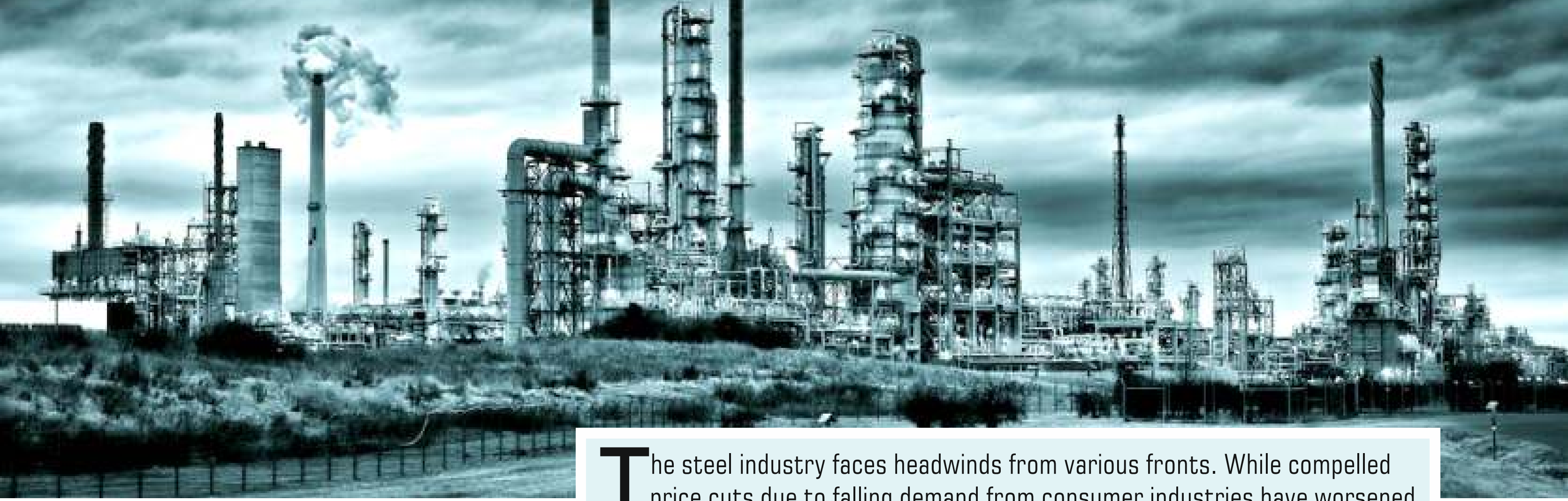
Supply Glut to Worsen Steel Companies' Earnings

- Steelworld Research Team



The steel industry faces headwinds from various fronts. While compelled price cuts due to falling demand from consumer industries have worsened their financials, weak recovery forecasts for future multiplied their problems. It is clear that the steel industry has, for the time being, reached the end of a major growth cycle which was based on the rapid economic development of China. Combined with China's slowdown we also face low investment, financial market turbulence and geopolitical conflicts in many developing regions. The steel industry is now experiencing low-growth which will last for the time it takes for other developing regions of sufficient size and strength to produce another major growth cycle.

The current headwinds, however, is likely to moderate by the end of 2016 but this is based on a belief that the Chinese economy would stabilise. Of particular concern is the vulnerability of the emerging economies to external shocks though is being expected some from the economies like India to show resilience to the global slowdown. On a positive note, the recovery of steel demand in the developed economies, even though the momentum has weakened a little, remains on track.

Falling Production

World crude steel production reached 1,622.8 million tonnes (Mt) for the year 2015, down by -2.8% compared to 2014, data compiled by the World Steel Association showed. Crude steel production decreased in all regions except Oceania in 2015. Annual production for Asia was 1,113.8 Mt of crude steel in 2015, a decrease of -2.3% compared to 2014. China's crude steel production in 2015 reached 803.8 Mt, down by -2.3% on 2014. China's share of world crude steel production increased from 49.3% in 2014 to 49.5% in 2015. The average capacity utilisation in 2015 was 69.7% compared to 73.4% in 2014. The World Steel Association recently forecast that global steel demand would decrease by -1.7% to 1,513 Mt in 2015 following growth of 0.7% in 2014. In 2016, it is forecast that world steel demand will show growth of 0.7% and will reach 1,523 Mt.

The Chinese economy has decelerated as the impact of the rebalancing measures on the investment and real estate sector turned out to be more severe than expected. As a result, activities in the construction and manufacturing sectors have slowed considerably. China's steel demand is expected to decrease by -3.5% in 2015 and -2.0% in 2016, following its demand peak in 2013. There is an increasing risk associated with this economic slowdown and the consequent financial market volatility, which has become a global concern. The performance of some key emerging and developing economies started to deteriorate in 2012 due to internal structural issues, lower commodity prices associated with China's economic slowdown, and in some cases, escalating political instability. For example, Russia and Brazil are experiencing severe contraction in steel demand. Geopolitical tensions and political instability in the Middle East, Africa and Ukraine continue to have a negative effect. On the other hand, steel demand in India and Mexico and other countries in the ASEAN and MENA regions are expected to maintain growth momentum despite the adverse external environment due to positive domestic demand and progress in reform. Steel demand in the emerging and developing economies excluding China will, despite the major slowdown in some countries, grow by 1.7% in 2015 and 3.8% in 2016.

The strong momentum seen in the developed economies in 2014 weakened considerably in 2015. While the US economic fundamentals continue to remain solid, steel demand in the US is expected to show negative growth in 2015, due to currency appreciation and a slowing energy sector. In the EU there is a broadening of the recovery momentum aided by low oil prices, low interest rates, and a weak euro. Developed Asian countries like Japan and Korea are expected to show negative growth

due to adverse structural forces weighing on their economies.

In 2015, steel demand in developed economies is expected to contract by -2.1%, but positive growth of 1.8% is expected in 2016. Steel demand in the world excluding China will grow by -0.2 % in 2015 and 2.9% in 2016.

Chinese Slowdown

As Chinese demand declines further amid slower economic growth, its steel producers will continue to export their giant stockpiles of steel, pressuring prices in the region. Antidumping measures and safeguard duties will slow the Chinese export growth, but the overall volume will remain high. In 2015, China's steel consumption declined 5% year on year, while net exports grew 25.5%. We expect Chinese demand will fall another 5% in 2016 and exports will rise by a single-digit percentage.

Steel mills' overall earnings will likely be lower than the weak levels in 2015 and significantly below their historical levels because production volumes and spreads will contract further amid the oversupply and resulting low prices. Given the massive supply in China, producers there, including Baosteel Group, will underperform their regional peers. Posco, Nippon Steel & Sumitomo Metal Corporation (NSSM) and JFE Holdings, Inc. are better positioned to weather adverse market conditions thanks to their focus on premium products. In India, the ramp-up of new steel production capacity, resumed captive iron ore production and introduction of minimum import prices will mitigate earnings pressure on Tata Steel Ltd. and JSW Steel Ltd.

High Debt Leverage

The substantial earnings deterioration in 2015 resulted in weaker debt service ratios for most influencial Asian steel companies. Most Asian steel companies are leaders in their respective markets, and have healthier balance sheets and stronger cash flow than the industry average. They can therefore increase their business scale and market share by acquiring small or inefficient steel producers that become unviable in the tough operating environment. But despite the government's efforts to consolidate the domestic steel industry, there is significant uncertainty about the pace of the capacity reduction and rebalancing of supply and demand in China.

Chinese steel demand is declining amid slower economic growth, and the country's steel producers are exporting their giant stockpiles of steel, exacerbating the Asian supply glut and pressuring prices in the region. Export growth will slow this year but the overall volume will remain high. China accounts for half of the world's steel production and three quarters of Asia's, and is a giant steel consumer. Its supply-demand dynamics therefore have a significant effect beyond its borders. In 2015, China's apparent steel demand (production + imports – exports) declined 5% year on year to 701 million tonnes, while net exports grew 25.5%, according to an estimate based on data from the China Iron & Steel Association and General Administration of Customs. Steel demand in China is expected to fall another 5% to about 670 million tonnes in 2016 given the slow investments in real estate and infrastructure development as well as weakening domestic manufacturing activity.

The year-on-year growth in Chinese net steel exports will likely fall to a single-digit percentage in 2016, because other countries are taking steps, such as anti-dumping investigations and safeguard duties, to limit imports. On 5 February, the Indian government imposed minimum import prices for 173 grades of steel for six months to bolster the domestic prices and curb imports. And last year, the Korean government imposed an anti-dumping duty of up to 33% on H-beam products from China, which are mainly used in construction.

The slowdown in export growth is from a high base. China's exports totaled 112 million tonnes in 2015, representing about 14% of its total steel production, according to the China Iron & Steel Association. This export volume was larger than the 105 million tonnes of steel manufactured in Japan, the world's second-largest steel-producing country. About two thirds of the Chinese exports were shipped to Asian countries. The resulting pricing pressure is significant, as evidenced by the Chinese export hot rolled coil price of $267 per tonne at the end of 2015, which was much lower than India's domestic price of $400 per tonne. Consequently, selling prices declined for Asian steel companies and most reduced production given the market oversupply.

Earnings to Weaken in 2016

Steel mills' overall earnings in 2016 is expected to be lower than the already depressed levels in 2015 because production volumes and the spread between raw material prices and the prices of finished steel products will contract further. Steel production volumes will decrease primarily because of the decline in Chinese demand. The only bright spot in the region is India, where we expect year-on-year demand will increase by a mid- to high-single-digit percentage because of increased infrastructure spending. But this growth won't be sufficient to prevent an overall demand decline in the region, because India accounts for only about 8% of Asian steel production.

It will take time for producers to reduce capacity in response to the declining demand, so oversupply will remain significant and prevent a price recovery in 2016. Prices increased modestly in January 2016 from a very low level in the fourth quarter of 2015. But the increase was triggered by a temporary reduction in supply after many steel mills started maintenance and idled production, rather than a fundamental improvement in the supply-demand balance. Moreover, new production coming on-line in 2016 will dilute the rebalancing efforts. This new capacity includes Baosteel Group Corporation's 9 million tonnes per annum (mtpa) Zhanjiang project and Wuhan Iron & Steel Company's 9 mtpa Fangchenggang project, both in China, Tata Steel Ltd.'s 3 mtpa greenfield Kalinganagar plant and JSW Steel Ltd's 4 mtpa brownfield expansion in India, and Formosa Plastics Corporation's 7 mtpa Ha Tinh project in Vietnam.

The contracting spreads reflect Asian steel companies' inability to reduce their input costs faster than the fall in steel prices. The bargaining power of Asian steel mills against ore suppliers remains weak due to the fragmented nature of the region's steel industry, where many producers bid for seaborne iron ore from a handful of Australian and Brazilian suppliers. At the same time, Asian steel companies' bargaining power against customers is also weak given the oversupply. As Chinese production spreads fell to a historical low in 2015, large and medium-size Chinese steel mills collectively reported a staggering loss of RMB64 billion, more than their combined profits in the previous three years. Nonetheless, steel mills' focus on cash flows to pay for employees and interest on bank loans, coupled with asset disposals and government subsidies, keep the mills running despite the deep losses.

Given the massive oversupply in China, steel companies there will underperform their regional peers. Baosteel Group's steel earnings will likely decline further in 2016, despite cost-savings efforts, owing to the partly suspended production at its Bayi Iron & Steel subsidiary and the high initial costs of ramping up its Zhanjiang steel plant. However, the company will continue to outperform its domestic peers by a wide margin thanks to its substantial investment income, as well as its competitive edge in producing premium steel products. We estimate that Baosteel Group's earnings, hit by a decline in earnings from its steel operations, asset impairments and foreign-exchange losses, fell to a multi-year low in 2015.

Resilient Asian Steel Mills

Leading Korean and Japanese steel companies such as Posco, Nippon Steel & Sumitomo Metal Corporation and JFE Holdings, Inc. are more resilient thanks to their focus on quality premium products, which allows them to command higher prices and margins than producers of commodity products. The companies also have leading technologies and long-term contracts with major automotive customers, both of which mitigate earnings pressure. That said, these companies are still exposed to the depressed regional steel prices and their earnings will stay below their historical levels. For instance, Posco reported a 55% year-on-year decline in reported operating income during the fourth quarter of 2015, with its operating margin falling to 2.5% from 4.6% a year ago. Its negative rating outlook reflects this weak earnings trend.

Indian steel companies will also be pressured by the regional supply glut and price declines. However, for major Indian steel mills, the ramp-up of new steel-production capacity,

resumed captive iron ore production and the government's introduction of minimum import prices will help them mitigate earnings pressure in 2016. In particular, the expected ramp-up of Tata Steel's and JSW's new production facilities will help raise the companies' earnings in 2016, but earnings will remain below 2014 levels given the weak industry fundamentals. The earnings decline for Tata Steel and JSW was steeper than for Posco, NSSM and JFE in 2015. The sharper decline is largely because of a significant increase in steel imports to India - 29% year-on-year during April-December 2015 - that depressed steel prices for the two Indian companies, along with inventory losses on their expensive iron ore purchases in the previous year. Tata Steel's earnings were also affected by iron ore supply disruptions at one of its mines in India and the negative EBITDA contribution of its European business.

Consolidation Looming Large

Despite some progress in consolidation over the last few years, the steel industry in China remains fragmented with the 10 largest companies accounting for only 37% of domestic production as of 2014.

In Japan, the steel industry is already fairly concentrated with NSSM and JFE accounting for 43% and 28%, respectively, of the domestic steel production in the fiscal year ending March 2015. NSSM will increase its domestic market share to 47% after its planned acquisition of Nisshin Steel, Japan's fourth largest steel company by production volume. Similarly, we estimate POSCO accounted for about 50% of the steel production in Korea in 2015 and Hyundai Steel for about 30%. Hyundai Steel added another 1.5 mtpa of capacity after merging with Hyundai Hysco Co. Ltd. in July 2015. In India, Tata Steel and JSW will gain market share after ramping up their new production facilities. Subsequently, Tata Steel (12 mtpa, excluding Tata UK) and JSW (18 mtpa) together will account for about 30% of the country's steel production.

The first month of CY2016 has seen some stabilization of global steel prices. Prices, particularly in China, saw some uptrend. This can be attributed to the capacity curtailment that China is trying to undergo. Most of the mills would be making losses at the current steel price levels and also possible restocking before Chinese New Year. Global iron ore and coal prices meanwhile, continued to remain weak. We don't see any sustainable recovery in global steel demand. We believe, China needs to cut its capacity more proactively to balance with falling demand, which will ultimately help price stabilization.

Steel prices stabilized to some extent and rose during the month. The prices showed resistance to fall, slight rise in prices can be attributed to strong demand in China and capacity shutdown during the month. China HR sheet prices also increased marginally, which can be attributed to restocking and some capacity curtailment. We expect steel prices to remain weak in the near term before gradually stabilizing. Iron ore price movement would be important in this regard as lower iron ore prices can pull down steel prices too. Ironically, aggressive capacity curtailment is required for steel prices to get support but this initially would put pressure on the iron ore prices. Thus, second half of the current calendar year can see some gradual improvement in steel prices; however, H1CY16 is likely to remain subdued for steel prices.