



ALUMINUM

CURRENT TRENDS

- In March 2018, the Trump administration enacted a tariff of 10% on aluminum imports; subsequently, China enacted a 25% punitive tariff on aluminum scrap imports, resulting in distress across manufacturing and consumer industries
- Tariffs and countervailing duties applied for trade cases resolved in 2018 have fully rolled through the industry so the impact of tariffs is fully included in most inventories
- To the extent that a U.S./China trade deal were to be finalized, it would presumably unwind the non-exempted 10% tariff (countervailing duties would be presumably unaffected), which would likely negatively impact base aluminum prices and positively impact aluminum scrap prices

PROJECTED VALUES (12-MONTH OUTLOOK)

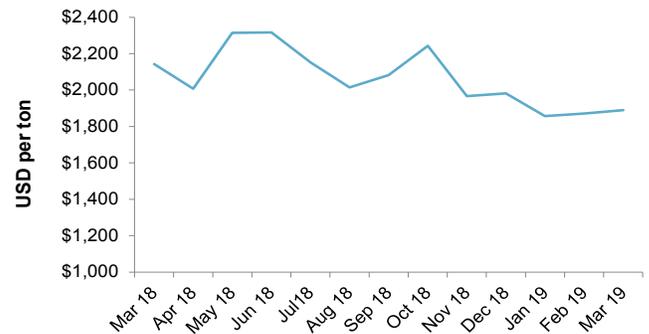


APPROXIMATE NET RECOVERY ON COST

70-85%
finished goods

55-65%
raw materials

LME ALUMINUM PRICE (CASH BUYER)



Source: LME

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TARIFFS CREATE UNCERTAINTY ACROSS THE SUPPLY CHAIN: In 2018, the Trump administration imposed a 10 percent tariff on all U.S. aluminum imports, with the exception of certain exempted trading partners, citing that aluminum was a “critical mineral.” Initial exemptions were extended for the European Union (EU), Australia, Brazil, South Korea, and Argentina, and widespread specific transaction-level exemptions have been applied for (over 6,700 requests as of November 2018) and granted. The tariffs took effect on March 23, 2018, and by April 2, 2018, China had announced a 25 percent retaliatory tariff on U.S. aluminum scrap imported to China. The EU (and other countries) also announced retaliatory tariffs in reaction to U.S. tariffs. Canada is the leading supplier of imported steel and aluminum to the United States, accounting for 16 percent of imported steel and 41 percent of imported aluminum, per reporting by CNBC. Canada was initially exempted from the aluminum tariffs, but this exemption expired in late May 2018. Canada immediately announced a retaliatory tariff of 10 percent on U.S. exports of aluminum products. Although lifting these tariffs was discussed during the NAFTA re-negotiation (now the USMCA), which occurred in the fall of 2018, the final agreement signed in late November 2018 did not address aluminum tariffs. There has been an expectation that the Trump administration will eventually drop the tariffs and subsequently impose a quota on Canadian aluminum, but no consensus agreement has been reached on this issue to date.

In November 2018, the Department of Commerce applied a countervailing duty against Chinese aluminum foil in a trade case that was initiated in November 2017. Separate from the 10 percent tariff discussed above, the duty on foil went from 46.4 percent to 106.1 percent. In addition, a determination was made in June 2018 on a Trade Act of 1974 Section 301 trade case initiated in June of 2017 on aluminum alloys, semi-fabricated aluminum products, and unwrought aluminum that applied a 25 percent countervailing duty. Section 301 of the Trade Act of 1974 provides the United States with the authority to enforce trade agreements, resolve trade disputes, and open foreign markets to U.S. goods and services. In addition, a determination was made in November 2018 on a Section 301 trade case initiated in August of 2017 on common aluminum alloy sheet that applied a 167.2 percent anti-dumping rate set on Chinese imports of aluminum sheet. Although discussions relating to the U.S./China trade war have been ongoing, it does not appear that a resolution is near. A meeting that had been scheduled between Trump and China’s President Xi Jinping for early spring 2019 was recently pushed back to June 2019.

INDUSTRY EXPECTATIONS: Worldwide aluminum capacity continues to be robust, with significant excess production and or reserve capacity in the United States, Brazil, Canada, and China among other nations. In the United States capacity came on line at several smelting plants in reaction to the 2018 tariff and duty activity, and capacity utilization was higher in 2018 over 2017 as a result. U.S. primary aluminum capacity utilization was up year-over-year to 49.7 percent in 2018 versus 40.5 percent in 2017, and base U.S. pricing was up year-over-year approximately 16.9 percent reflecting the impact of tariffs. Despite higher prices and utilization in the United States, the price of the aluminum metal traded in London has declined 12.8 percent amid growing concerns that a continuing trade war between the United States and China may slow global growth, reducing demand

for industrial metals including aluminum. According to the U.S. Geological Survey, the key drivers for U.S. aluminum consumption are transportation (40 percent), packaging (19), construction (14), electrical (9), consumer durables (8), machinery (7), and other (3). All of these sectors continue to do well in a U.S. economy that grew by 2.6 percent in the fourth quarter of 2018, and 2.9 percent annually over 2017. Yet concerns persist over the economy being very late cycle at this point, slowing Chinese growth, increasing geo-political instability and unrest in general, high deficit spending, and interest rate growth.

INVENTORY COSTING AND MARK-TO-MARKET RESERVES: When a company’s inventory contains commodity-type items, like aluminum, which are subject to frequent price fluctuations, it is imperative to understand the company’s inventory costing methodology. A standard cost approach includes updating inventory costs periodically and, depending on the frequency of the update, can result in the company’s reported cost varying from the market in an inflationary or deflationary environment. A rolling weighted cost approach utilizes an average weighted cost for each purchased item that equates to a rolling perpetual average. This methodology is useful for commodity-type items as a company’s reported cost will remain closer in line with the market, although costs will still trail market prices by a set period. Given the volatility in the aluminum market, lenders should be aware of the target company’s costing methods and should consider incorporating a mark-to-market or lower-of-cost-or-market reserve. A mark-to-market reserve account will adjust the cost basis to market and ensure that an advance rate based on a percentage of cost remains relevant even in a volatile market. As a result of the newly levied tariffs on all U.S. imports, borrowers may face unexpected cost increases that could compress margins. Operators that work on a project basis are most vulnerable as input prices may differ at the time materials are purchased from when the contract price was agreed upon. Recoveries on existing aluminum inventories, on the other hand, may benefit from reported cost varying from the market in an inflationary or deflationary environment.

ALUMINUM TYPES IMPACT RECOVERY VALUES: Aluminum is produced in a wide variety of forms and alloys. Base aluminum prices are tracked for either billet or scrap, but most aluminum is actually sold and used in a fabricated form, such as sheet and coil, bar stock, extrusions, forgings, and castings, among others. For certain applications, such as aerospace and military, aluminum may be produced in proprietary grades and to conform to industry specifications. As such, while the price of base billet can be tracked daily, the cost and value of fabricated aluminum is more difficult to update and track. In a liquidation, the value of aluminum will be driven by marketplace demand and need, with proprietary forms of aluminum, absent a waiting customer, generating a scrap value. Aluminum products in standard sizes and quantities with materials certifications that are widely used will generate strong recoveries in the secondary marketplace.

ELECTRICAL COSTS IMPACT PROFITABILITY: Critical to the refining process of aluminum is the consumption of electricity, and U.S. aluminum producers continue to be impacted by the rising cost of electricity. While cheap natural gas in the United States could be a lifeline in the near term, energy prices over the next several decades will have a much more far-reaching impact on the economic feasibility of domestic operations. Currently, the industry is powered 50 percent by coal electricity, and there are significant concerns around how much coal prices will be impacted by the Environmental Protection Agency’s newly tightened emissions regulations at power utilities. Lower domestic electricity prices also bolster the case for smelter restarts. Electricity costs in the United States moved down slightly in 2018 compared with the previous year, a change that improved conditions for aluminum producers. On average, the industrial power rate throughout the United States came in at 6.54 cents per kilowatt hour (KWH) as of December 2018, down from 6.65 cents per KWH in December 2017, according to U.S. Energy Information Administration data.

The Expert: Alex Sutton



Alex Sutton oversees the production of Gordon Brothers’ inventory valuations. Prior to this role, Alex headed AccuVal-LiquiTec’s Inventory Valuation practice, which was acquired by Gordon Brothers in 2015, where his team produced reports used primarily for financing and financial reporting. Read his full bio [here](#)



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