Can Enron Succeed as Steel's Market-Maker?

Enron Corp., a financial force in energy and other commodity markets, hopes to spark a sea change in steel.

BY CORINNA C. PETRY, MANAGING EDITOR

Although experts see appeal in Enron Industrial Market's offer of risk management and financing tools for the steel industry, they predict Enron faces an uphill battle in its quest to become steel's market maker.

Enron Corp., which reported revenues of $101 billion last year, markets electricity, natural gas and broadband communications, and delivers physical commodities and financial risk management services to customers around the world. It hopes to do the same for buyers and sellers of steel.

Enron Industrial Markets President Jeff McMahon, addressing members of the Steel Service Center Institute during their annual meeting in May, listed 10 reasons Enron has targeted the steel industry.

"No. 1, we see inherent price instability as a good thing because Enron's core competence is managing price risk."

Service centers, he said, have price exposure when buying at a fixed price from the mill. Often, by the time the material arrives, its value has decreased, and the company loses money on that inventory.

"What Enron can do [No. 2] is take

that price risk, that six-week lead time, away from the service center. We give the service center the fixed price it had to pay the mill. In return, the service center pays Enron the then-market price of steel that his customer takes away. So what's left to the service center is the conversion fee. That's what the market is really paying the service center to do—add value to a commodity product," McMahon said.

No. 3, Enron believes the industry operates with an "extremely dysfunctional distribution system. It's inefficient; it's archaic. It asks the service center to hold all the price risks. Service centers, frankly, are the least likely player in the value chain to be able to manage prices. That's a flawed structure," he said.

Instead, Enron proposes to hold physical inventory and price risk for the service center. "We intend to provide just-in-time delivery of physical commodity steel products to your customer in certain key geographic areas. That allows us to pass some of the capital cost savings on to the customers as well as remove, reduce or eliminate their price risks," McMahon said.

Reason No. 4 is "suppliers are undependable. The market is in financial stress. The producer segment will undergo restructuring over the next three to five years. We think Enron's strong balance sheet and good reputation for customer service in other industries should help us compete very effectively in this environment against existing suppliers."

The fifth reason is asset valuations. "Let's face it. The steel industry is the poster child for the old economy. Producers' valuations have clearly suffered." Enron believes this valuation situation provides enormous up-side potential beyond merely returning capital to investors.

No. 6, the steel market is fragmented. "This is a place where scale should matter and no one really has big scale. No one has pricing power. There are price takers; there are no price makers out there at all."

The largest supplier has a 10 percent market share, while the largest consumer has 5 percent or less, McMahon said, which gives his company the ability to build scale and bring some efficiencies to the distribution channel.

Enron will do that by creating liquid markets in both physical and financial steel products in certain regions, starting with hot-rolled and cold-rolled sheet inventory at depots in Chicago, Cleveland, Houston and Los Angeles.

The steel industry operates with an "extremely dysfunctional distribution system. It asks the service center to hold all the price risks. Service centers are the least likely player in the value chain to be able to manage prices."

Jeff McMahon
Enron Industrial Markets

The seventh reason is the scarce availability of capital to the steel industry. Enron provides capital in the form of debt, inventory financing, equity investments for preferred stocks, senior loans, etc., to the energy industry around the globe, and could do the same for steel.

"Most of the capital has fled the steel industry. What little is left is expensive. If you've done a bank deal recently, you'll find they want covenants on just about everything they can get their hands on," McMahon said.

For its service center customers, Enron will offer to retain legal title to inventories in their warehouses. Enron will own the steel as it sits on the shelf, and then transfer the title to the service center when the material is pulled out of inventory for processing. "Most bank facilities probably advance 50 cents on a dollar toward financing inventories. Our product provides much closer to 100 cents on a dollar."

Enron's eighth reason is the producer segment's "blatant disregard" for service center customers. The mills' most valued customer, the auto industry, is actually their worst customer, he said. In a falling market, the carmakers expect their supply contracts to be renegotiated; in a rising market, the mills are stuck with the contract. "Yet those are the customers they seem most concerned about. Mills, in our experience so far, have really seen this [distribution] segment of the industry as more of an annoyance than anything else," McMahon charged.

No. 9, Wall Street has forgotten the steel industry, and there are bargains aplenty to be had. Enron wants in before the industry restructures and the market recovers, in order to exploit opportunities inherent in a recovery.

Lastly, he said, "The best reason we have to be in the steel market is that most existing suppliers don't want us here. To us, that's probably the clearest sign that there is real opportunity."

Market-making fundamentals

In a recent interview with *Metal Center News*, McMahon says Enron Industrial Markets expects to move up to 3 million tons of product by the end of the year. He declined to name either suppliers or buyers, saying it would violate confidentiality agreements.

"We have done business with the whole spectrum, except for automakers, but the majority of our transactions to date, on the sell side, have been with service centers."

Enron believes its value proposal is unique. "Can anyone buy hot-rolled? Sure. Can anyone buy hot-rolled, fixed tonnage at a fixed price, three years forward? And I mean *firm* price, where both parties need to perform or there are liquidated damages associated with it?" McMahon asks. "That's a little tougher to find in the industry, and Enron will offer that."

Those who register on Enron Online's steel site (*www.enron.com*) can get monthly, quarterly and annual prices for hot-rolled and cold-rolled sheet in coil. It's not a price list, McMahon says, adding, "I want to differentiate from what Nucor did 15 years ago. It's not a list price that *begins* a negotiation. It is *the* price, at that second in time, at which we're willing to sell or buy hot-rolled or cold-rolled steel for delivery."

McMahon declined to reveal how much money Enron has invested in its steel business, but says, "We have about 100 people dedicated to the steel effort so far. That's predominantly in Houston, but we do have an effort under way in London for the European market." He expects Enron's steel employment level to double over the next year. "The size of these markets and the amount of activity we anticipate will require us to have a pretty sizable trading and sales force."

Enron gathers market intelligence to make the most appropriate pricing decisions and disseminates that information to its traders and their customers. A market fundamentals group within the steel group works to understand which mills are producing what product, what capacity they are utilizing, industry inventory levels, imports and the effects of antidumping rules, where cargoes are on the water, and other logistical constraints, McMahon explains. The data are gathered daily and fed to the trading desk.

"Market fundamentals are very important in the way product is priced. If a mill shuts down for maintenance, and a 1-million-ton mill is out for two months, that should impact prices," he says. "If customers are worried about price increases, and we see a market disruption, we'll communicate that to our customers so they can protect themselves."

Asked how he responds to those who say that hedging steel will not work, McMahon says, "There is enormous demand. Countless participants in the steel industry have a huge desire to manage their steel price volatility exposure. Whether or not the product we provide can eliminate their price exposure remains to be seen, but we're certain we can accomplish that."

> Enron "can do something other metals companies have not been able to do—look into the future and find customers who might want to lock in prices for a year, three years, five years or 10 years."
>
> **David Fleischer**
> **Goldman Sachs & Co.**

He stops short of predicting steel will be as readily traded as energy. "Will it ever become as liquid as the natural gas market? Probably not. Natural gas is more homogenous than steel."

More than 70 grades of crude oil are produced worldwide yet, generally, "they all price off of West Texas Intermediate, which has probably the lowest production in numbers of barrels. But people use that WTI contract to hedge all these other grades. That's where we're heading in steel. If we create a hot-rolled benchmark, it becomes a useful hedge for whatever type of steel you're buying or selling."

McMahon expects Enron's steel business to be profitable in its first year of operation.

Views from Wall Street

Securities analysts who cover both the energy and steel industries had mostly positive things to say about Enron and its steel strategy.

The ability to build a trading portfolio by locking in raw material supply and revenues from forward sales of the product gives Enron a very predictable and stable margin stream from that business, says Anatol Feygin, an energy analyst with J.P. Morgan. "On top of that, it allows you to take advantage of volatility in the markets on both the supply and the revenue side."

Feygin suggests Enron's success may disintermediate some steel industry players. "Long term, the goal is to deal directly with large consumers of steel. You hedge their requirements from a volume metrics standpoint as well as from a market pricing standpoint. That, of course, would step on some toes in the distribution world."

Further, he says Enron's entry can hasten the producer segment's restructuring and rationalization. An interesting comparison is what Enron did in trading bandwidth. "As capital has dried up for various telecom players, one of their best sources for capital has been the forward sale of their capacity. That's a market that basically didn't exist until Enron came along," Feygin says. "There is value in that and, longer term, it provides a good signaling mechanism for how to deploy capital and rationalize the industry."

David Fleischer, a managing director at Goldman, Sachs & Co., says that in using its market intelligence, Enron "can do something other metals companies have not been able to do—look into the future and find customers who might want to lock in prices for a year, three years, five years or 10 years. And

some [mills] might want to supply steel on lengthy contracts, so Enron can create products that will make that happen."

Metals analyst Chuck Bradford of Bradford Research Inc., compares Enron's market strategy with what happened to aluminum, copper and nickel after the London Metal Exchange began trading them. "They trade at a premium price in the U.S., compared to world price levels. The prices are also very transparent. Everybody is trading at the same price, so therefore you can't have dumping."

Analyst Christopher Plummer at Metal Strategies Inc. says hedging would help diminish a lot of the volatility in the steel market. "It would also help in terms of financing new projects or existing capital projects at steel plants. When they have a more stable price from which to project earnings, it is something more tangible for banks to go on."

In the last 12 months, he says, hot-rolled sheet as been as high as $340 and as low as $220 per ton. "That makes it difficult to make business decisions."

Robert Schenosky, Merrill Lynch's steel analyst, says hedging should help normalize a world price and offer some stability: "We would view that as a positive for the overall environment."

He believes mills, distributors and end users will have to be educated in order to understand what Enron is trying to bring to the market. Meanwhile, "Uncertainty is always difficult for the steelmakers. Is it something to fear or embrace? We saw that [uncertainty] with the early entrants on the Web—e-STEEL and MetalSite. The difference here is that Enron is putting up the capital to trade the commodity. They have proven they can trade a commodity quite successfully."

Futures trading should work to the overall steel market's advantage, not its disadvantage, Schenosky continues. "This will help set the tone for at least a base price and, hopefully, prevent domestic producers from undercutting each other, and increase the focus on service, delivery, and quality as opposed to price alone." He adds that steel companies can use the tools Enron offers to stabilize their financial results and show an acceptable return on capital employed.

Distributors' reactions

A handful of service center executives quizzed about Enron's entry into steel expressed admiration for the company's innovation and are open to finding out how Enron's products and services can help their businesses. None, however, think Enron will revolutionize the industry.

"The producers are scared to death that Enron will create more fragmentation and take part of their margin away."

Nicholas Tolerico
Thyssen Inc. N.A.

"I will take a close look at anything that brings new solutions to the metal marketplace. What they are doing has a chance," says Michael Kirksey, chief executive officer of Metals USA Inc. "What service centers want is stability in metals pricing, and they want a technique through which they can lock in the economics for their customer's benefit as well as their own."

Lonnie Terry, president of the North American Steel Alliance, a distributor purchasing cooperative, says NASA leaders met with Enron Industrial Markets to listen to its proposal. "From our perspective, does our industry need innovative approaches? Absolutely. Whether the concept proves viable depends on how the industry hooks onto it.

"I heard McMahon at the SSCI meeting and he was pretty offensive to the steelmakers. If you take a hostile approach to a market, accusing companies of doing a poor job, you make [enemies]," Terry continues. "It's an easier transition if you prove to people what your value is, vs. telling everyone what they're doing is wrong and you're going to correct it in one fell swoop."

One hazard is that Enron's strategy may be rejected because it's not perfect. The company has the resources and the desire, he says. "They see a distressed market and see it as an easy entrance. I think it's a little more difficult than that. It isn't what model is employed; it's whether or not the timing is right and the market accepts it. A lot of that acceptance has to do with approach."

Thyssen Inc. N.A. already hedges risks through long-term contracts with its suppliers around the world, says Nicholas Tolerico, executive vice president. "For companies that have never signed long-term contracts or have never been able to secure that kind of coverage, Enron offers an opportunity to purchase risk assurance," he says, adding that this idea will gain acceptance in the long run.

"They have a very compelling product for the right market; they just have to find the right market. They've been pitching it to service centers and producers and have been rebuffed. On the service center level, those who are sophisticated enough to understand it and want it are already hedging. Smaller companies may not understand it yet or don't need it. The producers are scared to death that Enron will create more fragmentation and take part of their margin away."

Tolerico says Enron's products may be more attractive to large consumers—appliance and furniture manufacturers and pipe and tube converters—that don't want to hold inventory and want to secure prices, but who will use service centers as real supply chain managers, not so much for buying and holding stock, but for process-

ing and selling steel.

Executives of Reliance Steel & Aluminum Co. also met with Enron Industrial Markets. "We do not expect a large impact on our own business, and we don't expect there will be a big impact in the industry," President and CEO David Hannah says. "Some of the products they're promoting could be attractive to us and to others, if you had some issues to protect, in terms of assuring margins or hedging prices. We do not hedge. We buy what we need when we need it, and don't have a lot of contractual business."

Donald R. McNeeley, president of Chicago Tube & Iron Co., praises Enron's out-of-the-box thinking, and says the characteristics the company uses as criteria for entering an industry are all present in steel. As for the hackles Enron has raised, it reminds him of when Ken Iverson at Nucor started talking about the minimill concept 30 years ago.

A trio of issues give McNeeley pause, however. One is that a typical service center's asset base and net worth is 60 percent inventory. "If you abdicate control of your inventory, are you not abdicating your very sovereignty? That's asking a lot from a distributor."

Second, Enron's selection of commodity products where the large volumes are might be perceived as cherry picking by some. "If a mill has been cherry-picked, what's going to happen to the price of the stuff you're trying to get from them, if you're only getting leftovers?"

Lastly, McNeeley worries that if Enron's platform business, energy, implodes because of new regulation or further crises, its peripheral businesses, including steel, may also suffer. ■