Demonetisation Hits India's Steel Demand

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Steel industry in India is now passing through one of the difficult phases in the past several years due to weak consumer demand following liquidity crises arisen out of demonetization of high value currency notes. While the government had in February announced $1 trillion investment on infrastructure development, lack of government financing and disappearing private investment have forced a slowdown in steel demand over the last two years.

Contraction in Crude Steel Production

Spurt in China steel production in Q3 CY2016 helps reduce the contraction in world steel production While the world crude steel production contracted by 0.5% during January – September 2016, it was less than the 1.2% de-growth reported during January – July 2016, on account of a rise in China's steel production during July – September 2016. A 3.2% YoY increase in crude steel production in July – September 2016 helped China register a positive production growth of 0.4% during January – September 2016. One of the reasons behind an increased production was the improved growth in investments in China's property sector to 5.8% in January - September from 1% in calendar year 2015. However, given the moderation in China's steel exports in the last four months and a negative growth forecast for its apparent steel consumption for the current year and the next year by the World Steel Association, any material increase in China's steel production looks unlikely in the near term. Consequently, the world capacity utilisation rates, which increased in September 2016 to about 70.2% from 68.3% in July 2016, are unlikely to improve significantly from the current levels. Anti-dumping duties and high international prices to keep steel imports under check; expected weakness in demand post currency demonetisation to exert some pressure on domestic prices. Although the de-growth in steel imports during July – September 2016 was steeper than that in April – June 2016, overall steel imports of about 0.6 mt per month still remain high at an absolute level. As a result, India remains a net importer of steel despite registering a 63% growth in exports during Q2 FY2017. Nevertheless, with the full effect of anti-dumping duties setting in H2 FY2017 and increased international prices in recent months, steel imports are likely to reduce further in the coming months.

Despite increasing by Rs. 3000/MT, post the imposition of antidumping duty in August 2016, domestic HRC prices are currently cheaper than the imported offers by about 8%.

Negative Impact of Demonetisation

The currency demonetisation drive by the Union Government would have a negative impact on the long steel players having exposure to end-users in real estate and construction in the near term. While the flat steel producers would also be faced with a likely reduction in rural demand for roofing products, as well as lower demand from auto-makers, the impact of slowdown would be limited for them. Given these headwinds, domestic prices are likely to witness some pressure in the near term. Steel players would also have to grapple with logistical bottlenecks for a brief period due to the cash crunch being faced by most of the truck operators. However, in the medium term, demonetisation is expected to lead to (1) a reduction in lending rates by banks, which will help reduce the interest burden for the debt laden steel mills and (2) pave the way for increased share of organised players in the domestic market.

Meteoric rise in coking coal price to hurt blast furnace players financial performance in the fourth quarter of FY2017. International contract prices of benchmark low volatile premium hard coking coal (HCC) for Q3 FY2017 have been settled at US$200/MT, showing a 116% quarter-on-quarter (QoQ) increase from US$92.5/MT in Q2 FY2017. A resilient Chinese steel production since March 2016, coupled with a lower domestic coal production in China in the current year, has led to a 20% YoY jump in coking coal imports by Chinese steel mills in the period January-September CY2016, driving coking coal prices northwards. This sharp rally in international coking coal price is likely to hurt domestic blast furnace players. ICRA estimates that the increase in the cost of steel production for domestic blast furnace players dependent on imported coking coal will be around Rs 5,750/MT (~17% of hot-rolled coil price in November 2016).

As a result, the benefits from trade protection measures, which helped in the recovery in hot rolled coil (HRC) prices by Rs 8,500/MT between February and October of CY2016, are likely to largely disappear after the end of Q3 FY2017. As per Icra estimates, gross contribution levels of domestic blast furnace players in Q4 FY2017 is likely to dip by around Rs 4,000/MT over Q3 FY2017, unless the increased coking coal costs are accompanied by commensurate price hikes by the steel makers. Moreover, given that premium hard coking coal price between October-November of 2016 has steadily increased from US$213/MT to US$309/MT at present in the spot market, contract prices in Q4 FY2017 is poised to be settled at an even higher level than US$200/MT.

Odisha iron ore prices remain under pressure amid the supply glut; however, Karnataka prices moderately firm up on the back of tighter demand-supply balance. Domestic iron ore production had increased by a robust 22.8% YoY both in FY2016, and H1 FY2017, in turn pulling down domestic ore prices. A large share of India's incremental iron ore production has been contributed by Odisha based miners, which has created a regional supply glut and a buyer dominated market. Between March 2016 and August 2016, average lump ore prices (60%-62% Fe content) for Odisha based miners have declined by around 22%. However, the supply scenario in Karnataka, another large iron ore-producing state, remains tighter, given that the state has an overall mining cap of 30 mtpa as per the order of the Honorable Supreme Court.

This supply tightness in Karnataka, which has further intensified after the commissioning of JSW Steels 3.7 mtpa brownfield steel capacity in FY2017, has led to a divergence in pricing trends in Karnataka and Odisha in the current year, with Odisha prices sliding downwards, and Karnataka prices moderately inching northwards. In fact, Karnataka-based miners like NMDC Ltd. has adopted dual pricing for iron ore produced from its mines in Karnataka and Chhattisgarh, with the base price for the Karnataka auctions being set higher by around Rs 500 to 550 per MT as compared to the price of a similar grade ore produced in Chhattisgarh.

However, the operationalisation of the recently auctioned seven Category C mines in Karnataka, having a rated capacity of 8.2 mtpa, is expected to ease the state's supply tightness in FY2018, provided the Honorable Supreme Court allows a production beyond 30 mtpa of iron ore from the State. Increased coal prices amidst weak demand are likely to exert pressure on profitability of domestic steel companies Aided by a spike in realisations post MIP, operating margins of the steel industry (sample of 18 large and mid-sized steel players, accounting for about 60% of the current domestic capacity) increased to 18% in Q1 FY2017 from 9.5% in Q4 FY2016. While the realisations dropped again in July 2016 due to weak demand, they improved post the imposition of anti-dumping duty in August 2016 and remained firm in the last one month. However, the increase in realisations is not commensurate with the rise in coking coal prices in the last few months which, coupled with expected weakness in demand post demonetisation of currency, makes experts believe that the industry operating margins for H2 FY2017 are likely to remain lower than Q1 FY2017 levels. In line with operating margins, the coverage indicators of the steel industry improved in Q1 FY2017 with interest coverage improving to 1.52 time from 0.91 time in Q4 FY2016. However, expected pressure on profitability and elevated debt levels are likely to keep the debt protection metrics of the industry depressed in the near to medium term.

Challenging Times Ahead

The sharp rise in international coking coal prices coupled with an almost stagnant steel demand pose challenging times ahead for the domestic steel players. Domestic steel demand remained largely stagnant in the first quarter of

FY16, with consumption growing by just 0.4 per cent year-on-year (y-o-y) during this period. Cost pressures amid weak demand signal challenging times ahead for domestic steel players, rating agency Icra said in a report.

With demand for steel starting to improve from July 2016 onwards, steel consumption growth in Q2 was much higher at 6.8 per cent. However, going forward, an anticipated slowdown in the real estate sector on account of government's demonetisation drive will impact demand of long steel players in the immediate term. A majority of small-to medium - sized secondary steel players in India are positioned in the long product segment, impact of this slowdown in real estate demand is expected to affect their capacity utilisation levels. In the flat product category on the other hand, impact of the slowdown would be limited, though rural demand for some of the flat products like corrugated sheets and galvanised sheets is likely to reduce in the near term, transactions being largely cash-based. For the auto sector, the impact of demonetisation is expected to be marginally negative in the near term, especially for the two-wheeler and three-wheeler segments, where the share of the cash purchases has remained higher.

Secondary Producers to Impact Badly

The government's move to demonetise currency will impact the secondary steel sector as most of the business conducted by these mini mills and rolling factories is cash-based, which in turn would help the large producers. Counted among the top 10 steel makers globally, the Mumbai-based firm said that demonetising will also temporarily impact steel demand in rural India as the business there is also mostly cash-based. "We are watching secondary sector very closely because a lot of that business used to happen on cash. And maybe 60-70 per cent of the long products business is actually driven by the secondary sector. "So it could have a significant positive impact on the long products business for the integrated or bigger players," Tata Steel India and South East Asia Managing Director T V Narendran was quoted as saying. Government demonetised Rs 1,000 and Rs 500 notes from the midnight of October 8 with the aim to fight black money and corruption.

But in any case, market was shifting towards integrated sector because between JSW Steel, Tata Steel, RINL and JSPL and everyone else, lot more long products capacity is being added over last few years, which is encouraging the consumer segments to shift towards formal sector. But, demonetisation move should accelerate that process. The secondary steel sector, which accounts for almost half the steel produced in India, uses sponge iron and scrap to make steel in small induction furnaces. These producers generally procure sponge iron feedstock from nearby manufacturers and sell crude steel, mostly pencil billets and ingots, to re-rollers. India, the world third largest steel maker, produced 89.58 million tonnes of the metal in 2015. Tata Steel is also witnessing some impact on logistics as some movement of material got disrupted due to "confusion at the toll gates and excise points" which is getting "sorted out". Rural demand, which is largely cash-based, will get impacted temporarily. Most primary steel producers normally deal with their distributors through online payment and hence, have no major impact of demonetization on their business.

Impact on Raipur Steel Industry

There are 200 rolling mills, 100 furnaces, 50 sponge iron plants, about 200 steel traders and another 250 agents in this market alone and the steel industry of Chhattisgarh is much bigger. All these players are independent. The sudden ban and lack of adequate new currency notes has prompted a liquidity crunch across industries especially smaller and medium sized businesses that depend on cash transactions. One such segment is the iron and steel trade industry in Raipur, where according to the Raipur Iron and Steel Trade Association president Sanjay Jain, the demonetisation drive has led to a severe drop in business, which in turn means that manufacturing units are on the verge of shutting down. Retail trade has been hit the most, not just in Chhattisgarh, but across the country. Also, manufacturing continues in some pockets but with the lack of funds may bring it to a halt. Besides, the cash crunch has meant few buyers in the market. The retail steel market is completely dependent on cash for its usual business and since the flow of cash has stopped, the market has stopped too. There are about 800 participants just in the Raipur association who are currently sitting jobless, on piles of stock but no cash to conduct their business. Till the time cash returns to the market, the situation will be like this and it will only add to our losses which were already mounting due to bad market conditions for industrial steel.

Trade sources believe that the whole market that runs on cash is the conventional mode of payment for most things here. If consumers are buying supplies from a small trader, he would want his payment in cash and similarly, buyers for our goods want to pay in cash. Cheque payments only work for the big players in the market who can afford to wait for two-three days for the cheque to clear. But even they are not accepting cheques anymore since cheques also need to be converted into cash and banks have placed a limit on withdrawals. No matter which mode of payment is used, there is cash involvement at some level and the market cannot function smoothly if you squeeze cash out of it. Since nobody (in the market) has cash with them anymore, steel traders are all sitting without any work to do.

Immediately after demonetisation, all activities came to a halt. People have stocks of goods but there is no buyer or supplier in the market because cash is not available. The full chain is interlinked and if one part stops working, other parts start getting affected too. Even labourers cannot be paid because they don't know banks and don't have accounts. Daily wage labourers work on cash only and if they can't be paid, they won't come to work so the market anyway does not have the capacity to serve customers but there are no customers right now. There will be losses of at least Rs 20 crore in the market every week till the situation normalizes i.e. liquidity crisis gets over. Business has come down to just a quarter of what it was two days ago.

Recovery Looms Large

While the liquidity is gradually easing, the steel demand has started coming in. Sensing the revival in demand, mills have decided to raise steel prices by Rs 6000 a tonne effective January 1, 2017, one of the highest rises in recent years. But, sharp increase in steel price may affect demand, albeit marginally.