Japan
AsiaView

February 6, 14

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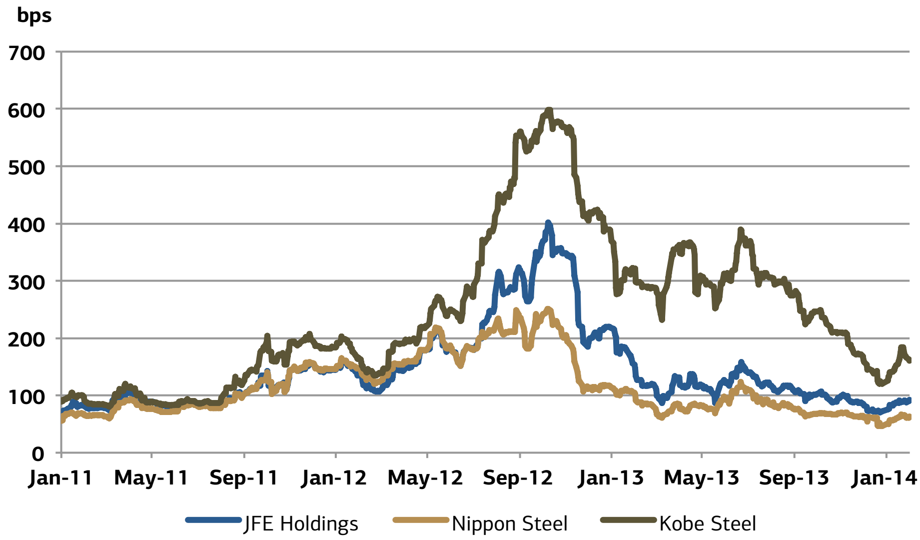
Companies discussed

JFE Holdings (5411 JT)
Nippon Steel and Sumitomo Metal (5401 JT)
Kobe Steel (5406 JT)



Source: Bloomberg

Japanese steel CDS premiums have fallen as a result of Abenomics-driven Yen depreciation. But what would happen if the Yen were to appreciate?

Japanese steel CDS: a cheap way to play a China downturn

+ Abenomics has temporarily saved Japanese steel companies

Massive Yen depreciation has provided relief to the companies' Yen-denominated cost structures.

+ Heavily leveraged, with falling export volumes

The Japanese steels are highly leveraged. Despite Yen depreciation, their export volumes continue to fall. Yen appreciation would smash exports.

+ Using CDS as a proxy for a China slowdown

Japanese steel CDS are correlated with Chinese bank CDS and spiked during China's June 2013 interbank funding debacle. They are a potentially cheap way to express a China slowdown view.

KEY POINTS

1. Japanese steels are a China risk proxy
2. Abenomics has temporarily saved these weak companies

By Kevin Yeoh

Buying the CDS of Japanese steel companies is an indirect way to position for a China slowdown. A financial crisis in China would likely see the RMB depreciate and the Yen appreciate, putting the export-focused Japanese steel companies under pressure and exposing the soft underbellies of these companies. In addition, Chinese steel demand would collapse, sending export steel prices south, further hurting the Japanese steels.

The Japanese steel sector has been a key beneficiary of Abenomics. In 2012, the companies were in the doldrums. Heavily leveraged, at the top end of the cost curve and facing a regional supply glut, companies like JFE Holdings ("JFE"), Kobe Steel, and Nippon Steel & Sumitomo Metal ("Nippon Steel") faced a bleak future.

Then along came Abenomics. Massive Yen depreciation saved these companies as exports were over 50% of their sales and their Yen-denominated cost structures were suddenly more competitive.

The stock prices have basically been leveraged FX plays. Prices have doubled or tripled from September 2012 lows.

- JFE (current price JPY 2,023) has more than doubled from its September 2012 low of JPY 964.
- Nippon Steel (current price JPY 296) almost doubled from a price of JPY 148.
- Kobe Steel (current price JPY 145) has almost tripled in price from its September 2012 low of JPY 57.

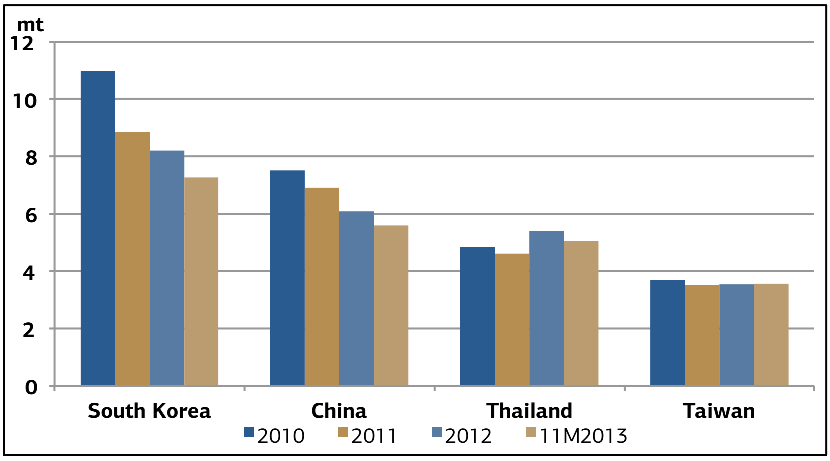
➲ Abenomics has papered over the cracks in the Japanese steels. They are fundamentally very weak.

But Abenomics has simply papered over the cracks. These companies are fundamentally very weak. A China slowdown would likely expose these weaknesses.

Losing market share, including in Thailand

Japanese steel exports have been losing market share. Volumes to key Asian markets have been falling (Chart 1), while Chinese special steel exports to Korea and Taiwan have been growing (Chart 2). Special steel is a key product category for Japanese steels, so it's instructive that China is taking share in this market. In particular, Chinese special steel exports have now overtaken Japan in the key auto production market of Thailand (Chart 3).

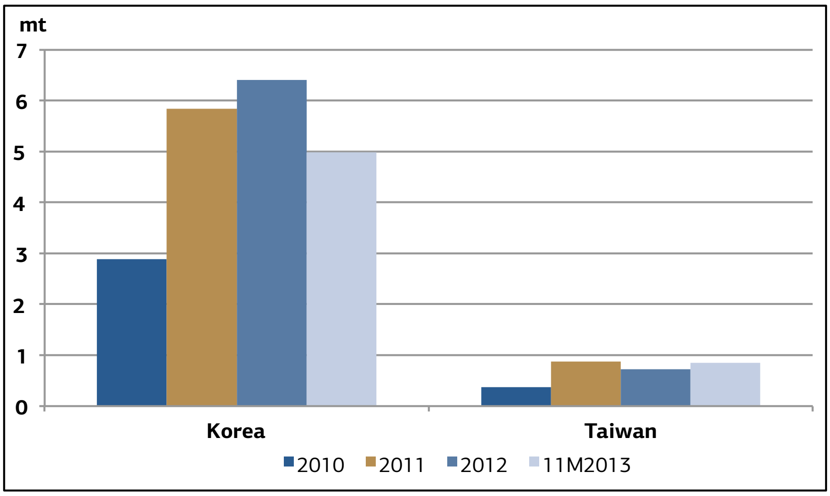
Chart 1. Japanese steel exports have been falling



Source: MySteel, J Capital Research

➲ Japanese exports have been falling, while Chinese exports have been rising.

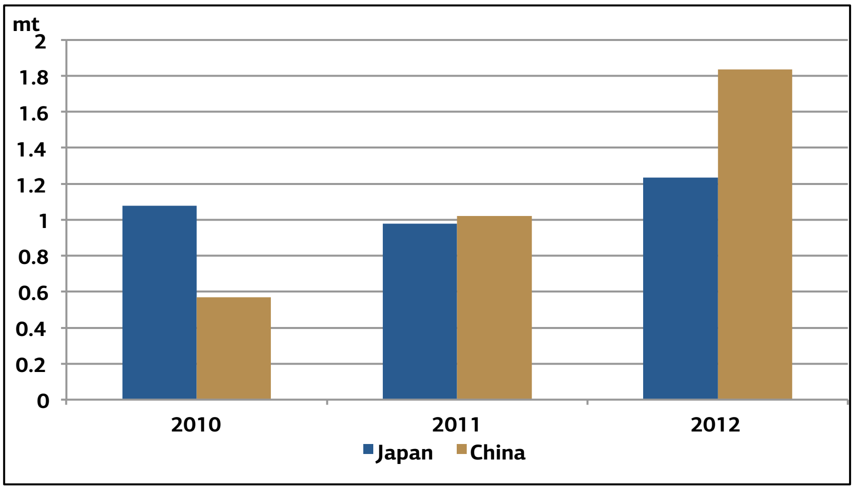
Chart 2. Chinese special steel exports: increasing



Source:

MySteel, J Capital Research

Chart 3. Chinese special steel exports have overtaken Japanese exports in Thailand

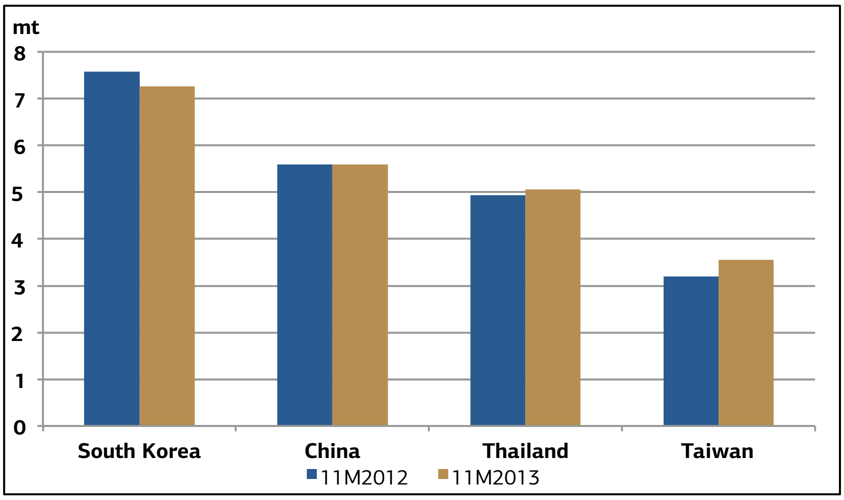


Source: MySteel, J Capital Research

Yen depreciation hasn't increased sales

Yen depreciation in 2013 hasn't led to higher export volumes. Chart 4 shows the year-on-year comparison for Jan-Nov 2013 vs 2012. Exports to South Korea fell, China was flat, while Thailand and Taiwan saw marginal increases. If anything, Yen depreciation has merely resulted in Japanese export volumes keeping their heads above water. Yen appreciation would likely see these export volumes fall precipitously.

Chart 4. Japanese export volumes 2012-2013



Source: MySteel, J Capital Research

High leverage, very sensitive to Yen movements

The Japanese steel companies are highly leveraged. Kobe Steel is the most heavily geared with Debt / Equity of 168% and Net Debt / Equity of 148% (Table 1). Debt coverage is also weak with Total Debt 6x EBITDA.

➲ Still high leverage.

JFE and Nippon Steel also have very high Net Debt / Equity ratios, though both companies have benefited from Abenomics, with their leverage ratios falling – but we're still talking about net leverage of 88% for JFE and 72% for Nippon Steel. Nippon Steel's debt coverage is the strongest of the 3 with Total Debt 4.3x EBITDA.

Table 1. Japanese steels still highly leveraged

Debt ratio	JFE Holdings	Nippon Steel	Kobe Steel	POSCO	Baosteel
2012					
Debt / Equity	109%	91%	141%	60%	23%
Net Debt / Equity	104%	87%	125%	49%	19%
Debt / EBITDA (x)	5.9	6.7	4.5	4.3	3.1
31 Dec 2013					
Debt / Equity	91%	75%	168%*	61%	**
Net Debt / Equity	88%	72%	148%*	51%	**
Debt / EBITDA (x)	5.7	4.3	6.0	4.8	**

Source: Company reports, J Capital Research

* Sep 31, 2013 results. Dec 31, 2013 not yet available.

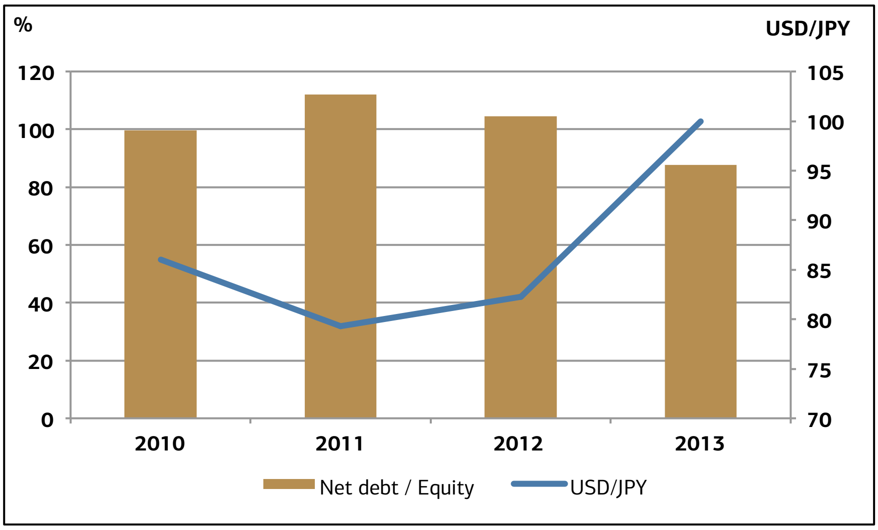
** Dec 2013 results for Baosteel not yet released.

Chart 5 shows how JFE's net gearing has changed with Yen exchange rate movements. In 2010, USD/JPY averaged 86 and JFE's net gearing was 100%. When the Yen appreciated in 2011 to 79, JFE's net gearing also increased to 112%. 2012 saw JFE's net gearing fall after the Yen depreciated.

With the 20%+ Yen depreciation in 2013, JFE's net gearing also saw its largest drop to 88%.

Therefore, a strong appreciation of the Yen would likely see JFE's gearing increase.

Chart 5. JFE Holdings Net Debt / Equity moves with the Yen

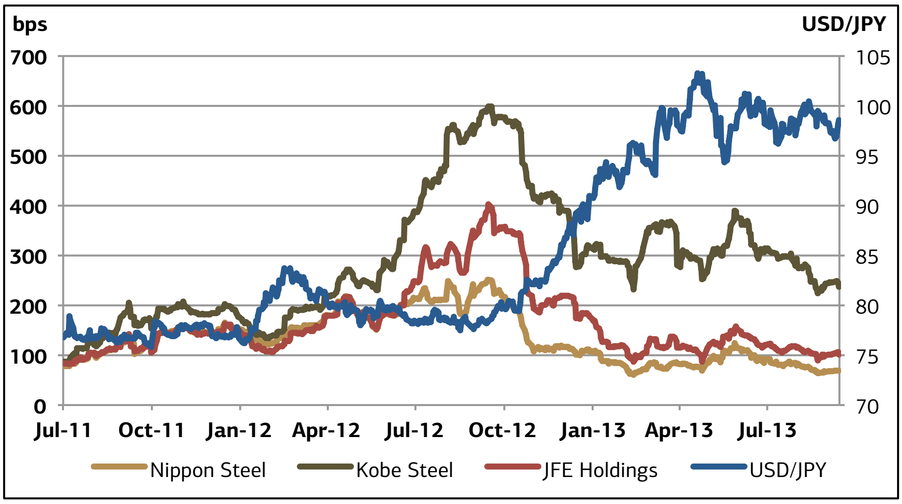


Source: Company reports, J Capital Research

Yen depreciation lowered CDS premiums

The impact of Yen depreciation can be seen in Chart 6. When the USD/JPY depreciated from 80 to 100 over the Oct-2012 to Apr-2013 period, the CDS premiums of Kobe Steel, JFE and Nippon Steel all halved – Kobe fell from 600bps to 300bps, JFE fell from 400bps to 200bps and Nippon Steel fell from 200bps to 100bps.

Chart 6. CDS premiums halve on Yen depreciation



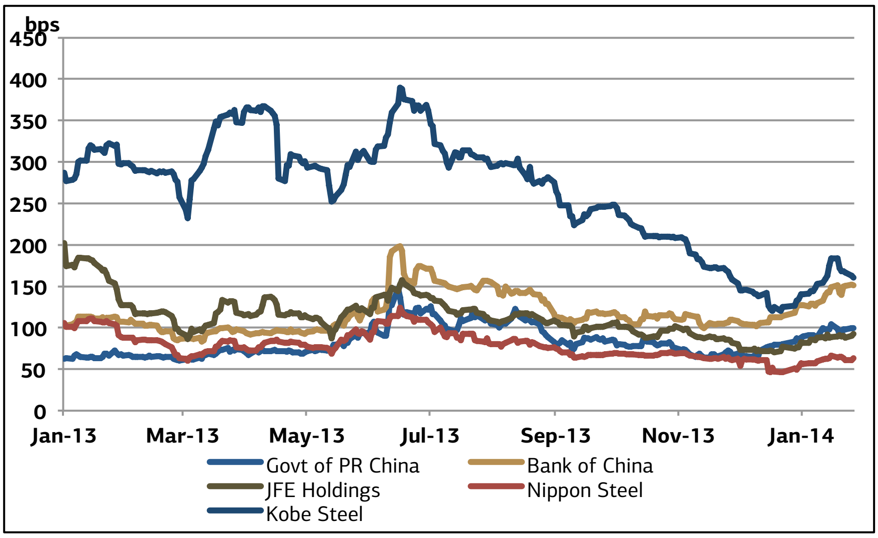
Source: Bloomberg, J Capital Research

Chinese banks and Japanese steel CDS correlation

Japanese steel CDS also appear to have a strong correlation with Chinese bank CDS. In particular, during China's June and December 2013 interbank funding spikes, the Japanese steel CDS replicated the rise in the CDS of the Chinese Government and the Bank of China.

It is this correlation which suggests the Japanese steel CDS are a good proxy for playing China financial risk events.

Chart 7. Japanese steel CDS also spiked during China's June 2013 interbank funding debacle



Source: Bloomberg, J Capital Research

CDS hedge

Long JFE Holdings and Nippon Steel & Sumitomo Metal CDS <100bps; Kobe Steel < 120bps

The Japanese steel CDS hedge

LONG five-year Credit Default Swaps of JFE Holdings below 100bps; Nippon Steel and Sumitomo Metal CDS below 100bps and Kobe Steel below 120bps.

In a China slowdown we think the following scenario will occur:

- RMB depreciates. Yen appreciates. Japanese steel export prices and cost structure become relatively more expensive.
- Export steel prices fall due to a collapse in Chinese demand. Falling Chinese demand will have 2nd-order impacts on South Korean and Japanese automakers and further crimp demand for Japanese steel.
- Iron ore price falls in USD terms (favorable to Japanese steels).

We believe that in the long term a China slowdown could be favorable to the Japanese steels, as Chinese steel overcapacity will recede. A lower iron ore price will also provide cost relief.

However, the challenge for the Japanese steels will be surviving the short-term fallout. The band-aid solution of a cheap Yen will be ripped off, accentuating their already declining export volumes and re-exposing their highly leveraged business models.

Trade risks

- **Japan doubles-down on Abenomics**: If the effects of Abenomics begin to wear off, it is possible that the Japanese Government will print even more money. This is a key risk. Accurately forecasting the dynamics of Japanese politics is a challenge.
- **Continued Yen depreciation** would provide a life-vest for the Japanese steels.
- **No China slowdown**. We think a China slowdown is inevitable, but i) we could be wrong, or ii) the Chinese government's fixed asset investment addiction could continue keeping the boat afloat.
- **Japanese steels improve their cost structures and deleverage**: We think this is unlikely to happen given that these companies have been heavily leveraged for over 10 years. In 2004, JFE Holdings' Debt/Equity was 236%, Nippon Steel's was 151% and Kobe Steel's was 255%. The Japanese steels have found it hard to lower their heavy debt burdens.
- **Iron ore price collapses independent of a China slowdown**: This would provide cost relief. We think it's an unlikely scenario.

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