Cleveland-Cliffs

Eduardo Dias Ribeiro, Sept. 30, 2024

# Executive Summary

Ticker Symbol: CLF

Sector: Basic Materials

Price Target: $17.50

Current Price: $12.65

Recommendation: Buy

Investment Thesis:

CLF has a vertical monopoly of the steel manufacturing industry and, though it has been a troubled 12 months as reflected on the stock price, its extremely low price compared to historical data and FCF generation makes it a great buy opportunity even if growth isn’t stellar, although it very well could be if management’s plans come to life

# Company Overview

Business Description:

Cleveland-Cliffs is a steelmaker producing steel products with diverse applications ranging from Civil Construction, Domestic Appliances, Electronics, Manufacturing and Automotives. The company operates primarily in the U.S. and Canada, with an upcoming merger with Stelco aiming to increase its presence in Canada and increase its production volume with a CAD cost.

Management:

Management’s strategy emphasizes controlling the full steelmaking process, having a vertical monopoly and not relying on third party partners, which leads to a competitive advantage in possible supply chain issues while also reducing import dependence.

Management has been focusing on lowering the overhead costs, with SG&A costs going down from 149M to 103M in 1 year, and paying off their debt following several M&A deals in the past few years going from 5,784M in Q2 2022 to 4,199M this quarter

Management has focused also on a strong share repurchase program. Their shares outstanding have gone from 532M in Q2 2022 to 474M Q2 2024.

# Industry Overview and Competitive Positioning

With recent government stimulus to American industries, steelmakers have been put into the spotlight again trying to push back the Chinese absolute dominance in the sector (this is a view shared both by the Biden-Harris administration and Trump’s). The protectionist approach by the American Government may allow for a higher than average growth in the industry in the coming years. CLF, with its vertical monopoly of the industry and massive production volume, will be in prime position to take advantage of it. However this analysis is not dependent on the growth of this market, or these stimulus to happen it's based on the, slowly but surely, market realization that this company is oversold.

# Financial Analysis

Income Statement Highlights:

- **Revenue** for First 6 months of 2024 x First 6 months of 2023: 10,291 x 11,279. Driven by a lower average price of steel

- **Adjusted** **EBITDA Margin** YTD 2024 x YTD 2023: 7% x 9%, driven by a lower average price of steel

Balance Sheet Overview:

- **Current Ratio**: 1.87

- **Debt to Equity Ratio**: 47%, debt mostly tied to PP&E and loans granted for acquisition of other companies in the past few years.

- **$237m** Debt reduction in the quarter

Cash Flow Analysis:

- **Cash Provided by operating activities**: 2024 x 2024: $519M v $887M

- **Free Cash Flow**: 2024 x 2023: $322M x $529M (\*see “valuation” point 3 for more)

# Valuation:

- **EV/FCF analysis**: CLF: 7 /// STLD: 8 /// NUE: 10 /// X:7.5

- **EV/EBITDA**: CLF: 7.1 /// STLD: 7 /// NUE: 6.4 /// 7.2

Method Used: Reverse DCF valuation

- Assuming it’s FCF in the TTM of 1,414 Billion USD, a 0% FCF growth over the next 10 years, a terminal growth rate of 1.5% (in line with the US’s GDP growth) and an extremely conservative discount rate of 18% per year (average of market being 10%), the stock should be trading at $17.58

- Using its current share price and assuming the same stats for WACC, FCF and TGR, We calculate that the market is intrinsically projecting a -7% CAGR in the next 10 years. However, according to Yahoo Finance, the lower end of Wall Street analysts actually project positive EPS growth from $-0,62 to $-0,25 from 2024 to 2025.

- The decrease in FCF over the last year (of about 40%) is already reflected in the $21 to $13 stock price decline, showing that this decrease in company performance has already been priced into the stock, and, according to this valuation, it made it undervalued.

- Share Repurchase program: Since 2022, the company has increased its effort to reward shareholders. In the past 2 years, shares outstanding have gone from 532M to 474M

# Risks

- If the price of steel continues to trade at an unfavorable price, the company might need to burn through cash to keep their, expensive to operate, plants open. With a robust cash reserve, they can keep up with it for a while, but not long term.

- The perspective of the market towards the company might turn more negative if the merger with Stelco doesn’t go through. However, these valuation metrics do not take the merger into consideration, so if that doesn’t happen, things will, on a fundamental level, stay the same

- More of the US’s steel demand is supplied by other countries (specially China) more than it is today, very unlikely to happen with either a Harris or Trump administration.

# Conclusion

**BUY.**

CLF, while it is not a “once in a generation” kind of company, the management has been moving in the right direction for the past year and FCF generation, money actually coming in, has been way more predictable and positive than the EPS, which is influenced by lots of nuances. The Reverse DCF technique, which was VERY conservatively used in this case with super high WACC and low CAGR, makes the question of investing simple: Will CLF grow more than -7% CAGR in the next 10 years? I have no reason to think it wouldn’t. If we assume no growth at all, another very conservative assumption, we arrive at a value of $17.50 a share, implying a huge upside from today’s levels. This is a great opportunity to buy a company at a cheap price, especially with the incredible share repurchase program they have been having.