METALS & MINING

14 October 2022

China demand to pick up but margins to take longer: Baosteel

- **Baosteel expects steel demand recovery in China to commence from Oct-Nov'22 but weak margins to continue into Q4CY22**
- **We see a bottoming out of India steel margins in the September quarter and stabilisation over FY24 as recovery takes hold in China**
- **Prefer defensive play TATA (BUY, TP Rs 140) in the current volatile environment**

Kirtan Mehta, CFA
research@bobcaps.in

We hosted Ms Tao, representative of Securities Affairs from Baosteel (Not Rated), a listed arm of the world's largest steel producer China Baowu Group.

Margin revival in China only after Q4CY22: Despite expectations of steel demand recovery starting from Oct-Nov'22, Baosteel still believes margins will weaken in Q4CY22 as the industry is recuperating from sluggish demand in Q3 and relatively high coking coal prices. Considering the possibility of an extended downturn, Baosteel is focused on deepening cost reductions to protect margins.

Demand to start recovering from Oct-Nov: Boasteel expects Chinese steel demand to start gaining traction from October-November, driven by higher volume offtake from the infrastructure (H1: -3.2% YoY, H2: +16%) and automotive (H1: -14%, H2: +8.8%) segments, even as real estate continues to decline (H1: -9.3%, H2: -7.7%). The company sees demand growth resuming in CY23 on a lower base of CY22.

China industry needs to match production to lower demand: With no explicit supply reforms in progress, market-based mechanisms are at play to align production with demand, leading to margins below the 10Y average. Chinese steel industry profit is down 88% YoY to US$ 5.8bn over Jan-Aug'22.

Read-across for steel players: A return of Chinese demand is the first step towards stabilisation of margins. Given Baosteel's forecast of soft margins continuing into Q4CY22, we now believe margin stabilisation at a mid-cycle level could materialise over FY24 (vs. FY23 earlier) as demand traction rises post the Chinese lunar holidays. However, Indian steel margins are likely to bottom out earlier in Q2FY23 – we expect recovery from Q3 led by a drop in coal cost, increase in sales volume and gradual revival in prices. Coking coal costs have eased from US$ 440/t (average) in Q2 to US$ 250-300 levels but face upside risk.

Constructive on Indian ferrous players: We remain constructive on Indian ferrous players as we look beyond near-term uncertainty and focus on delivery of the next wave of expansion. Defensive play TATA (BUY, TP Rs 140) remains our top pick.

Key takeaways

We hosted a call with Ms Tao, representative of Securities Affairs from Baosteel (Not Rated), a listed arm of China Baowu Group – the world's largest steel producer. Below are key takeaways from our discussion combined with highlights from the company's previous call with Chinese investors and analysts at the end of August.

Look beyond CY22 for China steel margin recovery

While Baosteel expects Chinese steel demand to recover during Oct-Nov'22, it still believes margins will weaken in Q4CY22 as the industry recuperates from sluggish demand in Q3 and high coking coal prices (relative to current steel prices). Baosteel has maintained its October list price more or less stable with only minor adjustments.

The company indicated that the current downturn in China is potentially more severe than the previous two crises in CY08 and CY15. While China recovered rapidly in CY08 through stimulus policies, the revival in CY15 was backed by supply-side reforms. This time around weak real estate, sporadic outbreaks of Covid-19 in different parts of the country, stability of the macro economy and high inflation worldwide are weighing on recovery.

Focus on deepening cost reductions to protect margin

In view of the economic downturn, Baosteel is focusing on cost reduction measures to protect its margins. This involves using economic raw materials in furnaces, transmitting price pressure to iron ore/coking coal suppliers, raising efficiency of operations, and employing hedging instruments to curb inventory losses. The company has increased the use of lower cost materials to 35% of its furnace blend in H1CY22 by sourcing cheaper varieties of coal and iron ore. For raw materials, it is increasing the linkage between costs and steel prices.

Transmission to raw material costs to absorb some pressure

- **Iron ore** prices have eased as the market has turned into surplus following a pullback in demand. However, with low levels of iron ore inventory, prices could be volatile depending upon the pace of restocking and supply disruptions during the Australian and Brazilian rainy season.
- **Coking coal** prices have eased from the peak and are likely to continue a downward trend.
- **Scrap prices** are likely to follow rebar prices with the scrap market turning into oversupply.

Demand to start recovering from Oct-Nov'22

- **Sluggish demand in Q3CY22:** Demand weakness in China has extended into Q3CY22 owing to sluggishness in real estate, home appliances and construction machinery. Pockets showing improvement now include passenger vehicles and electric vehicles, ship building, and machinery related to infrastructure. However, the infrastructure (16% of steel consumption) and automotive (5-6%) segments have not been able to offset the demand downturn in major steel consumer, real estate (38%).
- **Recovery starting Oct-Nov:** Baosteel expects improvement in offtake from the infrastructure, appliances and industrial machinery segments. Automotive demand has already improved. While real estate remains lacklustre, the Chinese government has taken several measures in Q3 to accelerate project completion.
- **Demand to grow in CY23 on a lower base:** Growth will also be led by the potential easing of Covid lockdowns and stimulus feed-through into the economy.

Fig 1 – China steel demand outlook

(mt)	CY21			CY22			YoY growth (%)		
	H1	H2	Total	H1	H2	Total	H1	H2	Total
Real estate	185.1	192.1	377.2	167.8	178.1	345.9	(9.3)	(7.3)	(8.3)
Infrastructure construction	73.0	84.9	157.9	70.7	98.5	169.2	(3.2)	16.0	7.2
Excavator	2.2	1.5	3.7	1.6	1.4	3.0	(27.0)	(5.3)	(18.0)
Home appliances	7.8	7.2	15.0	7.3	6.7	14.0	(6.8)	(6.8)	(6.8)
Auto steel	27.8	27.4	55.2	23.9	29.8	53.7	(14.0)	8.8	(2.7)
Subtotal of select sectors	**295.9**	**313.1**	**608.9**	**271.3**	**314.5**	**585.7**	**(8.3)**	**0.5**	**(3.8)**

Source: Company, BOBCAPS Research

Exports from China to fall back in H2CY22

China's direct and indirect steel exports are likely to fall back in H2CY22 owing to feeble international demand, the overhang of lean domestic inventory, and unfavourable price arbitrage. For economic viability, the international price differential needs to be higher to compensate for non-recovery of value-added tax (VAT).

China's steel industry must downsize to match demand

"The main problem is on the demand side, but the real solution is on the supply side", stated China's Party Secretary of China Iron and Steel Industry (CISA) back on 29 Jun 2022. This indicates that China's steel industry needs to readjust production* to match the lower demand. Baosteel's commentary suggests that no supply reforms are currently under implementation and supply adjustments are being left to the market.

- Baosteel's plan for CY22 is to not exceed last year's production level even though it has started a new blast furnace this year.
- The Chinese steel industry is already under high pressure with the sharp reduction in prices and high coking coal costs. This is reflected in a steep 88% YoY fall in profits of the ferrous metal smelting and rolling sector over Jan-Aug'22 to CNY 41bn (US$ 5.8bn), as per data from CISA.

Downturn to boost industry consolidation

Boasteel believes that the current situation could lead to consolidation within the Chinese steel industry, and will be looking at opportunities internally and externally. The company indicated that consolidation will help create scale to improve efficiency.

Baosteel better placed to weather the downturn

Baosteel highlighted that it is better placed in this downturn than the previous two crises given significantly lower debt, sharply lower inventory days, higher employee productivity, improving realisation of synergies by implementing best practices across different production bases, and optimisation of product structure.

- Baosteel's inventory is at only 80% of CY08 levels despite operations more than doubling in volumes.
- Employee productivity has risen to 1,552tonnes from 750t.
- Efficiency has improved by CNY 330/t with two rounds of cost cutting undertaken over CY16-CY18 and CY19-CY21, besides the ongoing deepening of cost control.
- Baosteel has maintained gearing under 50% for a considerable period. Average gearing for the steel industry at ~64% is also lower than levels seen during the previous two crises.

Carbon reduction ambitions on track

China's focus on carbon emission reduction could be lower near-term with efforts on to stabilise the economy. However, this is unlikely to impact the medium-term trajectory of Baosteel, entailing a 30% cut in carbon emissions by CY35.

Baosteel is progressing on its first commercial scale 1.1mtpa new hydrogen shaft furnace ie clean furnace plant being set up at a capex of CNY 1.9bn (US$ 0.3bn). Groundbreaking occurred in Feb'22 with an aim to complete the furnace by CY23 and start production. The plant is based on natural gas as feedstock however replication even after successful demonstration may be limited due to the shortage of natural gas in China.

Disclaimer

Recommendation scale: Recommendations and Absolute returns (%) over 12 months

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

Our recommendation scale does not factor in short-term stock price volatility related to market fluctuations. Thus, our recommendations may not always be strictly in line with the recommendation scale as shown above.

Rating distribution

As of 30 September 2022, out of 119 rated stocks in the BOB Capital Markets Limited (BOBCAPS) coverage universe, 67 have BUY ratings, 30 have HOLD ratings, 5 are rated ADD*, 1 is rated REDUCE* and 16 are rated SELL. Of these, 2 companies rated BUY and 1 rated ADD have been investment banking clients in the last 12 months. (*Our ADD and REDUCE ratings are in the process of being migrated to the new recommendation structure.)

Analyst certification

The research analyst(s) authoring this report hereby certifies that (1) all of the views expressed in this research report accurately reflect his/her personal views about the subject company or companies and its or their securities, and (2) no part of his/her compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) in this report. Analysts are not registered as research analysts by FINRA and are not associated persons of BOBCAPS.

General disclaimers

BOBCAPS is engaged in the business of Stock Broking and Investment Banking. BOBCAPS is a member of the National Stock Exchange of India Limited and BSE Limited and is also a SEBI-registered Category I Merchant Banker. BOBCAPS is a wholly owned subsidiary of Bank of Baroda which has its various subsidiaries engaged in the businesses of stock broking, lending, asset management, life insurance, health insurance and wealth management, among others.

BOBCAPS's activities have neither been suspended nor has it defaulted with any stock exchange authority with whom it has been registered in the last five years. BOBCAPS has not been debarred from doing business by any stock exchange or SEBI or any other authority. No disciplinary action has been taken by any regulatory authority against BOBCAPS affecting its equity research analysis activities.

BOBCAPS has obtained registration as a Research Entity under SEBI (Research Analysts) Regulations, 2014, having registration No.: INH000000040 valid till 03 February 2025. BOBCAPS is also a SEBI-registered intermediary for the broking business having SEBI Single Registration Certificate No.: INZ000159332 dated 20 November 2017. BOBCAPS CIN Number: U65999MH1996GOI098009.

BOBCAPS prohibits its analysts, persons reporting to analysts, and members of their households from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover. Additionally, BOBCAPS prohibits its analysts and persons reporting to analysts from serving as an officer, director, or advisory board member of any companies that the analysts cover.

Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients that reflect opinions contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. In reviewing these materials, you should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest. Additionally, other important information regarding our relationships with the company or companies that are the subject of this material is provided herein.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of BOBCAPS's clients. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice.

The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide for future performance, future returns are not guaranteed and a loss of original capital may occur. BOBCAPS does not provide tax advice to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment in certain transactions — including those involving futures, options, and other derivatives as well as non-investment-grade securities —that give rise to substantial risk and are not suitable for all investors. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only. We endeavour to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so.

We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material, may from time to time have "long" or "short" positions in, act as principal in, and buy or sell the securities or derivatives thereof of companies mentioned herein and may from time to time add to or dispose of any such securities (or investment). We and our affiliates may assume an underwriting commitment in the securities of companies discussed in this document (or in related investments), may sell them to or buy them from customers on a principal basis, and may also perform or seek to perform investment banking or advisory services for or relating to these companies and may also be represented in the supervisory board or any other committee of these companies.

For the purpose of calculating whether BOBCAPS and its affiliates hold, beneficially own, or control, including the right to vote for directors, one per cent or more of the equity shares of the subject company, the holdings of the issuer of the research report is also included.

BOBCAPS and its non-US affiliates may, to the extent permissible under applicable laws, have acted on or used this research to the extent that it relates to non-US issuers, prior to or immediately following its publication. Foreign currency denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of or income derived from the investment. In addition, investors in securities such as ADRs, the value of which are influenced by foreign currencies, effectively assume currency risk. In addition, options involve risks and are not suitable for all investors. Please ensure that you have read and understood the Risk disclosure document before entering into any derivative transactions.

In the US, this material is only for Qualified Institutional Buyers as defined under rule 144(a) of the Securities Act, 1933. No part of this document may be distributed in Canada or used by private customers in the United Kingdom.

Company-specific disclosures under SEBI (Research Analysts) Regulations, 2014

The research analyst(s) or his/her relatives do not have any material conflict of interest at the time of publication of this research report.

BOBCAPS or its research analyst(s) or his/her relatives do not have any financial interest in the subject company. BOBCAPS or its research analyst(s) or his/her relatives do not have actual/beneficial ownership of one per cent or more securities in the subject company at the end of the month immediately preceding the date of publication of this report.

The research analyst(s) has not received any compensation from the subject company or third party in the past 12 months in connection with research report/activities. Compensation of the research analyst(s) is not based on any specific merchant banking, investment banking or brokerage service transactions.

BOBCAPS or its research analyst(s) is not engaged in any market making activities for the subject company.

The research analyst(s) has not served as an officer, director or employee of the subject company.

BOBCAPS or its associates may have material conflict of interest at the time of publication of this research report.

BOBCAPS's associates may have financial interest in the subject company. BOBCAPS's associates may hold actual / beneficial ownership of one per cent or more securities in the subject company at the end of the month immediately preceding the date of publication of this report.

BOBCAPS or its associates may have managed or co-managed a public offering of securities for the subject company or may have been mandated by the subject company for any other assignment in the past 12 months.

BOBCAPS may have received compensation from the subject company in the past 12 months. BOBCAPS may from time to time solicit or perform investment banking services for the subject company. BOBCAPS or its associates may have received compensation from the subject company in the past 12 months for services in respect of managing or co-managing public offerings, corporate finance, investment banking or merchant banking, brokerage services or other advisory services in a merger or specific transaction. BOBCAPS or its associates may have received compensation for products or services other than investment banking or merchant banking or brokerage services from the subject company in the past 12 months.