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Ferroglobe PLC – GSM (6/5/19)

Description: Ferroglobe PLC operates in the silicon and specialty metals industry in the United States, Europe, and internationally. The company also operates quartz mines in Spain, the United States, Canada, South Africa, and Mauritania; and low-ash metallurgical coal mines in the United States. It serves silicone chemical, aluminum, and steel manufacturers; auto companies and their suppliers; ductile iron foundries; manufacturers of photovoltaic solar cells and computer chips; and concrete producers. The company was founded in 2015 and is headquartered in London, the United Kingdom. Ferroglobe PLC is a subsidiary of Grupo Villar Mir, S.A.U.

Ticker: GSM
Price: $1.55
Market Cap: $262M
Performance: -2.5% YTD

Analysis

Metals and mining firms Grupo FerroAtlantica and Globe Specialty Metals entered into an agreement to combine their businesses in an all-stock deal to form Ferroglobe with an enterprise value of $3.1B back in February of 2015. Ferroglobe's ordinary shares were listed on NASDAQ under GSM in December 2015 in connection with the completion of the business combination at roughly $10 per share.

Ferroglobe is another requested company CUBE has received that is a play on a turnaround story. The stock currently sits about 85% lower today from its levels in 2015 as it deals with a fairly large debt burden and a tough macroeconomic environment for silicon and specialty metals. To be fair, many companies in the industry are struggling right now as GSM is reliant on the growth in the solar, automotive, consumer products, construction and energy sectors – all of which are seeing some headwinds right now.

GSM is a global leader in the production of silicon metal, accounting for 14% of the global production capacity and they are in a tough spot right now as not only are the prices for silicon metals falling, GSM is also pulling back on production.

Here's the situation laid out simply that GSM is in:

- The company's net debt (debt minus cash) position as of the end of Q1 was $420M
- The company has cash on hand of $217M and total liquidity of $285M when including their revolving credit facility

As we mentioned, GSM is trying to navigate this really tough environment so as a result they have:

- Signed a contract to sell 100% of their interest in noncore Hydro assets in Spain, together with the ownership of the Cee-Dumbría ferroalloys factory particularly down to the hydro assets, for a total value of approximately $190M. This will help GSM get that net debt position down to $236M according to management.

They are also trying to replace their current revolving credit facility with two different lines of credit:

- They are currently pursuing the first-lien senior secured term loan for up to $125 million which will be secured with a subset of PP&E (property, plant, and equipment) in the United States. Management is confident and expects to close the new term loan around the end of Q2 which should be sometime in the next few weeks.
- The second part of the refinancing is an asset base revolving loan secured with accounts receivable and inventories in the United States for a total facility size of up to $140 million. Management expects to close this loan around the end of the second quarter as well.

So at the end of Q1, their net leverage ratio stood at 2.4x and if management is able to secure the new lines of credit in addition to the sale of some of their assets, they believe they can get that down to 1.5x.

This is crucial because according to management's remarks and forecasts, they expect the rest of the year to be a challenging environment and under current conditions the company is not cash flow positive. In Q1, their free cash flow burn was about $5M.

Let's turn to management's exact remarks about the future of their business on the Q1 conference call:

"The activity levels realized during the first quarter suddenly confirms this high degree of caution, and our ongoing discussions with customers reinforce that this sentiment will linger.

Despite the uncertainty surrounding trade conflict and political instability, the global macro environment continues to be perceived by most analysts and experts as relatively strong. So the kind of demand slowdown we are witnessing in our end markets is somehow surprising. While it is impossible to pinpoint all the specific reasons driving the change in customer behavior, there are certain trends which are clearly impacting our sales into each major end market.

Sales of silicon-based alloys and manganese-based alloys into the steel sector are impacted by a slowdown in steel demand, although, coming down from historical highs. In our various Q1 results forecast, several global leaders in the steel sector announced lowered expectations for the year and planned actions to curtail capacity. This trend will clearly continue to impact our business into the steel sector.

Our sales into the aluminum industry are being impacted by the slowdown in the automotive industry, as manufacturers struggle with evolving emissions regulations and trade war -- and trade war uncertainty amongst other factors. Beyond auto sales, customers are also commenting on general slowdown in demand for aluminum going into building and construction, all the transportation including airplanes and everyday consumer goods.

The most perplexing end market is chemicals. Our silicon metal ultimately goes into thousands of everyday consumer and industrial products. Given the relatively healthy global economy, the drop in volumes into this market experienced at the beginning of 2019 was surprising. We believe that what is transpiring here is a greater focus on inventory management among our customers, who have appear to be de-stocking and not only a real fall in -- on end user demand.

And finally, a picture for the photovoltaic industry has not changed much, as industry continues to suffer from low prices following the ongoing trade war actions. As a result of this market environment, many of our customers have cut back production and idled facilities, which has directly impacted us. We do not see a reversal of this trend in the immediate term, but we believe that going forward the solar market will continue to grow at attractive rates and will be an important part of our business in the long-term."

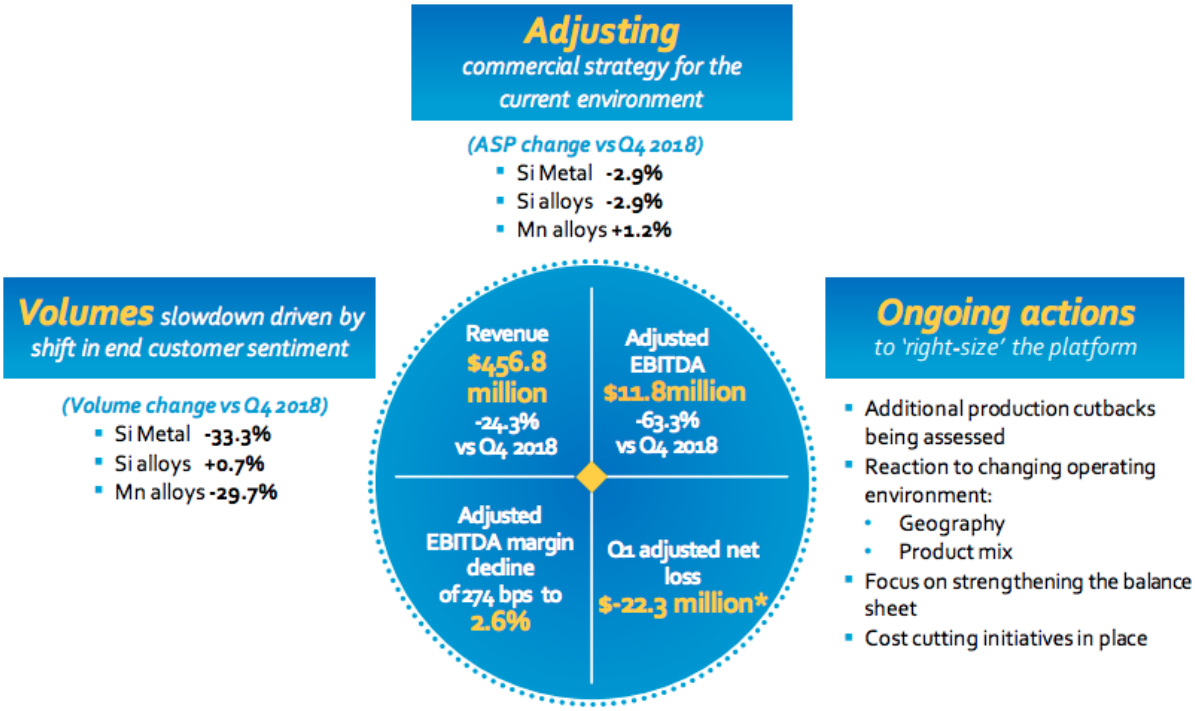
As we can see, every one of their business segments is being heavily impacted and their non-core hydro assets were a bit more consistent than their metals industry but that no longer matters now as they've sold that off.

In order to save cash, GSM also plans on implementing a cost cutting program. Plant level fixed costs are expected to contribute savings of $15 million in 2019, representing run rate savings of $25 million. Targeted savings and plans include, stock reduction, mainly in support functions, improved purchasing processes for services and materials and the

reduction and optimization of inventories for spare parts and consumables. In aggregate, total run rate savings are targeted at $75M.

Management's goal is to get net debt under $200M.

We mentioned the industry is struggling and referred to management's remarks but let's now dive into some of the numbers:

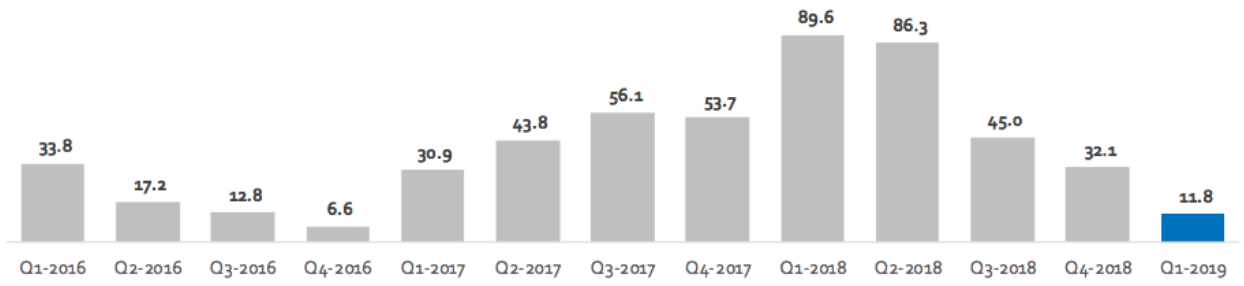


As we see from the image above,

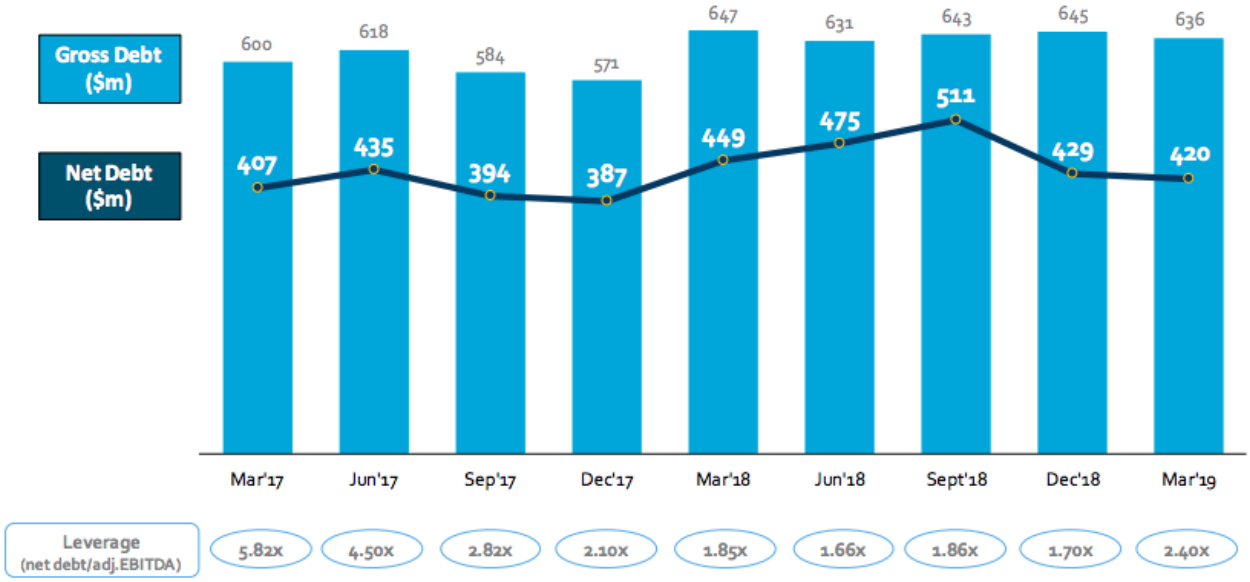
- Silicon Metal volumes are down over 33% Q/Q
- Manganese Alloy volumes are down roughly 30% Q/Q
- Average selling price for Silicon metals decreased by 2.9% to $2,358 per metric ton as compared to $2,429 per metric ton in the fourth quarter of 2018
- Average selling price for Silicon Alloys also decreased by 2.9% to $1,669 per metric ton, down from $1,719 per metric ton in the fourth quarter of 2018
- Average selling price for manganese-based alloys increased 1.2% to $1,172 per ton, up from $1,158 per ton last quarter

Overall, GSM posted Q1 Non-GAAP EPS of -$0.13 missing by $0.02 on revenue of $456.8M (-18.5% Y/Y) missing by $24.29M.

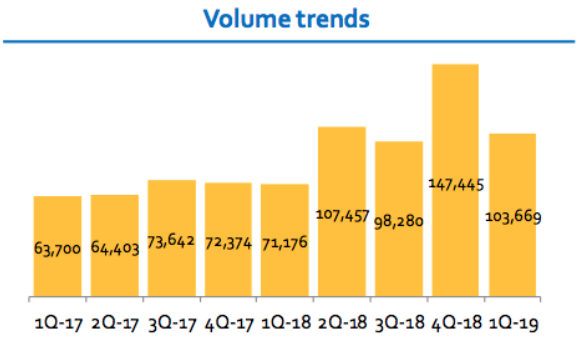
EBITDA has fallen off dramatically to it's lowest level since Q4 of 2016.

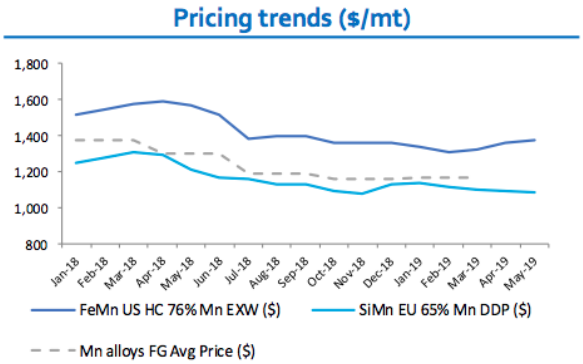


GSM's leverage ratio (Net Debt/Adjusted EBITDA) target of 1.5x and net debt of $236M after the divestiture and successful line of credit will be the lowest in company's recent history.

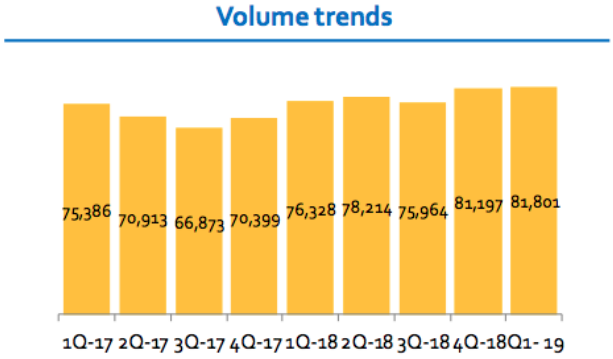


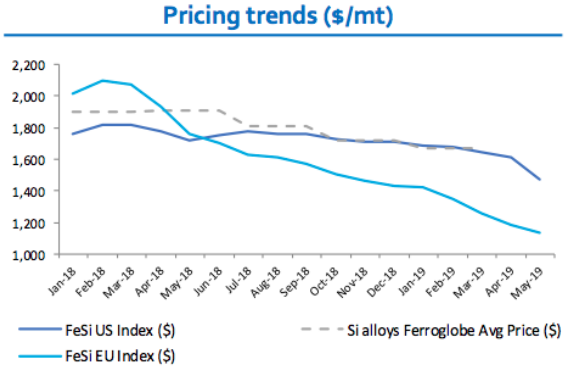
Their Manganese-based alloys division is holding up better than the others but volume has fallen off hard from Q4. We looked into it and Q4 2018 was a bit of an outlier as some volume from Q3 2018 spilled over into Q4 2018. Overall, Mn volume is pretty much in-line with 2018's numbers and pricing is a bit more stable. The issue here is that this division only added $0.9M to the $11.8M in EBITDA for the quarter.



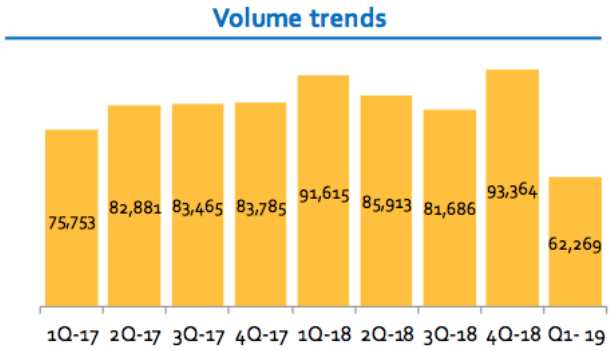


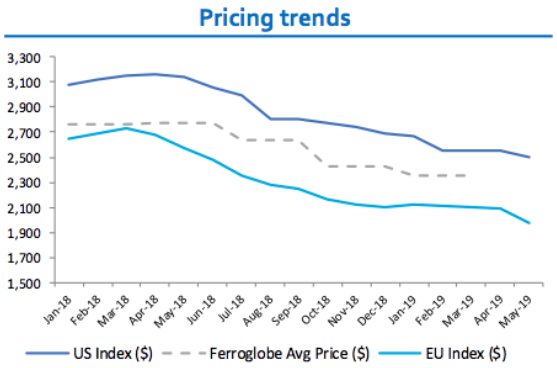
When it comes to Silicon-based alloys, the volume is more consistent but the prices are falling hard. As a result, EBITDA in Q4 in this division was $21.2M and it fell to $7.8M, making up a large majority of EBITDA for Q1. In other words, this division is vital to GSM's success and unfortunately, GSM does not believe the rest of 2019 will be any better as recent announcements by steel producers will continue to impact sales this year.





The silicon metal division is by far the one that is hurting the most for GSM. In other divisions, either volume fell off and pricing stabilized or pricing stabilized and volume fell off. In this case, both volume and pricing have fallen dramatically. Similar to silicon-based alloys, silicon metals is a huge EBITDA driver for the company and it too fell from $20.6M in Q4 to $8.3M in Q1.





All in all, EBITDA fell $32.1M in Q4 to $11.8M in Q1. Making matters worse is the EBITDA margins. EBITDA as a percent of sales came in at a mere 2.6% vs. Q4 of 5.3% and margins are contracting.

Now that we've discussed the business, where does this leave GSM. At $1.55 per share it seems many investors have thrown in the towel. We believe GSM is going to make it. It's not pretty but we don't see the company filing bankruptcy. We believe the sale of some of their assets were a huge plus for them and believe they'll be able to lock in at least one of those credit facilities – two would definitely be solid. Since this news is expected to come this month, it could give shares a nice little rise because it seems the market is expecting them not to lock it in. If the company does not lock it down then shares could most certainly fall further as the rest of the year will not be pretty from a revenue, EBITDA, EPS, or cash flow perspective.

Some other things to keep in mind are a bit alarming is the fact that the CFO resigned after less than a year on the job and the fact that GSM does pay a dividend but we think there is a legitimate chance this gets cut this year. According to GSM's website under the investor FAQ section "Does GSM pay a dividend?" it says, "The company has historically paid dividends. The Board is currently reviewing the dividend policy." Based on management cost cutting initiatives we believe the 15% yield is in jeopardy.

Something also interesting that CUBE found is that the rating agency, Moody's, downgraded GSM from Stable to Negative outlook but kept its B1 rating in March citing:

""The negative outlook reflects Moody's expectation that Ferroglobe operating performance will remain weak over the next 6 to 12 months as price of silicon metal remains volatile and the company's profitability is pressured by ongoing high production costs, particularly in its manganese alloys division," said Sven Reinke, a Senior Vice President and lead analyst for Ferroglobe. "Although the company's reported EBITDA during 2018 was just slightly below our expectations, current silicon prices and production costs indicate that profitability during 2019 is likely to deteriorate resulting in key credit metrics dropping to a level not consistent with the current B1 rating. However, at this stage, Moody's assumes that market conditions and Ferroglobe's profitability will rebound in 2020, aided by the company's announced capacity cuts and market fundamentals that remain good," continued Mr. Reinke.

Moody's expects the company's 2019 profitability to deteriorate from the 2018 levels as silicon selling price remains low and production costs are note easing. Current ratings, however, are supported by Moody's assumptions today that market conditions will rebound in 2020 as market fundamentals remains supportive of an upturn in prices eventually. Demand for silicon products remain strong, driven by a number of long term trends like population growth, urbanization and increasing usage of renewable energy.

RATIONALE FOR THE NEGATIVE OUTLOOK

The negative outlook reflects Moody's expectation that the company's operating performance and profitability will remain weak throughout 2019 while in the meantime key financial ratios will be below the level required by the B1 rating. Failure to restore profitability and reduce financial leverage towards 4.0x over the next 12 to 18 months is likely to lead to a rating downgrade.

WHAT COULD CHANGE THE RATING UP/DOWN

While there is limited upside potential, Moody's would consider upgrading the ratings over time if the company were able to improve its operating profitability and credit metrics, with an EBITDA margin at or above 15%, adjusted gross debt/EBITDA ratio of less than 3.0x, (CFO-Dividends)/Debt at or above 25% on a sustained basis, while maintaining an adequate liquidity position and comfortable headroom under its maintenance financial covenants.

The rating could be downgraded in case of protracted market downturn preventing any significant recovery in the company's operating profitability, and/or in case of a more aggressive than anticipated financial policy contemplating special distributions to shareholders or large debt-financed acquisitions. In particular, a downgrade could be triggered in case of an adjusted gross debt/EBITDA ratio exceeding 4.5x on a sustained basis, a (CFO-Dividends)/Debt ratio below 10%, and/or materially weakened liquidity and reduced headroom under the financial maintenance covenants. Negative rating pressure would also

immediately develop in case of deterioration in free cash flow generation or in the company's liquidity profile."

Even after the divestitures, cost cutting initiatives, probable dividend cut (can't see GSM paying out $20M in dividends in 2019 like they did in 2018), and if they are able to secure those new credit lines we still believe the company's financial health will not be enough to get upgraded in 2019 even though it will be in better shape since Moody's commentary.

Why?

- Moody's is talking about gross debt/adjusted EBITDA of 3.0x. What GSM has been referring to in their financials has been "Net debt" over adjusted EBITDA. Management expects gross debt to hit $570M and if we use the last quarter's EBITDA as a run rate for the year they're only going to bring in about $48M in EBITDA. That implies a gross debt/adjusted EBITDA of 11.9x – no where near Moody's target.
- Moody's mentioned EBITDA margins of 15% which GSM is way short on. As we mentioned, EBITDA margins in Q1 were 2.6% and only 5.3% in a better Q4. Q1 of 2018 was 16%.
- (Operating Cash Flow - Dividends) / Debt will not come close to 25% on a sustained basis. Let's assume GSM doesn't pay any dividends, and we just go Operating Cash Flow / Debt. In Q1 this number was $8.6M. Let's assume this is the run rate for the rest of year, that means cash flow from operations = $34.4M/$570M (expected gross debt) = 6%. As you can see this number is very from the 25% sustained Moody's is looking for to upgrade the company.
- In fact, we could argue there is greater chance Moody's downgrades the company's B1 rating if they are unable to grow margins, EBITDA, or cash flow as Moody's says they may downgrade the company if they are unable to meet 4.5x gross debt/ EBITDA or 10% OCF- Div/Debt.

All in all, we think the securing of the credit lines could give GSM a bump in price off of $1.55 but we do not like the prospects for the company in 2019. We believe there are far too many headwinds with the CFO out after less than a year, a potential inability to secure those two lines of credit, global macro headwinds in their industry, a possible (and we believe probable) announcement of a dividend cut, and/or downgrades from Moody's and the rest of the Street could weigh heavily on the stock for the foreseeable future. As you may already know but we want to say it anyway, investing here has considerable risk and it's something that should not make up too large of your portfolio.