Expected rise in steel demand to make price hike sustainable

- Steelworld Research Team

Primary steel producers in India raised their products' prices by 6 per cent effective January to pass on the increase in their cost of production arising out of a sharp increase in raw materials prices. Not only private steel mills like JSW Steel and Essar Steel but also government owned Steel Authority of India Ltd (SAIL) and Vizag Steel raised their product prices by Rs 2000 across grades of steel for January. Earlier, they had raised their product prices about a month ago to pass on a part of their increase in cost of production to consumers. Now, frequent increase in steel prices would make cost of infrastructure building proportionately higher as prices of other inputs have also gone up significantly over the last few months. Now, the question arises whether the current steel price hike is sustainable ? If one goes by global and domestic economic growth forecast and budgetary allocations made thereupon, it seems that the current steel price rise is sustainable.

Coal price increase and impact in secondary producers

Effective January 09, 2018, Coal India Limited (CIL) has increased the prices of thermal coal. This increase for domestic coal consumers comes on the back of an additional levy towards 'Evacuation Facility Charges' (EFC) of Rs 50 per metric tonne (MT), which started from December 20, 2017. Moreover, the Indian Railways has increased effective freight rates for coal and coke by around 4% (for all distance slabs) with effect from January 15. According to an ICRA report, the recent hike in coal price and railway freight rate hikes, following the earlier levy of EFC, is expected to increase the cost of steel production by Rs 150-500/MT for a secondary steel producer using sponge iron and induction/electric arc furnaces for steelmaking, and dependant on domestic coal. The quantum of increase would however depend on the specific grades of coal used by the steelmaker. The cumulative effect of this recent increase in raw material and freight costs would negatively impact the operating margins for secondary steel producers by 45-145 basis points at current price levels, unless such mills are able to pass-on this cost increase to consumers, says Jayanta Roy, Senior Vice President and Group Head-Corporate Ratings, ICRA. As for impact of increase in coal prices, the quantum of cost increase for a secondary steel producer would depend on the grade of coal used in the sponge iron kiln and captive power plant. This is due to the fact that the level of coal price increase implemented by CIL for the non-regulated sector is uneven across various grades. For the higher calorific value G7–G9 grades, which are typically used in the sponge iron kiln, the price increase (including duties and taxes) ranges from Rs 58/MT for the G9 grade, to Rs 468/MT for the G7 grade. For the

lower calorific value G10–G12 grades, which are typically used in captive power generation, the price increase ranges from Rs 58/MT for the G10 grade, to Rs 210/MT for the G11 grade. Further steel players are also expected to experience an increase in inward freight costs on account of the revision in freight rates by the Indian Railways for movement of coal and coke, the effective rate of increase has been around 4% over the prevailing rates across various distance slabs. The minimum cost increase following the coal price/freight rate hikes and levy of EFC comes to around Rs 150/MT of crude steel (when using a combination of G9 grade in the sponge iron kiln and G10 grade in the captive power plant), and the maximum cost increase comes to around Rs 500/MT (when using a combination of G7 grade in the sponge iron kiln and G11 grade in the captive power plant). Unless secondary players are able to pass-on this cost increase through steel price hikes, operating margins for such mills are expected to decline between 45-145 basis points at current price levels.

Steel players having a fuel supply agreement or dependant on e-auction/linkage auction will get directly impacted by the recent coal price and freight rate hikes. However, for players sourcing higher grade imported coal for sponge iron kiln, and using domestic coal for captive power plant, the impact would be lower at around Rs 50-80/MT of crude steel production (margin impact of 15-25 basis points at current price levels).

Profitability to improve

Profitability of Indian steel companies is likely to improve next year despite an increase in raw material prices, according to Moody's Investors Services. In its latest report 'Steel - Asia, 2018 outlook', the rating agency said that among major steel-producing Asian countries, operating conditions will be most supportive in India because of robust domestic demand and protectionist measures, and despite an increase in raw material prices and new capacity. Moody's has also revised the outlook of Asian steel companies to stable as it expects the profitability of these companies to be steady compared to 2017. The likely stable profitability for Asian steelmakers that we rate is underpinned by the removal of excess steel-production capacity in China and broadly steady demand in Asia as a whole. Steel production capacity in China will continue to decline, due to its government's supply-side reforms and environmental protection measures. These factors will reduce the supply glut in Asia, Moody's said in a statement.

China factor

China drives the outlook for steel companies in Asia because the country represents the region's largest steel consumer as well as producer. Overall steel demand in Asia will remain stable, with robust demand growth in South and South-East Asia, and flat growth in China. A likely slowdown in China's property sector sales will have a limited effect on overall demand and industry fundamentals over the next 12 months, because the strong fall in sales since 2016 will support new construction and steel demand over the next several quarters. Domestic demand will be steady in Japan and Korea, which, together with the steelmakers' efforts to cut costs and increase production of premium products, should push up earnings of companies in these two countries, it added. Basking under a slew of "protectionist" measures initiated by the government, the Indian steel makers are enjoying a huge premium in the domestic market, up to USD 200 a tonne, cutting into the competitiveness of highly employment-oriented user industries, mostly in the Small and Medium Enterprises sector, the Engineering Export Promotion Council (EEPC) India has said. There is a clear discrimination against the domestic users as the steel makers are fully exploiting various protectionist measures, said Ravi P Sehgal, Chairman of the apex engineering export organisation, EEPC India. He said export price is much lower than the domestic prices of the finished steel as also different products. To us, the domestic users, steel and products are supplied at a much higher prices raising the overall cost of production and in short raising the price difference between export price and domestic price of steel. The difference in the export price and the domestic prices is estimated to be around \$150 - \$200 per tonne. Barring wire rods, the domestic price of all other steel products is found greater than the export prices of the given products. Illustratively, against an average export price of \$497 per tonne, the domestic prices of HR coils had been pegged at a huge mark- up, at \$700 per tonne in September, 2017, as per the latest data compiled by the EEPC India. Likewise, domestic users of cold rolled coils were made to pay \$786 per tonne against the international price of \$566 per tonne for the month. For the billets, the domestic prices were \$603 per tonne against the global rates of \$453 per tonne. Similar trend is visible in , pig iron and wire of iron and non-alloy steel with difference of \$ 125-\$200 per tonne. The year-on-year price increase effected by the steel makers in the domestic market range between 19 per cent on cold rolled coils and 36 per cent on Billets and as much as 39 per cent for a product category called 'Blooms'.

China's steel supply chain to be stretched due to winter cuts & post supply side reforms

The winter cuts imposed on Chinese steel producers will significantly tighten the global steel markets over the next three to four months (and this tightness may possibly stretch to May – June 2018). Post the structural supply side reform, steel capacity utilization in China has improved to >80%. The further tightening of supply will stretch the Chinese steel supply chain and aid steel prices. Capacity utilization at Tangshan, one of the main steel producing regions in China has already fallen by close to 20% in recent weeks due to winter capacity cuts.

China's steel capacity cuts for mainstream producers amount to 42 mtpa (YTD) in Cy2017 - this is besides the 100 mtpa of closure of induction furnaces (not accounted in official statistics); besides 45 mtpa of capacity was closed towards 2HCY16. The closure of induction furnaces has led to a sharp increase in reported demand (per WSA) as the demand from this sector of the market is now supplied by mainstream steel makers and captured in the official statistics in 2017. Accordingly the steel demand for China's mainstream producers is expected to increase to 765 million tonnes for CY2017E from 681 million tonnes-almost a growth of 12%) resulting in industry utilization levels increasing to 81% (from 71%). The better demand within China has also resulted in lower exports-China exports declined by 35% yoy to 5 mn tons in October 2017. This is unsustainable for the domestic user industries as the steel makers have enjoyed the protection of the government through measures like Minimum Import Price, ' Safeguard duty and anti-dumping duty on imports , leaving the user industries in the country , particularly in the SME segment, at the mercy of the mega sized steel companies, Sehgal said. While the steel makers are having best of times both in the export market and in the domestic economy, the SME exporters are finding it difficult to compete and take advantage of the uptick in the global demand. "It is true that there is an improvement in global demand but we need to be controlling our costs to remain in competition and if the basic raw material prices are jacked up at this speed, it is the SMEs which become vulnerable. Remember, it is the SME sector which provides the maximum of jobs".

Tight global supply

Experts however think the stage is set for the global carbon steel market to tighten considerably in 2018, with the outlook for the year ahead relative to investor expectations arguably as positive as at any time since 2003/04. We are seeing the 'perfect storm' of several factors coming together at once, with four key themes to watch out for :

- Leading real demand indicators suggest ongoing strength in underlying steel demand, shifting in particular to the ex China market in 2018
- Global inventory levels remain low, with the 2014/15 destock still yet to be materially replenished supporting apparent demand growth ahead of real demand
- Steelmaking utilisation remains much closer to true realisable capacity than many investors believe, as raw material and input constraints, plus years of cost cutting in the steel industry, mean excess nameplate capacity is unachievable in reality and hence excess capacity is much lower than simple figures suggest
- Raw materials (especially coking coal & electrodes) pushing up the global cost curve creates an inflationary environment positive for earnings & apparent demand.

Steel price rise and room for sustainability

Indian steel mills raised their product prices by 5-6 per cent in January and are now eyeing to raise steel prices by another Rs 2,500-3,000 a tonne in February in order to bridge the gap between domestically produced and landed cost of imported steel and offset cost pressures. The government-owned NMDC raised iron ore prices by 19-22 per cent, one of the steepest ever, for January following similar price hikes by private miners in Odisha due to suspension of production at five major mines in the state as per the Supreme Court order. NMDC had raised iron ore prices earlier in December too, by 10-13 per cent. In calendar year 2017, the country's largest iron ore miner has raised prices by a staggering 48 per cent to match its prevailing price in the international markets. The sharp increase in raw material prices has significantly pushed up production costs, prompting steel makers to pass it on consumers. Consequently, steel producers across the country raised their product prices by upto Rs 2,500 a tonne for January to keep their profit margins intact. Recent increase in iron ore price by NMDC and Odisha's private miners are forcing steel companies to pass on increased cost of production. Increased cost of other raw materials like coal, refractory and electrodes is further fuelling this and leaving no other option, said Sajjan Jindal, Chairman and Managing Director of JSW Group of Companies, in a twitter post. In another tweet, Jindal said, "With closure of mines, people are losing jobs and the government is losing royalty. Thus it is helping no one. Instead of stopping iron ore production in Odisha due to non-payment of compensation by lessees, a new solution should be worked out. The government must approach the Supreme Court considering that the iron ore shortage of additional 20 million tonnes will lead to a disastrous situation wherein the small companies will be forced to shut operations." Prices of other raw materials have also jumped significantly in the last six months. After a rally in April 2017, prices of coking coal plunged towards May end last year. Its price, however, has bounced back starting June 2017 and is up 73 per cent to $269 a tonne currently in the Australian benchmark. Other raw materials such as refractory and graphite electrodes have also seen similar price spike in the last six months. Imported steel continues to remain costlier by Rs 2,500-3,000 a tonne. While we have already raised steel prices by 5-6 per cent for January, we would see whether this price gap can be bridged in February. But, certainly there is a room for steel price increase of Rs 2,500-3,000 a tonne to pass on the raw material price hike to consumers, said Jayant Acharya, Director (Commercial), JSW Steel.

Meanwhile, steel companies with captive iron ore availability – Tata Steel and Steel Authority of India (SAIL) - are also facing margin squeeze due to increase in the prices of other raw materials which they buy from others. Hence, these steel mills also raise steel prices to cover for increased costs or when the situation demands. Raw material price increase is not the only factor we consider before revision in steel prices. We also see whether market can absorb the price increase or not which currently we see a possibility. The steel cycle has become so short today that we cannot forecast our action plan three weeks in advance. Sometimes, steel price moves in opposite direction of the raw material prices. Therefore, we will take a price revision call as per the market situation at that point in time. Meanwhile, Credit Suisse in its latest report forecasts strong possibility of further spike in global steel prices. After some weakness in H1'17, steel prices in all regions are up year-on-year. We still think further upside is certainly possible. Steel prices remain low compared to the 2011 upcycle and, when taking into account inflation, low relative to 2003-04 also. We are now nearly two years into the global steel market recovery since the trough of Q4 2015 and Q1 2016, yet fundamentals continue to be strong, steel making margins remain healthy and if anything in 2018 we should see an acceleration in ex-China fundamentals. Equities, however continue to discount an imminent downturn in steelmakers' earnings that we do not think is likely in 2018, said Michael Shillaker, an analyst with Credit Suisse. The foreign brokerage believes that potential global supply constraints in iron ore, metallurgical coal and graphite electrodes could significantly tighten the market further. Investor sentiment remains negative and valuations are generally attractive (for raw material companies). The stage is set for the global carbon steel market to improve considerably in 2018, with the outlook for the year ahead relative to investor expectations arguably as positive as at any time since 2003-04.

Credit Suisse sees the 'perfect storm' of several factors coming together at once. Indian steel prices are still lower than the global steel prices and definitely there is not much of a case to enhance the steel prices any more. It has already absorbed the shock of enhancement in the iron ore as well as in the coking coal. It has settled there. Steel price below Rs 35,000 does not make the Indian steel industry very competent in manufacturing and it starts incurring losses. There has to be a breakeven point with a small margin of profit and there has to be a point where it does not become extortionist. Thus between Rs 35,000 and Rs 40,000, it is considered very reasonable. The Ministry of Steel's calculation varies depending on the vagaries in the input prices and not so much due to the international rate prices. The antidumping measures are to continue just to ensure that nobody starts dumping steel at less than their cost of production. Even if the cost of production in China is much more than our safeguard value, it only ensures that steel from China does not come here for lesser than that cost and that is the correct WTO way of working and that is what the Ministry of Steel has been resorting to.

Meanwhile, the concerning point in the industry is not so much on the supply side but more on demand. FY17 saw very meagre steel consumption growth and India continues to be one of the lowest steel consumers. India is a low consuming country but along with that, we are also a low infrastructure country and we are a country where there is a strong case of infrastructure expansion as is visible from the budgets of last two years of the government. So, there is a huge volume which is going in infrastructure. The GFR Amendment has made it mandatory now to calculate the lifecycle cost. The moment you calculate the lifecycle cost, steel is a winner. There are a number of places where steel consumption is going up. To give examples, in ports and harbours, new airports, new railway stations etc all will be steel intensive. Under Pradhan Mantri Awas Yojana, steel intensive housing is going to get a big fillip. All highways, crash barriers, bridge of railways as well as of the national authority, CPWDs, PWDs that is giving a boost and already the work has started. The rail replacement expansion that is also going to consume a lot of Indian made steel and then coach and wheel factories where more and more routes will be added. All this will give a big fillip to steel consumption. To rise from 50 kg per capita to 60 kg per capita we took seven years. But from 60 kg to 65 kg per capita consumption we have taken just one and a half years. In the sense that our track is right, consumption is going up and even on date when we are nearly going to touch 100 million tons in this financial year, our consumption is going to be 90 million tonnes, in fact much more. We export around 10 million tonnes, India imports 9 million tonnes. So in a sense we will be touching that figure in consumption and are absolutely on the right track. Steel mills are targeting to settle somewhere around 160 kg per capita as we go ahead. Now the steel industry has also come up with ready-to-use products and a one-point- shop. Basically, it is a very green industry and if you replace timber with steel for your doors, wardrobes, kitchen modular everything, it is a lifelong clean investment. Similarly, with a steel bridge, for 100 years you do not have to worry about it. Non-corrosive steel is also now coming in a very big way for the coastal areas. There has been a huge surge in India's exports in 2017 and you have alluded the numbers as well there. But a significant chunk could be attributed to the drop in Chinese exports which that enabled Indian makers to capture the market share. Do you believe that the export numbers could dwindle as China once again reopens capacities post winter?

No absolutely no problems. As far as China is concerned, they have gone in a big way to close their induction furnace polluting and inefficient capacities. And they have done a good job about it by closing down nearly 60 to 70 million tonnes of production. Parallely., they have also enhanced the techno-economic parameters of their new capacities. So the overall production has not come up. China's own consumption is 90% and they export the rest 10% which is not a small number and comes to around 70 million tonnes. That is enough to upset the markets. But China is also moving towards high-end products. As far as Indian exports are concerned, our exports are not limited to China alone. India is also exploring new markets as the country is giving fillip to shipping industry, to defence production industry, to capital goods industry. The country has enough requirement to absorb within the country itself.