Economic Downturn to Hit Steel Industry Badly

- Steelworld Research Team

While some pressures would continue to persist on Indian economy and perhaps weigh on growth prospects, the ultimate picture measures as an improvement over the year gone by. The low statistical base effect will help significantly to present relatively better numbers for certain economic variables given that the FY13 performance has come with virtual industrial stagnation, high inflation and conservative policies. In brief, growth is likely to pick up, albeit gradually but will continue to remain below the higher average growth trajectory of the last five years. The uptick in growth would be driven by a gradual revival in industrial production, stable agri-sector activity, and steady services sector growth. Supply-side constraints would ease to some extent as investments shelved in the last year (both government and private sector) begin to churn and flow into the economic cycle.

With easing inflation, the tough choice of balancing the trade-off between growth and inflation will be less pressing giving way to the emergence of what could be termed as a cautious growth-oriented pro-cyclical monetary regime. However, a clear picture will emerge only in the second half of the year. Capital markets in a more investment-favourable environment are also expected to receive the much required boost.

The external sector will be pressurized during the year and the challenges faced in FY13 such as rising current account deficit will continue to play in the mind of the government and RBI while formulating policies. However, it is expected that there would be some improvement in the CAD and the continued flows of foreign capital will keep the rupee largely stable - assuming that geo-political tensions do not deteriorate and global economic conditions remain where they are, with the recovery process also being cautious.

The update sequentially looks at expectation on overall growth, performance of the agricultural and industrial sectors, banking and capital markets, fiscal thoughts and external sector scenarios likely to emerge.

Moderation of growth over the past year is a pertinent concern on the weakening of economic fundamentals for the country. Structural bottlenecks, slow policy movement, stubborn interest rates on account of high inflation, declining exports, low non-food credit growth, declining industrial growth and subdued demand for both consumption and investment has led to the systematic decline in the overall economic growth of the country in FY13 which will be at the level projected by the CSO at 5.0%. Growth has hence been held up this year on both the supply and demand fronts which has impeded any pick-up in activity. It may be recollected that the year started with an assumption of upwards of 7.5% GDP growth for the year and the path followed has been quite different from what was expected.

Growth has consistently moderated quarter after quarter, from 5.5% in Q1 FY13 to 5.3% in Q2 FY13 and to 4.5% in Q3 FY13. The signs available for the fourth quarter do not look very different and a significant pick-up is not expected.

Deceleration in industrial growth has been evident from the consistent

low growth in the index of industrial production (IIP) observed over the months. Contraction in the mining and manufacturing sectors has been rather pronounced. Weakness in production in the manufacturing sector has further, been accentuated by volatility in capital goods production consequent on lower level of capital investments. Gross fixed capital formation (GFCF, used as a proxy to investments) in FY13 (Apr–Dec) stood at 29.7% of GDP, lower than 31.0% in the corresponding period in FY12. Capital goods production has accordingly contracted in FY13 (by 9.3% during the period Apr-Jan).

Subdues Demand Trend

Domestic demand growth remained subdued at 3%YoY in March (4.6%YoY FY13) as per provisional data released by Joint Plant Committee (JPC). Domestic steel price hikes have been muted in March Q even though a) demand is seasonally strong in March Q, and b) domestic prices are at a discount to import parity. Margins of domestic steel companies is likely to improve QoQ in March Q (though weaker than our earlier expectation) due to marginally better ASP, lower coking coal costs & op. leverage (seasonally stronger volume in 4Q). Domestic steel prices and margins, therefore, may be under pressure post March Q as demand seasonally slows post 4Q. Also, discount to import parity has narrowed after the recent correction in global prices. Analysts, cautious on the domestic steel sector and maintain our Underperform ratings on SAIL, Tata, JSW and JSPL.

Demand trends have remained surprisingly weak in March Q as auto-elated demand (22% of flats steel demand) has been sluggish, demand from existing projects is tapering off and there is limited demand from new projects. A meaningful recovery in demand appears unlikely near term as lead indicators are stagnant, recovery in investment cycle is likely to be delayed and destocking across end user segments (including autos) should continue. Also, construction and infra activity slows ahead of monsoon which should affect longs demand.

A report by India Ratings showed that the demand for steel from automobile, white goods and capital goods will remain muted throughout 2013, given the continued slowdown of Indian economy. Any prolonged deferral of corporate capex due to prevailing high interest rate could further impede growth in steel demand. RBI is expected to reduce interest rates gradually in 2013 and the magnitude of reduction will determine the extent of demand revival from enduser industries. Also, Indian government's plan to invest USD1trillion in the infrastructure sector could boost demand for steel, provided it is implemented on time. Domestic steel consumption grew by a modest 5.3% yoy over January-November 2012 due to headwinds from the unfavourable macroeconomic environment. During the same period, imports grew by 24.8% yoy to 7mt, while exports increased 15.4% yoy to 4.3mt.

Raw Material Pressure

Despite global softening of iron ore prices, experts believe domestic prices to rise in 2013 given the inadequate availability of iron ore, consequent to the prevailing mining mess. India's leading iron-ore miner NMDC Ltd's shift to import price parity for selling iron ore in the domestic market will result in narrowing of gap between domestic and seaborne prices. In the past, NMDC used to sell iron ore in the domestic market at a huge discount to seaborne prices. High iron ore prices will adversely impact the margins of steel makers having no captive mines while integrated steel makers with captive mines may see some margin expansion. The hard coking coal (HCC) market will remain fundamentally tight and production disruption will continue to show in price movements in 2013. Nevertheless, the agency expects prices of benchmark HCC, for which India is mostly dependent on imports, to be about USD200 per tonne in 2013 due to muted demand growth. This could provide partial relief to domestic steel producers making steel through blast furnace route subject to a stable rupee.

STEEL DEMAND-SUPPLY DATA (MILLION TONNES)			
Particulars	FY13	FY12	Variance (%)
Production	66.4	65.3	1.7
Imports	6.2	5.4	14.2
Exports	4.6	4.2	10.3
Net Exports	(-) 1.6	(-) 1.2	NA
Stock Variation	(-) 1.1	0.5	NA
Apparent Demand	69.1	66.0	4.6

Source : JPC

The average quarterly contract price for HCC (ex-Australia) declined by about 28% yoy to USD210 per tonne in 2012. However, depreciation of the Indian rupee against major currencies offsets some advantage that could have accrued on account of this reduction in input costs.

Steel Price Hike Muted

Steel prices are likely to show modest recovery in 2013 due to the cost-push effect. The ability to raise steel prices in the Indian market is also limited by the global nature of the market, coupled with oversupply and weak demand in the international market. Imports, though contained to an extent by rupee depreciation, have already touched an all-time high of 10% of the total production in 2012. Moreover, Indian government's free trade agreements with Japan and South Korea, under which these countries are eligible for lower custom duties, are resulting in an increase in imports of steel from these countries, thus further pressurising the domestic steel prices.

Domestic steel prices are ~Rs33,750/t-34,250/t (1-1.3%QoQ) as price hikes announced by steel mills did not stick due to weak demand and arrival of imports booked at lower Dec Q prices. Import bookings have slowed over the past few months as domestic steel prices were at ~6-9% discount to import parity in Jan/Feb. Net imports have declined to 0.07mt in March (0.17mt in Feb). The discount to import parity has narrowed to 3.5% (for Chinese steel) due to correction in regional steel prices. The discount is set to be even lower for Japanese/Korean steel, which is subject to lower import duty. This should cap any attempts to raise prices, while a further decline in regional prices could exert pressure on domestic prices.

Global steel prices had rallied from Nov lows led by restocking, but have slipped 4-9% across regions as restocking has faded, concerns around tightening in China resurfaced and as Chinese inventories are at record levels (~20.3mt). Destocking continues in China, albeit at a slow pace as supply has been resilient as per our China steels analyst. More supply cuts cannot be ruled out for price stabilisaiton.

Challenges

The domestic steel industry could face the risk of overcapacity in the medium-to-long-term as Indian steelmaking capacity is slated to cross 100mt in 2013, which could pressure steel prices. However, given the expected shortage of iron ore in 2013 due to iron ore mining mess, most steelmakers who depend on external mines for their iron-ore requirement may not run on full capacity thus limiting the overcapacity concern. Also, the delay in greenfield capacity additions, due to regulatory hurdles such as land acquisitions and the rehabilitation of settlements, will continue to mitigate some of the overcapacity concerns.

Most Indian steel producers' liquidity will remain stretched through 2013 given the increase in input cost resulting in enlarged working capital requirements. Domestic iron ore prices remain high; however, softening of coking coal prices may give some respite. The liquidity concern is further compounded by steel producers' expansions resulting in negative free cash flows. Lower-than-anticipated cut in interest rate by RBI in 2012 also stemmed demand growth from end-user industries. However, interest rate is expected to gradually soften in 2013 giving some relief to the industry. Indian steel industry's is one of the largest borrowers from the domestic banking system; any limited availability of credit could adversely affect the liquidity particularly of lower-rated issuers who do not have access to capital markets.

Indian steelmakers are expected to import iron ore over 2013 and 2014 to meet the domestic shortfall. Regulatory intervention in the mining industry (particularly in iron ore mining) has thrown up new challenges of securing iron ore supply to steel makers who do not have captive iron ore mines. Though the Supreme Court has lifted ban on category-A (with no or minor illegality) mines in Karnataka, iron ore deficit is expected to continue in Karnataka in 2013 as the ban on category-B and C mines is still in force. Due to a shortfall in iron ore, most Karnataka-based steelmakers will continue to underutilise their capacities in 2013.

Orissa, Goa and Karnataka produce bulk (FY12: 68%, FY11: 73%) of iron ore in India. Ban on iron ore mining in Goa will have a minor impact on the domestic supply of iron ore as a bulk of iron ore from the state is exported. Odisha's (the largest iron ore producer state in India) proposed move to restrict iron ore mining to steelmakers with captive mines in the state could further increase the scarcity of iron ore in the country. Due to the prevailing mining mess, iron ore production in India is already down 18% yoy in FY12 and is likely to fall further in FY13. Greenfield projects continue to suffer due to land acquisition, rehabilitation and resettlement issues. Land Acquisition, Rehabilitation and Resettlement Bill and Mines and the Minerals (Development and Regulations) Bill, which could have alleviated these problems, is yet to be passed by the parliament.