

From Russia With Love

Sector outlook: Negative

Steel

BSE Sensex: 15,858
Nifty: 4,756
BSE Metal: 10,040
** As on November 24, 2011*
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General pessimism held sway at the recently concluded SBB Russia Steel and Metals conference that we attended. However, Russia and the CIS markets continue to look promising due to the ongoing construction boom in the region as well as the inevitable shift of production facilities from non-resource-based regions like Europe to resource-based regions like Russia, the CIS, India and Africa since raw material prices continue to remain strong. The overall sentiment was that 2012 would not be better than 2011 for the metals industry with uncertainty continuing to cloud the outlook till H1CY2012.

China to remain maker or breaker of world steel industry: It seems that China is gradually moving towards a five-year long slowdown phase as Beijing tries to rein in asset bubble creation and inflation by attempting to cool its superheated economy. If this happens then we are likely to see increasing exports from the country putting pressure on steel prices. Meanwhile, the Chinese government is encouraging consolidation in its local steel industry and closure of outdated manufacturing facilities in a bid to reduce overcapacity. But the presence of too many small steel plants continues to pose a challenge.

Increasing production but declining consumption to keep prices under check: Consumption growth is less than production growth by 1.8% leading to an oversupply. World Steel production for the eight months of January-August 2011 increased by 8.3% YoY, whereas consumption grew by merely 6.5% for the same period. This will continue to keep prices under check unless production is reduced and some of the excess capacity folded up.

Raw material prices to remain strong due to lack of new resources: We believe that raw material prices will continue to remain strong due to lack of new resources. Floor for iron ore price will continue to remain high at USD120/t CFR China basis because margins of Chinese steelmakers will plummet if iron ore prices go below USD 120/t as steel prices will also follow suit. Besides, it is likely that cost of mining ore will increase to USD120/t as new assets need to be identified. Africa seems to be the one region that has unexplored as well as potentially high quality reserves. It will be the new destination of choice for iron ore miners as the continent with nearly 400 mt of reserves may offer cost competitive extraction. But new mining projects leading to 115-125 mt increase in production (~10% of the current production) will be only coming up in the period 2015-16. Coking coal prices are also expected to remain at high levels, again due to lack of new resources. The only alternative seems to be the increased use of pulverized coal injection method to overcome lack of new resources and tight supply situation.

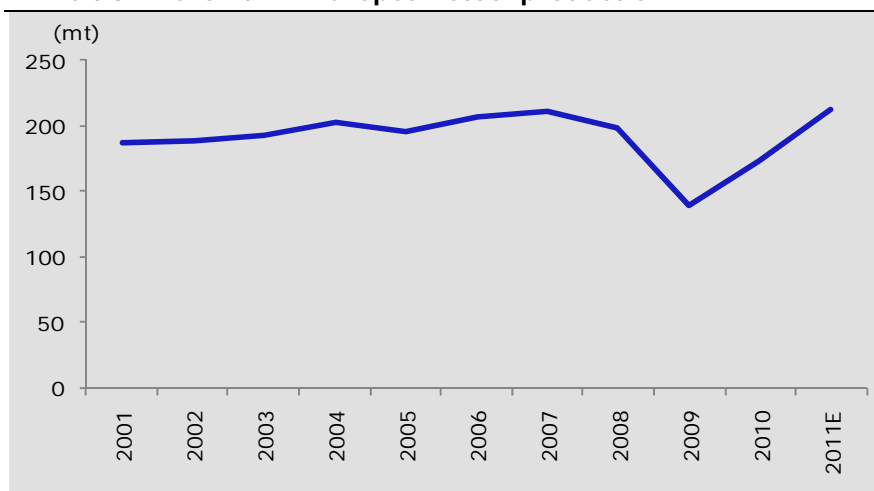
Sans resources European steel industry unsustainable: It is an irony that Europe, despite having no resources, continues to produce 150 mt of steel. But now with growth slowing down, its steel industry will increasingly start finding it difficult to remain profitable. We believe that European capacity will need to be either reduced or shifted to places like Russia, the CIS or India that provide both resources as well as growing demand. We can see this happening from next year onwards when Russia joins WTO in August 2012. Some European producers have already announced production cuts and shut down blast furnaces on the back of market uncertainty and all pervasive negative sentiment. Since restarting a blast furnace is a capital intensive proposition, the only solution before struggling European steelmakers is to close down unviable capacities.

Despite apprehension Russian metal producers hopeful that joining WTO to provide them access to new markets:

Speaker after speaker from Russian metal companies aired their apprehensions about joining WTO amid fears that lower import tariffs would eventually result in China dumping steel into the market. The general view was that despite the current customs duty of over 17% there is already a huge dumping of steel products like galvanized and polymer coated sheets and pipes by China. But they also acknowledged that this will allow them to increase exports to Europe as the prevailing restrictions on quantity will be done away with.

Profits to shift from steel to resource producers: We will continue to see shifting of profits from steel producers to resource producers. As such, we will see some of the capacities from Europe and China relocating to resource-rich countries like Russia and the CIS.

Exhibit 01: Growth in European steel production



Source: Worldsteel Association, Fortune Research

Ironically production has increased despite weak margins and lack of resources. We believe this is unsustainable in the long-term and European steelmakers would need to reduce capacity by about 30 mt.

Tangram of Chinese demand growth

The biggest question everyone seems to be asking these days is about demand growth in China and as to how long will it last? Frankly speaking, even at the SBB conference nobody had a clear answer for this as the world's fastest growing economy continues to remain an enigma in several respects. However, participants agreed that growth could be sustained provided how fast China shifted focus from investment to consumption. Current consumption in China is only about 35% of GDP as compared to 45% of GDP coming in through investment.

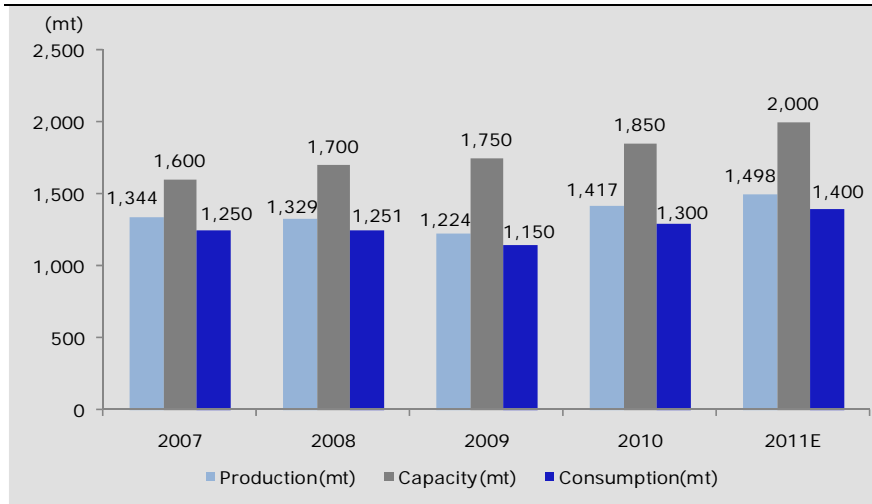
Slowdown in China?

As per the SBB presentation made at the conference, Chinese demand is expected to slow down over the next five years as the country tries to rein in inflation by curbing the spike in real estate prices. Due to Beijing's tighter monetary policy stance and lending curbs to the realty sector, property prices have corrected by 25% while interest rates have increased making it difficult for buyers to repay the mortgages, which has resulted in higher NPA for banks. Besides, people who have purchased apartments at high prices in the last two years are resisting builder's bid to liquidate the unsold inventory at lower price as it erodes their asset value forcing them to pay more margin money to the banks on the mortgaged properties. This further slows down the new projects by builders. The high debt exposure

of Chinese banks to the infrastructure and real estate sectors can limit growth.

Exhibit 02: Excess capacity continues to depress steel prices

Excess capacity seems to be the biggest problem before the global steel industry. On an average, there is 30% excess capacity and, besides, production exceeds consumption by about 7% leading to oversupply and depressed steel prices. We believe that there is excess capacity of about 70 mt in China followed by 30 mt in Europe and 20 mt in the US that needs to be either shut or relocated or simply consolidated.



Source: Worldsteel Association, SBB

Overview of Russian market and Russian steelmakers

- With growth in oil & gas industry slowing down demand for large diameter SAW pipes is also likely to decline.
- Joining WTO will make it easier for import of SAW pipes while simultaneously creating opportunity for Indian and Chinese large diameter pipe makers.
- Russia produced 250,000 t of nickel, 900,000 t of copper and USD3.3 bn worth of steel in 2010.
- Russian steel production is higher than domestic consumption. The country produces about 70 mt of steel, but its domestic consumption is a lowly 20-25 mt, which we believe will increase as foreign investment in infrastructure, steel plants and other projects picks up traction following its joining WTO next year.
- Plate market continues to remain good but bar/rods consumption to grow by 23% in 2011 in Russia. New capacity of 10.5 mt in bar/rods is expected by 2014, which is most certainly going to put pressure on prices as their production will be higher than consumption.
- Developed countries are expected to minimise consumption, which will have serious implications for Russian exports and steel industry.
- For the past few years the country has enjoyed political stability and its economy is growing. Russian GDP will grow with growth in steel consumption and, as such, it needs to ramp up investments in infrastructure projects to increase domestic consumption.
- Russian banks are strong and stable and the country's non-integration with the world banking system has worked to its advantage as the ongoing debt default crisis in the Eurozone economies has left it largely unaffected. Though growth has marginally slowed down due to problems in Europe, but projects have remained unaffected due to abundant liquidity in the system.

MMK Steel (Magnitogorsk Iron and Steel works, Russia)

Capacity - 14 mtpa. It controls 18% of the Russian market. The company is doing a capex of USD7 bn to further increase capacity by 50% over the next four years.

Severstal Russia

Capacity – 11.6 mtpa, HRC – 8 mtpa and CRC - 3 mtpa.

With 27 branches, Russia's leading steelmaker has the largest distribution network in the CIS.

Current market share is 8% and it is striving to increase its further and maximise EBIDTA.

Led by Chinese and European demand, expects consumption for rolled steel products in the world at about 1300 mt for CY2012.

Due to growth in construction, pipes and machine building sectors, the Russian steel market is growing at 8-10%.

The company expects some reduction in consumption in 2012, but Russian growth is largely expected to remain better.

Expects slowdown in LSAW pipe segment in Russia and, in fact, expects negative growth in H2CY2012.

To stave off credit crunch from slowing down projects it has entered into an exclusive tie up with a Russian bank, Metallurgy Commercial Bank or Metkombank, for financing of projects which will help the company in increasing sales despite slowdown. Severstal also holds a controlling stake in Metkombank.

Metkombank is present across 16 cities in Russia and will act as financier of Severstal projects mainly for its metals business. As such, it will finance entities consuming at least 1,000 t/month of steel. It will open credit lines of up to 12 months and overdraft facility of up to 45 days at competitive rates. This will help small consumers avail finance during challenging times.

Metinvest Holding, Ukraine

It is basically a mining company and controls 24 industries in Europe and the US. It is also into distribution of iron ore, coking coal and LSAW pipes. Ranking 26th in the world, it is Ukraine's largest steelmaker.

Current production capacity – 9 mtpa, and it is going to increase it to 14.5 mt as it recently acquired competitor Ilyich Steel & Iron Works.

Its vast deposits of iron ore help in keeping production costs low.

Sales grew by 60% in 2011 to 13 mt with the acquisition of Ilyich Steel & Iron Works.

As per the company's view, profits will shift from steel producers to resource producers.

Distribution network in Russia is 1 mt and is expected to grow by 12%, with 7% growth coming in from long and 12% from flat products. The company exports 80% of its production.

The company believes that Asian economies will grow faster and China's contribution to growth will increase from the present 20% to 25% in 2015.

Vyksa Steel Works

Vyksa has commissioned a new rolling facility, Mill 5000, for heavy plate production with a capacity of 1.5 mtpa. The mill is supplied by United Metallurgical Co. Vyksa undertook capacity expansion to meet growing plate and sheet requirements of leading Russian manufacturers of large diameter and LSAW pipes.

The mill can produce plates and sheets required for pipes of high durability grades of K60, K65, X100 and X120. Sheets and plates for underwater pipelines, especially, require high geometrical precision and uniformity in mechanical properties.

Mill 5000 can also be used for manufacturing plates for shipbuilding with a guarantee of mechanical properties and thickness of 70-90 mm and width of 0.9-4.8 mt and length of 6-25 mt.

Investment ratings (Returns)

Buy (>10%)	Hold (-10 to 10%)	Sell (<-10%)
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