$55.00/share]
- Nippon Market Cap: $21.4 billion
- Nippon (FY March 2023) Net income: $5.2 billion
- U.S. Steel Market Cap: $10.7 Billion
- U.S. Steel EV: $14.9 Billion
- U.S. Steel EV/EBITDA: 5.2x

Company Information

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Nippon Steel Corporation (TSE - 5401)

- Nippon Steel was formed by a merger between Yawata and Fuji Iron & Steel in 1970. They are currently Japan's largest steel producer, with 65 million tonnes (Mt/Y) of steel produced annually. - They have four business segments: Steelmaking, Chemicals, Engineering and System Solutions, and they operate in over 15 countries with over 83,000 employees globally. Nippon Steel has been vital to Japan's economic development post-World War II.
- In the past few years, Nippon has faced challenges such as remaining competitive with China and reducing its carbon footprint, forcing it to look for growth abroad and seek more sustainable steel recycling solutions.
- For 2023 (FY ending March), Nippon Steel brought in a net income of $5.26 billion, up 10% from 2022's $4.75 billion. The growth was due to Nippon's implementation of profit-oriented strategies such as streamlining production, upgrading facilities, and improving direct contract-based sales.
- Their most recent 2023 earnings yielded an EBITDA of $1.73 billion, an increase of 21% from 2022's $1.43 billion. This resulted in an EPS of $0.95, putting their current P/E at 4.8x, which is low compared to the industry average of 8.5x among peers and rival companies.
- EPS should increase in 2024 as this acquisition is expected to be accretive to EPS.

U.S. Steel (NYSE: X)

- Founded in 1901 by J.P Morgan and Andrew Carnegie, United States Steel was America’s first billion-dollar business in 1901. Headquartered in Pittsburgh, Pennsylvania, they focus on converting upstream resources such as raw materials into downstream products, allowing them to profit from the control of both upstream and downstream. They primarily operate in the US but also in Europe.
- In recent years, foreign competition has challenged US Steel to remain competitive, which has led to US Steel shares declining by more than 24% over the last 5 years, prompting the company to look to create value for shareholders through this acquisition.
- 2023 Q3 earnings for United States Steel yielded an Adjusted EBITDA of $578 million, down 33% from 2022 Q3 and adjusted net earnings of $350 million, down from $490 million. This equalled an EPS of $1.40, which led to a P/E of 23x, placing them in the 94th percentile compared to other firms.

Deal Rationale

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Potential growth and diversifying risk

- **Reasons Behind Acquisition: Expected Rise in Steel Prices**
  - Recent settlement of strikes with trade unions expected to boost automaker production.
  - Increased vehicle production requires substantial steel, driving demand.
- **U.S. Steel's Attractiveness as Takeover Target**
  - After recently settling strikes with trade unions, automakers are set to ramp up production of vehicles, which requires a significant amount of steel to produce.
  - U.S. Steel's declining market cap makes it an appealing target for competitors.
  - U.S. Steel, with its focus on steel production for the Automotive and Renewable Energy sectors, presents an appealing opportunity for companies looking to broaden their portfolio.
- **Diversification and Risk Reduction for Nippon Steel**
  - Nippon Steel is heavily reliant on Asia's macroeconomic conditions (60% revenue from Japan, 82% from Asia).
  - Acquisition of U.S. Steel diversifies risk, reduces reliance on domestic markets, and enhances resistance to economic shocks.

Regulatory Concerns

- **Main Acquisition Risk: Political Opposition**
  - US lawmakers near U.S. Steel’s operations express hostility towards the acquisition.
  - Democratic Senator John Fetterman vows to block foreign sale.
  - President Biden’s economic adviser, Lael Brainard, calls for serious scrutiny and an investigation into this acquisition.
- **Concerns About Collective Bargaining Agreements**
  - Sale to a foreign buyer raises fears of disregarding existing union agreements.
  - Biden initiates investigation due to potential issues with honoring collective bargaining agreements.

Industry Analysis

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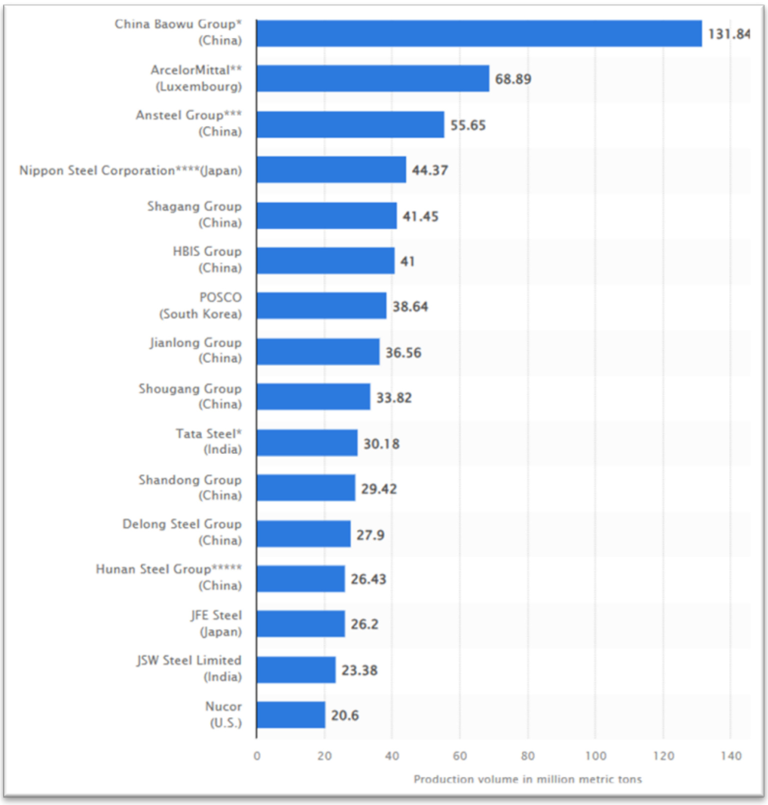
Steel Industry

In 2022, the Steel Industry was dominated by Chinese firm Baowu Group as shown on the graph below. Global Steel Production is heavily controlled by Asian-based firms, with the exception of ArcelorMittal from Luxembourg. This is primarily due to the cheaper price of labour in these countries and the lack of labour legislation, therefore reducing labour costs.

The largest 15 Crude Steel producers by production volume



- Regarding demand for finished steel products, 70% is from Asian and Oceanian countries, with only 7.7% from North America. Europe only accounts for 10.8%.
- When comparing Steel production outputs, Nippon Steel is currently 4th in the world. After the acquisition of U.S. Steel, they are expected to increase their output capacity to 86 Mt/Y, making them the second largest steel producer in the world compared to other firms in the industry.
- World crude steel production has risen 20% over the last decade, with a 6% fall in 2022 due to Covid. Global Steel demand is forecasted to grow by 1.7% in 2024 due to the steady rise in EV demand.

Steel Industry Challenges

- Steel production is a carbon-intensive industry that utilises coal as its energy source in the blast furnace to produce steel. The use of coal in steel production contributes to 7-9% of global emissions and has a carbon emission intensity of 1.41 tons CO2/tons Steel, which is well below the Net Zero Emission 2030 target of 1.07 t CO2/t Steel.
- According to the IEA, Total CO2 emissions from steel production have risen over the past decade due to the increase in Steel demand.
- Nippon plans to reduce Scope 1 & 2 CO2 emissions by 30% compared to their 2013 levels [102 million tons/year] by adopting hydrogen steelmaking that will create a by-product of water.

Final Thoughts

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If US regulators don't block this acquisition, this deal should prove to be fruitful to Nippon as this acquisition gives them deeper market penetration into their current US and European markets and allows them to capitalise on any expected Steel price increases. Furthermore, this deal will assist in reducing Nippon's dependence on domestic markets, as during 2022, 70% of its revenue came from Asia.

During 2022, Japan also experienced a very volatile price fluctuation in the Yen, which may have caused Nippon to look for external growth opportunities to help diversify their business and help them grow revenues internationally, leading them to make this acquisition.

However, Nippon is rather significantly overpaying for United States Steel as a 40% premium, or a 142% premium based upon their stock price in August, is very steep for a company in a mature industry like the steel industry.

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