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METALS & MINING

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Expert calls: Steel recovering; aluminium price range-bound

- **We summarise key takeaways from our interactions with ArcelorMittal (MT NA) and Alcoa (AA US)**
- **Our interactions suggest near-term range-bound aluminium prices but the possibility of upside over the medium term**
- **MT reaffirmed our view of continuing recovery in steel margin through FY24; prefer TATA and JSP**

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MT on steel recovery: MT flagged improving market sentiment amid reduced fears of recession and anticipates double-digit HoH improvement in apparent demand over Jan-Jun'23. The company confirmed the restart of most of its shut-in European capacity (20% of total) given lengthening of the order book. It expects margins to improve in the March quarter as higher volumes and absorption of fixed costs offset weaker prices, and in the June quarter as better prices make up for raw material costs. Refer our note **Steel cycle recovery underway – AMNS**, 10 February, for added colour.

AA on near-term range-bound aluminium price: AA attributed the 9% correction in aluminium prices since Jan'23 to a pullback in sentiment. Though it flagged cautious buying behaviour, it is seeing the end of destocking. Management does not expect Yunnan supply cuts to move the needle and believes European/US restarts look difficult due to high energy costs. However, lower coal pricing could pose a risk if it accelerates restarts in China. The company raised the possibility of medium-term upsides in aluminium price as supply could lag a demand revival. See **Aluminium outlook healthy but limited price upside in FY24E**, 8 March, and **Constructive outlook despite uncertainty – Alcoa**, 19 January.

China soft but will support recovery: Both MT and AA find China's 5% GDP growth target for CY23 to be soft. While MT believes its base case for steel demand recovery still holds, AA indicated that the government's focus on improving the economy will support recovery and that the continued thrust on infrastructure spend, renewables and grid development is positive for the aluminium sector.

Read-across for Indian steel: Our interactions with the two global majors affirm our view of continuing recovery despite slower CY23 growth in China and higher interest rates in the western world. We retain our constructive outlook on Indian steel sector and continue to prefer **TATA** (BUY, TP Rs 140) and **JSP** (BUY, TP Rs 670).

Read-across for Indian aluminium: Aluminium pricing is likely to remain range-bound in the near term but see an upside over the medium term. Margins for Indian players will depend upon domestic coal availability and international coal prices.

Recommendation snapshot

Ticker	Price	Target	Rating
JSP IN	575	670	BUY
JSTL IN	676	715	HOLD
SAIL IN	87	95	HOLD
TATA IN	107	140	BUY

Price & Target in Rupees | Price as of 13 Mar 2023

We discuss highlights from our investor calls with Hetal Patel, General Manager – IR of ArcelorMittal (MT NA, Not Rated) and Jim Dwyer, VP – Investor Relations and Pension Investments, Alcoa (AA US, Not Rated).

ArcelorMittal: Key call takeaways

Read-across for Indian steel industry

Our interaction with MT reinforces our view that steel industry margins have bottomed out in India during the October quarter and globally during the December quarter. Potential recovery in China and improvement in apparent offtake in western markets are likely to underpin a revival in demand. Though a slower growth target for China and higher interest rates for longer will weigh on the construction sector, these factors are unlikely to derail recovery. MT anticipates better margins in Q2CY23 (ending June), which is in line with our expectation of improvement in Tata Steel Europe's margin by mid-FY24 as the latter completes turnaround at one of its furnaces in the Netherlands.

Price and margin outlook

- **Steel pricing and margin bottomed out in Q4CY22.** European hot rolled coil (HRC) prices increased by EUR 160-200/t from lows and US HRC prices were up 50% from lows.
- **Q4CY22 to Q1CY23 has seen a marked change in sentiment** with reduced recessionary fears and a significant drop in destocking. This has resulted in a lengthening of order books, enabling the restart of steel plants closed in Q4. The improvement is consistent across Europe, the US and the UK.
- **H1CY23 apparent demand is expected to grow in double-digits HoH**, reversing the impact of destocking, even though underlying real demand may not see a material change. Weakness in real construction and manufacturing demand is likely to be partially offset by improvement in automotive demand in western world. Real demand is slightly weaker in Europe than in the US. More importantly, MT expects apparent demand to improve across markets.
- **European restarts confirm improved outlook.** With lengthening of the order book, MT has restarted most of its shut-in European capacity (20% of total), barring two furnaces.
- **MT's Q1CY23 (ending Mar'23)** performance is likely to benefit from improvement in volumes and better absorption of fixed costs with the restart of plants, partly offset by weaker prices due to a 3-6-month lag in spot prices feeding through realisation.
- **MT's Q2CY23 (ending Jun'23)** print is expected to benefit from better pricing (with a 3-6-month lag) and continued volume pickup, offset by higher coking coal and iron ore costs.

- **Softer China CY23 growth and higher western interest rates are within the base case.** MT expects improvement in demand from the infrastructure and automotive sectors in CY23 but does not foresee a restart of real estate activities until the end of the year.
- **Confidence in recovery is visible in the YoY increase in CY23 capex budget.** MT has doubled its strategic growth and decarbonisation capex to US$ 1.5bn and US$ 0.4bn respectively, for a total of US$ 4.5bn-5bn in CY23. The company also expects to remain free cash flow-positive for the year.
- **Cash flow volatility is lower than earnings volatility when debt is under control.** Working capital accumulation and release help lower cash flow volatility as well.
- **MT adhered to its strategic plan through the downturn.** With a focused portfolio and an investment-grade balance sheet, MT believes that its 50:50 capital allocation between strategic projects and shareholder returns will be resilient through the cycle.

AMNS India updates

- AMNS India is repositioning itself from a discount supplier to a premium supplier by introducing value-added projects. The company plans to commission the Continuous Galvanising Line 4 (CGL) by H2CY23 and cold rolled mill (CRM) complex by mid-CY24. Its Hazira plant benefits from access to captive ports, iron ore mines and a pellet plant.
- The Hazira plant is being expanded to 16mtpa by CY26 and the company sees further potential to increase capacity to 20mtpa. It is also considering another 12mtpa greenfield plant in Odisha, East India.

Progress on decarbonising steel

- MT has started its first commercial scale carbon capture, utilisation and storage (CCUS) project in Belgium.
- The company has bought four metal scrap recyclers with a collective 1.2mt of scrap capacity, in a bid to improve scrap collection and availability.
- MT has initiated conversion of its BF (blast furnace) to the DRI+EAF (direct reduced iron + electric arc furnace) route in Canada with government support and is also working to garner EU support for 50% of capex for a similar plan. So far, it has secured country-level approvals from Belgium, France, Germany and Spain.

Alcoa: Key call takeaways

Read-across for Indian aluminium industry

Our interaction with AA suggests range-bound aluminium pricing in the near term given that the benefits of Yunnan (China) supply cuts are likely to be limited and lower coal prices in China could pose a downside risk to aluminium if plant restarts accelerate. Demand pressure has eased in the western world and destocking has largely abated. While near-term pricing is likely to be range-bound, there is still a possibility for upsides in the medium term as supply is likely to lag demand once the recovery gathers pace.

Aluminium price corrected on change in sentiment

AA attributed the 9% correction in aluminium price since Jan'23 (after a 15% rally in Jan) to a change in sentiment. The correction is in fact lower when it is considered as a proportion of total price, which includes the rising regional premia in western markets.

Inputs on China – a key driver for the aluminium market

- The Chinese government's focus for CY23 is largely on bolstering the economy.
- While AA reckons that the 5% GDP target set by China for CY23 is soft, it considers the focus on infrastructure, renewables and building the transmission grid to support renewables as positive for the aluminium sector.
- AA does not consider the mandated Yunnan production cuts (amid power shortages) to be overly supportive of aluminium prices as compliance remains spotty and suppliers in other regions can increase production to make up for such cuts. While the cuts are net positive, it is unlikely to change market balance materially.
- Lower coal prices in China could pose a downside risk to aluminium prices, but the impact would depend upon the acceleration of plant restarts that the cheaper fuel would encourage in the country.
- AA believes that China's aluminium demand is maturing and hence Chinese supply may no longer need to exceed the previously set cap of 45mt (CY22 production run rate was 42mt meaning there is still 3mt gap to cap).
- China's aluminium supply powered by renewables introduces supply volatility in the absence of a well-developed hydro-power system. Although China has successfully lowered dependence on coal from 90% of the aluminium fuel mix to 70-75% by raising smelting in Yunnan to 12% of the mix, this has made supply more unpredictable.

Inputs on western world demand and supply

- Destocking pressure is abating in western markets, having wound down fully in Europe and nearing an end in most sectors in the US. Current pressure on demand is from cautious buying behaviour. However, change in buying behaviour could produce a positive result for aluminium demand with current inventory levels at 15-year lows.
- Higher interest rates for longer may pose risks to demand from the building and construction sectors, but AA believes the rest of the economy in US is healthy.
- Restarts in Europe are difficult to execute and hence unlikely to pose a risk in the near term. Europe has seen the shutdown of 1.4mt of aluminium capacity in response to higher energy prices. While energy prices have eased, they are still double that of pre-war levels and forward prices are much higher than spot prices. In this scenario, it is difficult for shut-in capacity to resume. Also, other costs (carbon, coke, pitch) are still significantly high, weighing on margins for smelters.
- Even in the US, restarts are still not under consideration though Henry Hub prices have fallen to US$ 2.5/MMbtu and coal is available at much lower rates. Both Century and Alcoa are not indicating any restarts at present.

Potential medium-term price upside

While AA is uncertain about the timeline for demand normalisation, it believes the supply chain will be unlikely to respond in a timely manner when demand does make a comeback. This could pose an upside risk to aluminium prices.

Alumina market largely balanced

AA highlights that the global alumina market is largely balanced or in slight surplus. Alumina price will be directionally dependent on aluminium smelting recovery.

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BUY – Expected return >+15%

HOLD – Expected return from -6% to +15%

SELL – Expected return <-6%

Note: Recommendation structure changed with effect from 21 June 2021

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