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U.S. Steel Corp.'s Big Deal For Big River Is A Credit And ESG Milestone

TORONTO, Dec. 10, 2020 /PRNewswire/ -- U.S. Steel Corp.'s proposed acquisition of the remaining equity of Big River Steel LLC could deliver meaningful credit benefits with a strategic repositioning of assets and potentially stronger cash flow, but it trades vital near-term credit support of $774 million cash. U.S. Steel's market capitalization dropped to $1 billion at the depths of the industry and COVID-19 pandemic uncertainty in early 2020, so this acquisition would be a remarkable strategic shift off a cyclical low.

Our issuer ratings, issue-level ratings, and outlook on U.S. Steel are unchanged, pending demonstrably better earnings for both companies, as well as improved cash flow visibility from the ramp-up of Big River's Phase II-A expansion and U.S. Steel capital expenditures (capex). If the transaction closes as contemplated in the first quarter of 2021, U.S. Steel would have acquired Big River's equity for about $1.5 billion along with its $1.88 billion debt load, indicating about a $1 billion premium over the $2 billion construction costs for the Osceola, Ark., electric arc furnace (EAF) steel mill. Both companies are highly leveraged, with U.S. Steel's capital structure characterized by a large debt load and postretirement obligations. Big River's financial risk is characterized by a five-year track record of debt-funded greenfield capex. Phase I was completed in 2017, and Phase II-A was recently completed under budget and a few months ahead of schedule.

U.S. Steel's cash balances have been important for funding the ongoing capital and fixed-cost requirements of its blast furnace business during the recent downturn. The bounce in steel prices above $800 per ton of hot-rolled coil late in 2020 from below $500 at midyear improves our expectations for cash flow substantially. We estimate the company's free cash flow will turn positive from the fourth quarter if market conditions hold. Nevertheless, a restart of about $1 billion of strategically important capex, notably the Mon Valley continuous casting project, could consume incremental cash flow.

The transaction lays the foundation for U.S. Steel to rebalance its output to lower-cost and lower-emissions EAF steel from aging blast furnaces with high greenhouse gas (GHG) emissions. Until Big River's secured debt is repaid, however, we expect U.S. Steel will benefit only from residual cash flow distributions to its equity interest after Big River capex and debt service. Big River's secured notes mature in 2029, so the full integration of cash flows may not occur until then despite the expected consolidation of financial statements and deepening strategic integration.

Our recovery ratings on U.S. Steel secured and unsecured debt are also unchanged. We accord no value to U.S. Steel's current cash balances in a default scenario, so the acquisition of Big River equity for cash should modestly improve our recovery estimates, particularly for U.S. Steel's unsecured debt. Consistent with our issuer credit analysis on U.S. Steel, we assume the company would only benefit from a residual of Big River's value in a default scenario. We do not believe upstream or downstream guarantees will be implemented with the proposed acquisition, so we continue to assume U.S. Steel would realize a stressed 35% of its $1.5 billion investment in Big River in a default scenario.

This transaction demonstrates how environmental, social, and governance considerations are rising in importance for investment decisions (see "The Shape Of Recovery For Global Steel Companies Depends On ABC: Assets, Balance Sheets, China", published Dec. 1, 2020). U.S. Steel aims to reduce its GHG intensity 20% by 2030. A greater mix of modern EAFs is a meaningful step in that direction with the added credit benefit of potentially better operating cost and capital efficiency. On the other hand, the strategic integration of the two entities presents unusual circumstances for social and governance risks, bringing together different cultures and competitive propositions. EAF producers in the U.S. such as Big River are typically nonunion shops with some variable compensation schemes or profit sharing, modest pension and health care obligations, and an entrepreneurial culture that aims to take market share from basic oxygen furnace producers such as U.S. Steel's legacy assets. Big River is owned by its founders, financial sponsors, and a subsidiary of Koch Industries Inc. Meanwhile, U.S. Steel is a 120-year old icon of American industry with large postretirement and environmental obligations, a long history of choppy relationships with employees and unions, and a besieged competitive position as lower-cost, mini-mill steel and lighter, corrosion-resistant aluminum take market share, particularly in automotive applications.

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For further information: PRIMARY CREDIT ANALYST: Donald Marleau, CFA, Toronto, + 1 (416) 507 2526, donald.marleau@spglobal.com; SECONDARY CONTACT: William R Ferara, New York, + 1 (212) 438 1776, bill.ferara@spglobal.com