

## Iron Brew #4

### Trial separation? Credit & equity markets move apart on MT/TKA

- **Weekly charting tidbit** — As you would intuitively expect, the credit and equity markets tend to hold similar viewpoints on the comparative merits of individual companies. Historically this has held for TKA vs. MT. As shown below in periods when MT's equity has outperformed TKA's, this has been reflected in a relative tightening of credit spreads in favour of MT. However this relationship has broken down. Since Sep 13, the debt markets have become increasingly more positive on the outlook for MT with the 5yr CDS spread dropping to 280bps, around parity with TKA and a relative outperformance of 100bps. Concurrently, TKA's equity has outperformed, particularly since the turn of the year.
- **Cevian's support crucial** — A key factor, in our view, in the dislocation between the two markets has been the systematic equity stake-building in TKA carried out by Cevian, the private equity group. Since an initial filing in September 2013, Cevian has increased its holding from c5% to 11-15%, depending on estimates ([Reuters article](#)). Based on average volumes, this implies the group has represented 11-17% of the daily volume of shares traded in TKA over the period: enough to provide substantial support, in our view.
- **We expect the gap to close** — The question remains to what extent Cevian will continue to amass a larger position in TKA. In the absence of this support we would expect the outlook of the credit and equity markets to converge. We rate ArcelorMittal Buy (€13.7 TP) and Thyssenkrupp Neutral (€17.6 TP).

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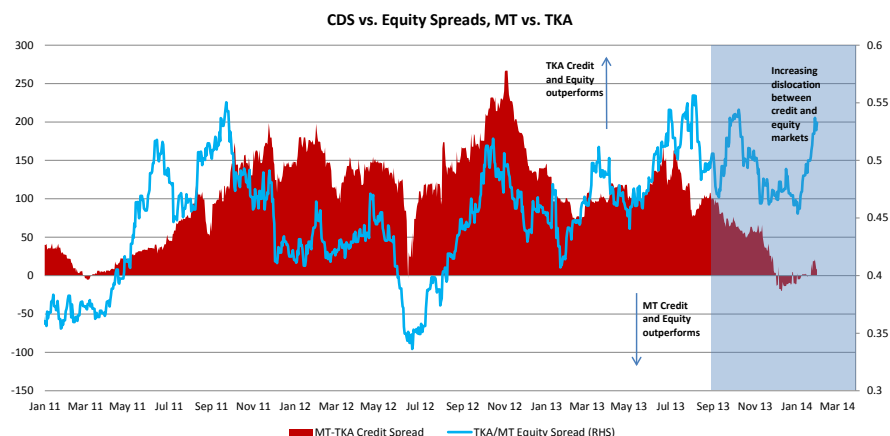
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Figure 1. Credit and equity markets have divergent views on MT and TKA



Source: Citi Research, Bloomberg

#### See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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## ArcelorMittal

(ISPA.AS; €12.16; 1)

### Valuation

We have a EUR13.70 target price for ArcelorMittal. We use an equal-weighted combination of DCF value, Residual income, EV/EBITDA and FCF analysis. Our DCF-based model drives a value of EUR9.3 per share. We use 5-7 x 2014E average EBITDA on the various business segments. This drives our multiples value of EUR9.7 per share. Our FCF and residual income models suggest fair value of EUR15.6 and EUR20.2, respectively.

### Risks

ArcelorMittal's net debt reduces investment flexibility.

ArcelorMittal shares are sensitive to spot steel prices, contract renegotiations and raw material input costs.

ArcelorMittal has high fixed costs, and high net debt overlays financial gearing to already high operational gearing to the cycle. The group is the key steel stock to own if you're positive the cycle, and key one to avoid if your negative the steel cycle.

If the impact of these risk factors is more negative than we currently anticipate, then the share price would be impeded from reaching our price target.

## ThyssenKrupp AG

(TKAG.DE; €19.14; 2)

### Valuation

We have a €17.6 target price for ThyssenKrupp. We use an equal-weighted blend of DCF, FCF yield, residual income and sum-of-the-parts methodologies. Our DCF-based model calculates a value of €35 (WACC of 7%, beta 1.19x, risk-free rate 3.5%, equity risk premium 3.75%, terminal growth 2%). Our residual income valuation yields a valuation of €17. The steel sector has historically traded at 5.5x EV/EBITDA, elevators at 8-10x EBITDA and capital goods businesses at 7-8x. We use 2013/14E EBITDA to calculate our sum of the parts deriving a value of €19 per share. We expect TKA to be burdened by ramp up costs in 2013/14 and 2014/15 resulting in negative free cash flow from its Brazilian assets. On applying our FCF valuation, we derive a valuation of €0.

### Risks

ThyssenKrupp is exposed to industry- and company-specific risk factors.

ThyssenKrupp produces steel from a single site in Germany, which allows for better optimisation of logistical costs and leaves potential for better margins versus European peers.

ThyssenKrupp sells a high proportion (c.60%) of its carbon steel sales on annual and multi-annual contracts, which reduces the group's flexibility to adjust to short-term movements in raw material costs.

A high proportion of the group's capital goods operations are based in countries that operate in US\$; the group also purchases most of its raw materials in US\$, and the US\$/euro exchange rate holds risks on translated earnings.

The sale of Steel Americas could experience delays and this could lead to higher than expected cash-drain.

If the impact on the company from any of these factors proves to be more negative than we anticipate, the stock will likely have difficulty achieving our financial and price targets.

## Appendix A-1

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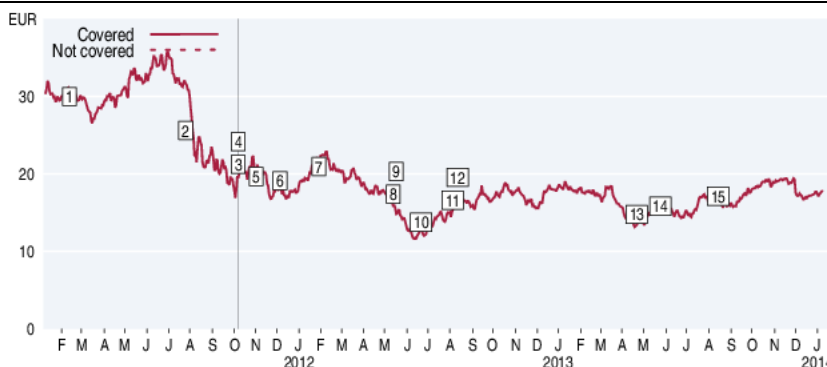
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#### ThyssenKrupp AG (TKAG.DE)

##### Ratings and Target Price History Fundamental Research

Analyst: Michael E Flitton

Covered since August 12 2013



	Date	Rating	Target Price	Closing Price
1	11-Feb-11	1M	*41.00	30.29
2	26-Jul-11	1M	*40.00	31.66
3	7-Oct-11	Stock rating system changed		
4	7-Oct-11	*1	40.00	19.46
5	2-Nov-11	1	*38.00	20.11

\* Indicates change

	Date	Rating	Target Price	Closing Price
6	6-Dec-11	1	*33.00	18.00
7	30-Jan-12	1	*30.00	21.11
8	14-May-12	*2	*18.20	15.77
9	17-May-12	2	*18.10	14.83
10	21-Jun-12	2	*14.00	12.95

	Date	Rating	Target Price	Closing Price
11	6-Aug-12	2	*15.00	15.43
12	13-Aug-12	2	*17.00	16.24
13	22-Apr-13	2	*14.90	13.40
14	24-May-13	2	*15.50	15.15
15	14-Aug-13	2	*17.60	16.63

Rating/target price changes above reflect Eastern Standard Time

#### ThyssenKrupp AG (TKAG.DE)

##### Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Michael E Flitton

Covered since August 12 2013



	Date	Rating	Target Price	Closing Price
1	11-Feb-11	*ADD MP	-	30.29

\* Indicates change

	Date	Rating	Target Price	Closing Price
2	15-Nov-11	*REM MP	-	20.19

Rating/target price changes above reflect Eastern Standard Time

## ArcelorMittal (ISPA.AS)

### Ratings and Target Price History

### Fundamental Research

Analyst: Michael E Flitton  
Covered since August 12 2013



	Date	Rating	Target Price	Closing Price
1	10-Feb-11	2M	*25.00	27.98
2	15-Sep-11	*1H	*20.00	13.44
3	7-Oct-11	Stock rating system changed		
4	7-Oct-11	*1	20.00	13.20

\* Indicates change

	Date	Rating	Target Price	Closing Price
5	21-Mar-12	1	*19.00	15.44
6	7-Aug-12	1	*17.00	13.09
7	5-Oct-12	*2	*11.30	11.40
8	1-Feb-13	2	*13.90	12.81

	Date	Rating	Target Price	Closing Price
9	14-Mar-13	*1	13.90	11.53
10	8-Aug-13	1	*13.60	9.63

Rating/target price changes above reflect Eastern Standard Time

## ArcelorMittal (ISPA.AS)

### Ratings and Target Price History

### Best Ideas Research

### Relative Call (3 Month)

Analyst: Michael E Flitton  
Covered since August 12 2013



	Date	Rating	Target Price	Closing Price
1	11-Feb-11	*ADD LP	-	27.98
2	15-Nov-11	*REM LP	-	13.59

\* Indicates change

	Date	Rating	Target Price	Closing Price
3	14-Feb-12	*ADD MP	-	16.72
4	15-May-12	*REM MP	-	11.90

Rating/target price changes above reflect Eastern Standard Time

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	Buy	Hold	Sell	Buy	Hold	Sell
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