METALS & MINING

19 December 2022

China policies set stage for steel demand recovery: Valin Steel

- **Steel prices in China saw initial recovery in November and can rise further in Mar/Apr'23 as economic recovery takes hold**
- **CY23 to see only a slight YoY increase in demand and margins, capped by supply recovery and raw material cost increases**
- **We expect Indian steel margins to bottom out in the December quarter followed by gradual stabilisation over FY24**

Kirtan Mehta, CFA
research@bobcaps.in

We hosted Liu Xiafoi, Director of Securities Department at Valin Steel (Not Rated). Key takeaways:

Near-term outlook – Prices could increase from Mar/Apr'23: Valin Steel expects policy changes in China, by way of softer quarantine restrictions and measures to prop up the real estate market, to encourage downstream demand over H1CY23 and thereby support recovery in the economy and in steel demand. Should the recovery be slow to take off, the company expects the Chinese government to step in with added policy measures. This could drive a further pickup in steel prices from Mar/Apr'23.

Medium-term – Demand to inch up in CY23: Valin Steel anticipates only a slight improvement in Chinese steel demand in CY23 as offtake from the infrastructure and manufacturing sectors only just offsets weakness in real estate (direct & indirect).

Medium-term – Limited margin upside in CY23: While margins for China's steel industry could stabilise in CY23, Valin Steel expects the upside to be limited as higher demand could drive up supply as well as raw material prices. Industry production is likely to remain disciplined given the annual production cap and should aim for modest YoY reduction. Chinese exports will remain constrained by EU/US trade barriers and could attempt to capture growth only in Southeast Asia. Coking coal availability for Chinese players could improve further from Mongolia in CY23, and the informal import ban on Australian coking coal may be relaxed as diplomatic relations are on the mend.

Longer-term – Structural readjustment ahead: Valin Steel expects Chinese steel demand to gradually stabilise to a level of 700mt and production to remain in a range of 900-1,000mt over the next 5-8 years following the current capacity swap policy. Given rising demand for steel in new applications and slowing demand for construction steel, the market balance will need structural readjustment.

Implications for Indian players: We expect India's steel industry margins to gradually settle at mid-cycle levels over FY24 as economy recovers and steel demand in China stabilises.

Key takeaways

H2CY22 – Challenging period for China's steel industry

- **Margin compression drives curtailments.** In China, steel industry margins contracted sharply in Q3CY22 as domestic supply aligned with the sharp decline in real estate demand seen in prior quarters. Valin Steel estimates that this compression drove half of the players in the steel industry into losses, with those focused on construction steel facing the brunt of the impact. Subsequent voluntary production curtailments by players have helped arrest the price decline.

- **Steel demand is stabilising or even growing in some pockets.** As against the loss of consumption from the real estate sector, some pockets in the manufacturing space did offer stable-to-growing demand for steel. Demand pockets included shipbuilding, wind power, new energy vehicles and the oil & gas industry. That said, the decline in real estate offtake also eroded steel consumption from the construction machinery and home appliance segments.

Near-term outlook – Modest price recovery setting in

- **Prices recovered in Nov'22.** Steel prices have seen a modest recovery from the bottom with the relaxation in quarantine restrictions and new policies to stabilise the real estate market in China. Rebar, used in construction steel, also crossed RMB 4,000/t from the bottom of RMB 3,790/t in early November.

- **Prices are likely to rise further from Mar/Apr'23.** Valin Steel expects these policy changes to aid improvement in downstream demand over H1CY23 and thereby support recovery in the economy as well as in steel demand. It also expects the Chinese government to step in with additional policy measures if the recovery is slow to take off, which could fuel a further pickup in steel prices from Mar/Apr'23.

Medium-term outlook – Demand and margins to inch up

- **CY23 is likely to see only slight improvement in demand.** Valin Steel believes that steel demand from China's real estate sector will continue to decline in CY23, which will also impact offtake from the construction machinery and home appliance segments. However, with the government focused on accelerating investments in infrastructure to drive economic recovery, the company anticipates a slight improvement in overall steel demand in CY23 as infrastructure and manufacturing offset the weakness in real estate.

- **Higher demand could drive up supply as well as raw material prices, limiting upside to steel margins**. Production has eased with a sharp cut in electric arc furnace (EAF) and modest cut in blast furnace (BF) output. However, with recovery in demand, production is likely to return, in turn pushing up raw material prices. Even so, Valin Steel expects industry production to remain disciplined given the annual cap (of prior-year output) and to follow a path of modest YoY reduction. Specific output reductions are targeted in three major regions – Beijing and Tianjin, the Yangtze River Delta and Shanxi.

Valin Steel's plan for CY23 also follows the same philosophy. While it plans to increase automotive sheet production by 0.2-0.3mt, it aims to maintain annual CY23 output at or below the CY22 level.

- **Capacity is likely to see limited rationalisation but will not grow either.** China follows dual control over capacity and output. In terms of output, Valin Steel expects the Chinese steel industry to follow a path of modest annual reduction. In terms of capacity, there may not be significant rationalisation (closures) in the near-to-medium term. The current capacity swap scheme allows the industry to implement a new BF after closure of the old one at a reduced new-to-old plant ratio of 0.5:1. New EAF capacity is allowed at a 1:1 ratio.
- **Exports are limited to capturing growth in SE Asia.** China exports only 4% of its annual production. Owing to significant trade barriers in Europe and the US, China finds it difficult to increase export in these markets. Thus, the industry may attempt to capture demand growth in only available market, Southeast Asia.
- **Value-add producers have a relative advantage over commodity steel producers.** Prices and margins for commodity products are more influenced by demand patterns and inventory levels in industry than value added products (VAP). The latter are normally negotiated directly with the customer and hence earn more stable prices and margins.
- **Coking coal availability should improve over CY23.** With the construction of a new railway line, the availability of coking coal from Mongolia has improved. Valin Steel expect supply from Mongolia to rise further YoY in CY23 as logistics stabilise. The company also sees the possibility of some relaxation of the informal import ban on Australian coking coal as diplomatic relations are gradually improving.

Longer-term outlook – Structural readjustment ahead

- **Surplus capacity must exit eventually.** Over the next 5-8 years, Valin Steel expects Chinese steel demand to settle around ~700mt, production to remain within the 900-1000mt range, and export growth to remain constrained due to trade barriers in the EU/US. This could eventually require exit of surplus capacity. This is not happening as yet because small private players are waiting to earn good sale prices on their steel plants.
- **Demand for new steel applications will increase.** Even in a scenario of tapering overall demand, consumption of steel from new applications (such as renewables and electric vehicles) will continue to increase. In contrast, construction steel is likely to have higher surplus capacity due to the structural decline in demand from the real estate sector. The market balance thus needs to adjust to the changing demand structure.

- **Government is promoting a shift to EAF but this isn't economical.** While the government is encouraging a shift from BF to EAF by allowing a higher replacement ratio, this switch is not economical as the cost of steel production via the EAF route is higher by RMB 200-300/t.
- **Key themes to watch:** In this era of structural decline in demand from the real estate sector, (i) players focused on VAP are better placed than commodity counterparts, (ii) construction steel players are at a disadvantage, and (iii) strong and competitive players will likely absorb the weaker ones. Valin Steel notes that some larger companies are still competitive even as smaller players with higher cost efficiency or with a focus on specialised steel are also well positioned.

NOT FOR DISTRIBUTION, DIRECTLY OR INDIRECTLY, IN OR INTO THE UNITED STATES OF AMERICA ("US") OR IN OR INTO ANY OTHER JURISDICTION IF SUCH AN ACTION IS PROHIBITED BY APPLICABLE LAW.

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.

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 BOB Capital Markets Limited (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 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. BOBCAPS research reports follow rules laid down by Securities and Exchange Board of India and individuals employed as research analysts are separate from other employees who are performing sales trading, dealing, corporate finance advisory or any other activity that may affect the independence of its research reports.

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.

No part of this material may be (1) copied, photocopied, or duplicated in any form by any means or (2) redistributed without BOBCAPS's prior written consent.

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.

Other disclaimers

BOBCAPS and MAYBANK (as defined below) make no representation or warranty, express or implied, as to the accuracy or completeness of any information obtained from third parties and expressly disclaim the merchantability, suitability, quality and fitness of this report. The information in this report has not been independently verified, is provided on an "as is" basis, should not be relied on by you in connection with any contract or commitment, and should not be used as a substitute for enquiries, procedures and advice which ought to be undertaken by you. This report also does not constitute an offer or solicitation to buy or sell any securities referred to herein and you should not construe this report as investment advice. All opinions and estimates contained in this report constitute BOBCAPS's judgment as of the date of this report and are subject to change without notice, and there is no obligation on BOBCAPS or MAYBANK to update this report upon issuance. This report and the information contained herein may not be reproduced, redistributed, disseminated or copied by any means without the prior consent of BOBCAPS and MAYBANK.

To the full extent permitted by law neither BOBCAPS, MAYBANK nor any of their respective affiliates, nor any other person, accepts any liability howsoever arising, whether in contract, tort, negligence, strict liability or any other basis, including without limitation, direct or indirect, special, incidental, consequential or punitive damages arising from any use of this report or the information contained herein. By accepting this report, you agree and undertake to fully indemnify and hold harmless BOBCAPS and MAYBANK from and against claims, charges, actions, proceedings, losses, liabilities, damages, expenses and demands (collectively, the "Losses") which BOBCAPS and/or MAYBANK may incur or suffer in any jurisdiction including but not limited to those Losses incurred by BOBCAPS and/or MAYBANK as a result of any proceedings or actions brought against them by any regulators and/or authorities, and which in any case are directly or indirectly occasioned by or result from or are attributable to anything done or omitted in relation to or arising from or in connection with this report.

Distribution into the United Kingdom ("UK"):

This research report will only be distributed in the United Kingdom, in accordance with the applicable laws and regulations of the UK, by Maybank Securities (London) Ltd ("**MSL**") who is authorised and regulated by the Financial Conduct Authority ("FCA") in the United Kingdom (MSL and its affiliates are collectively referred to as **"MAYBANK**"). BOBCAPS is not authorized to directly distribute this research report in the UK.

This report has not been prepared by BOBCAPS in accordance with the UK's legal and regulatory requirements.

This research report is for distribution only to, and is solely directed at, selected persons on the basis that those persons: (a) are eligible counterparties and professional clients of MAYBANK as selected by MAYBANK solely at its discretion; (b) have professional experience in matters relating to investments falling within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, as amended from time to time (the "Order"), or (c) fall within Article 49(2)(a) to (d) (high net worth companies, unincorporated associations, etc. as mentioned in the stated Article) of the Order; (all such persons together being referred to as "relevant persons").

This research report is directed only at relevant persons and must not be acted on or relied on by any persons who are not relevant persons. Any investment or investment activity to which this material relates is available only to relevant persons and will be engaged in only with relevant persons.

The relevant person as recipient of this research report is not permitted to reproduce, change, remove, pass on, distribute or disseminate the data or make it available to third parties without the written permission of BOBCAPS or MAYBANK. Any decision taken by the relevant person(s) pursuant to the research report shall be solely at their costs and consequences and BOBCAPS and MAYBANK shall not have any liability of whatsoever nature in this regard.

No distribution into the US:

This report will not be distributed in the US and no US person may rely on this communication.

Other jurisdictions:

This report has been prepared in accordance with SEBI (Research Analysts) Regulations and not in accordance with local regulatory requirements of any other jurisdiction. In any other jurisdictions, this report is only for distribution (subject to applicable legal or regulatory restrictions) to professional, institutional or sophisticated investors as defined in the laws and regulations of such jurisdictions by Maybank Securities Pte Ltd. (Singapore) and / or by any broker-dealer affiliate or such other affiliate as determined by Malayan Banking Berhad.

If the recipient of this report is not as specified above, then it should not act upon this report and return the same to the sender.

By accepting this report, you agree to be bound by the foregoing limitations.