

METALS & MINING

20 September 2021

Steel sector may face contagion risk from China property sector

- Credit event at Evergrande has potential to spread contagion risk to property sector, though China can possibly manage the situation
- Any material slowdown in China's property and infrastructure sector a key risk for global steel prices and margins
- We currently assume normalisation of steel prices over medium term; prefer TATA and JSP

Kirtan Mehta, CFA
 researchreport@bobcaps.in

Potential contagion risk for China's property sector: Evergrande, a top-3 property developer in China with outstanding liabilities of US\$ 300bn, could potentially miss an interest payment to lenders on 20 September. A default may snowball into a contagion risk for China's property sector if improperly managed. Evergrande is scrambling due to tight funding availability for the sector following the 'Three Red Lines' reforms initiated by China in Aug'20. At this stage, we need to monitor whether China can avert this threat given the scale and possible spread of default risk to other firms across the property sector.

Material risk for global steel industry: Evergrande's debt crisis has the potential to severely weaken global steel demand and induce a sharp correction in steel prices and, in turn, margins for India's steel industry. This event could have a significant impact on close to 60% of steel demand in China, which equates to ~30% of global steel demand in CY20. The concern is visible in the sharp correction in iron ore price to ~US\$ 90/t from a peak of US\$ 239/t in May'21.

China can potentially avert contagion: The risk of widespread defaults can possibly be avoided by managing consumer confidence, property prices and investor trust. This could involve protecting consumer deposits for incomplete properties, avoiding fire sale of properties and working out debt resolution plans. For Evergrande, a breakup or buyout solution would be perceived as a better route over bankruptcy or bailout.

Expect normalisation of steel margins over medium term: We currently factor in softening of margins over the next 6-12 months with steel prices easing to US\$ 650/t by FY23. Our estimates do not build in contagion risk to China's property sector.

Prefer TATA, JSP: With the steel cycle at a peak, we prioritise capital discipline over expansion projects. Accordingly, we are positive on Tata Steel (TATA) and Jindal Steel & Power (JSP) who are now focusing on responsible growth (see [Disciplined capital allocation key to improving payout](#), 16Aug21). Also refer to our [Ferrous Chartbook](#) which tracks global supply and demand drivers.

Recommendation snapshot

Ticker	Price	Target	Rating
JSP IN	351	555	BUY
JSTL IN	633	795	HOLD
SAIL IN	106	150	HOLD
TATA IN	1,253	1,755	BUY

Price & Target in Rupees | Price as of 20 Sep 2021



Evergrande's debt crisis

Evergrande is a top-3 property developer in China whose stock has corrected ~90% in 14 months and ~30% over the last week as it faces a liquidity crunch that raises concerns over payment of dues to lenders, suppliers and investors. Its dollar bonds are trading 60-70% below par. The Hang Seng Property Index has corrected 6.7% today, hinting that other property firms may also be facing tight liquidity.

- **Trigger:** Introduction of the Three Red Lines policy for Chinese property developers in Aug'20 to reduce debt in the industry, curb runaway prices and lift standards. This has tightened the availability of finance for property developers in China.
- **Outstanding liabilities:** US\$ 300bn which is an estimated ~6.5% of the total liability of China's property sector.
- **Banks' exposure:** (a) Direct exposure of US\$ 80bn (loan, debt, off-balance sheet wealth management products), (b) Indirect exposure of US\$ 100bn through suppliers (developers' trade payables).
- **Payment due this year:** Interest on bank loans (quantum not disclosed) is due on 20 September with a one-day grace period. A further US\$ 83.5mn interest payment on 8.25% five-year dollar bonds is due on 23 September with a 300-day grace period, along with a US\$ 36mn coupon on onshore bonds payable on the same day. In all, the company must pay interest of US\$ 699mn during the remainder of CY21, of which US\$ 615mn is on dollar bonds.

Material risk for global steel industry

China accounted for ~55% of global steel demand in CY20. Any slowdown in its property sector could cripple global steel demand and pose significant risk to steel prices and margins.

- The property sector accounts for 40% of steel consumption in China and demand has grown at 6.5%/9.0%/6.7% in CY18/CY19/CY20 as per Bloomberg.
- A slowdown in real estate has the potential to dampen demand from the infrastructure sector as well, which accounts for another ~20% of China's steel consumption. State funding for infrastructure is linked to land sale by states.
- The property sector accounts for 14% of China's GDP and the Evergrande crisis could have a far-reaching impact on the country's growth.

Averting the contagion

The risk of loan defaults spreading to other property developers could potentially be averted by a three-pronged approach from the Chinese government:

- **Preserve consumer confidence** by protecting household deposits on incomplete projects. Evergrande may have presold 1.4mn apartments valued at US\$ 200bn (Bloomberg quoting Capital Economics).
- **Avoid a sharp deceleration in property prices** and a domino effect on other developers by preventing fire sale of properties.
- **Manage investor trust** and prevent a run on other developers by working out an appropriate debt resolution mechanism to maximise recovery for stakeholders.

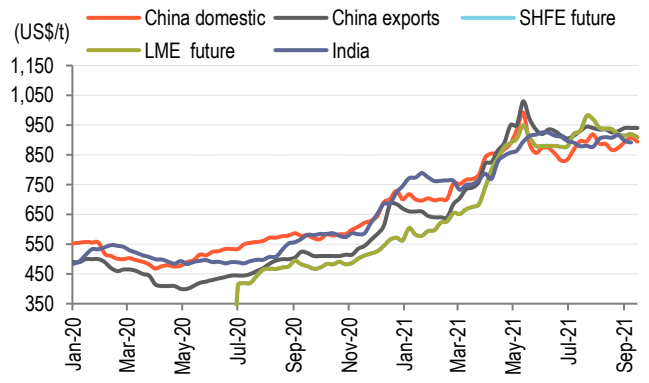
Managing potential default at Evergrande

- Potential bankruptcy at Evergrande must be managed judiciously to avoid a domino effect of other defaults.
- If authorities can work out a suitable breakup or buyout option to avoid spreading of the contagion risk, that would mitigate the threat to the steel sector. For completed properties, debt can be carved out and managed through deployment of cash flow. For incomplete projects, it would be important to involve investors/developers in their completion to protect consumer deposits and ensure recoveries for investors.
- A state bailout may not be a healthy option as it could undo the reforms initiated since Aug'20.

Banking sector can recover if contagion risk averted

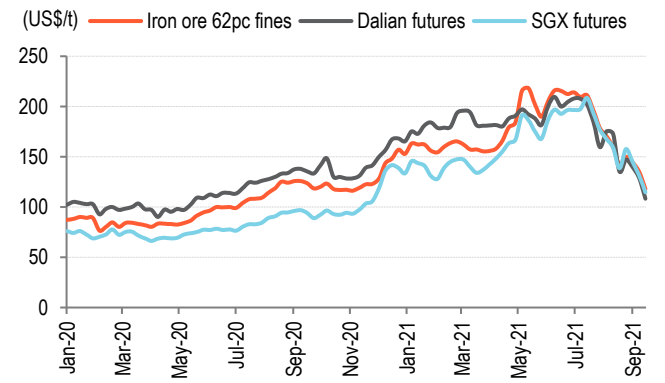
Fitch Ratings has cited a recent [sensitivity test by People's Bank of China](#) which indicated that if the NPL ratio of property development loans rises by 15ppt and of mortgages by 10ppt, the average capital adequacy ratio of the 4,015 banks assessed would drop only modestly to 12.3% from 14.4%. The study suggests that the Chinese banking sector can survive a potential default at Evergrande if the contagion risk is contained.

Fig 1 – HRC steel prices (China and India)



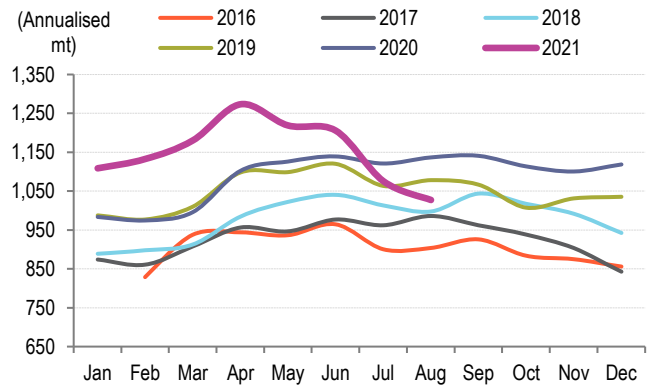
Source: Bloomberg, BOBCAPS Research

Fig 2 – Iron ore prices



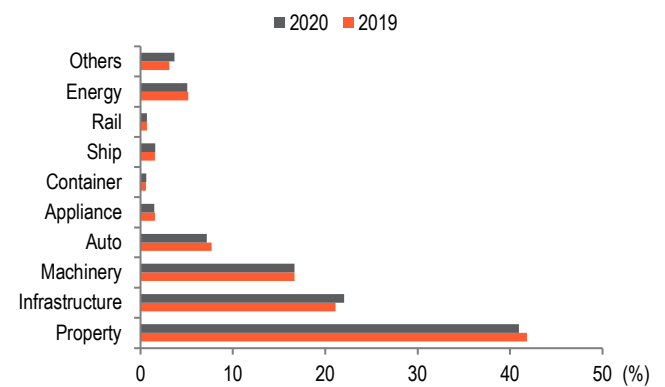
Source: Bloomberg, BOBCAPS Research

Fig 3 – China steel apparent consumption



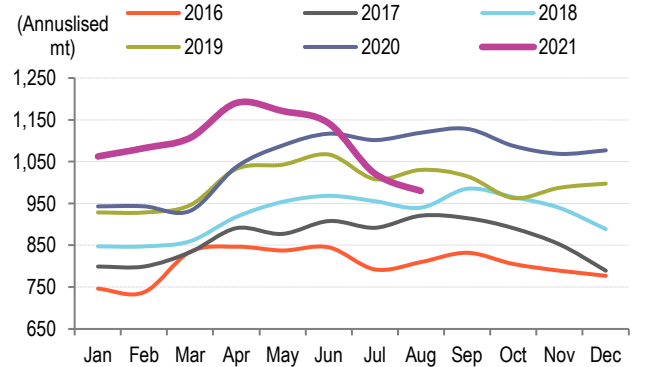
Source: Bloomberg, China Customs, China National Bureau of Statistics, BOBCAPS Research

Fig 4 – China steel consumption mix



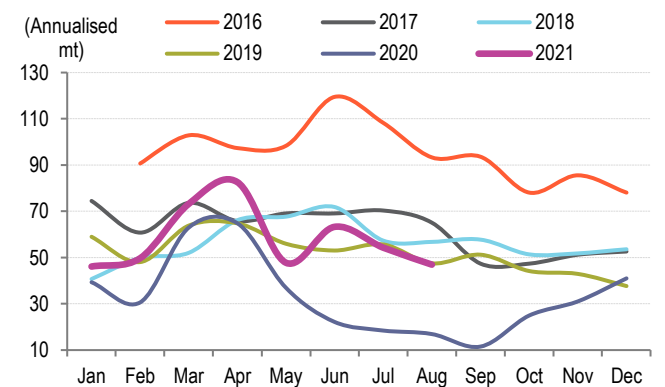
Source: Bloomberg, BOBCAPS Research

Fig 5 – China steel production



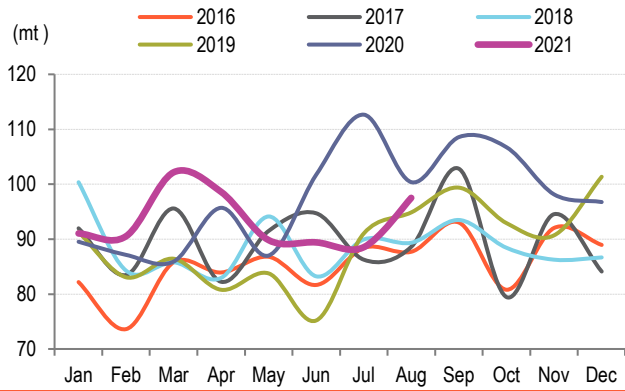
Source: Bloomberg, China Customs, China National Bureau of Statistics, BOBCAPS Research

Fig 6 – China steel net exports



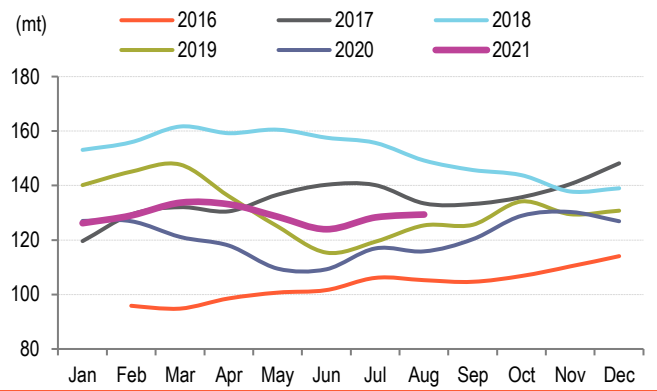
Source: Bloomberg, China Customs, BOBCAPS Research

Fig 7 – China iron ore imports



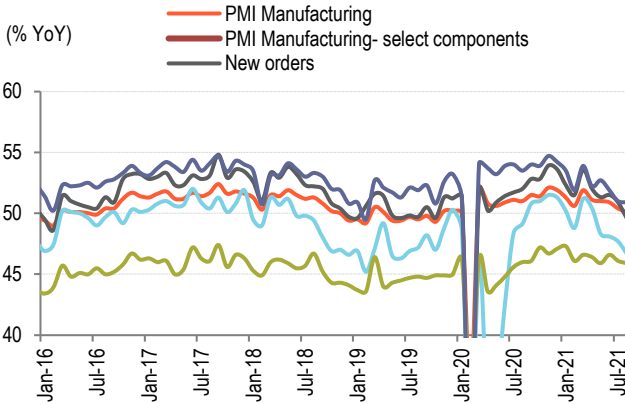
Source: Bloomberg, China Customs, BOBCAPS Research

Fig 8 – China iron ore port inventory



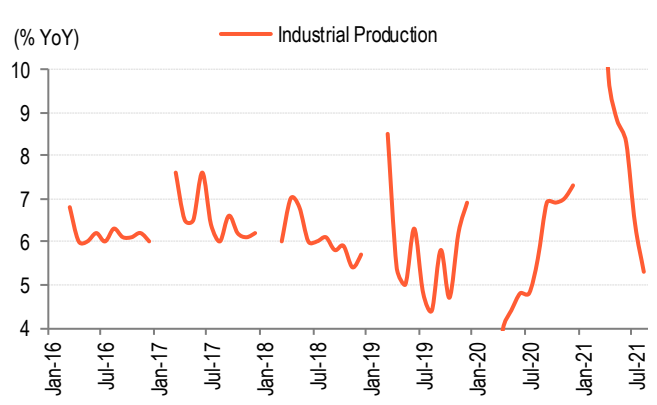
Source: Bloomberg, Steelhome, BOBCAPS Research

Fig 9 – China manufacturing PMI



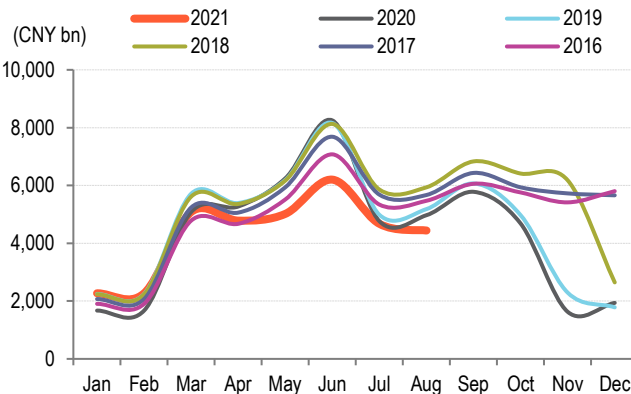
Source: Bloomberg, National Bureau of Statistics, BOBCAPS Research

Fig 10 – China industrial production YTD growth



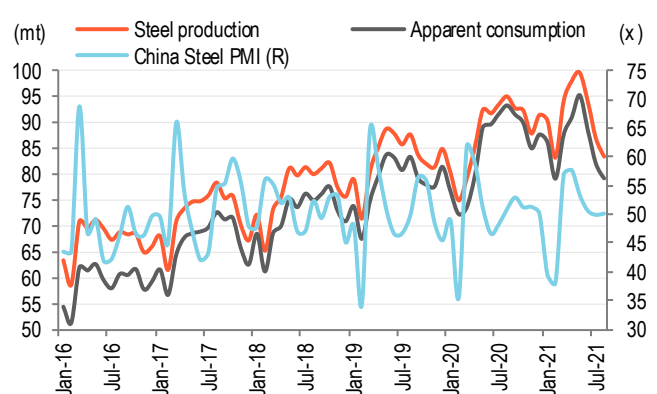
Source: Bloomberg, National Bureau of Statistics, BOBCAPS Research

Fig 11 – China FAI ex-rural households



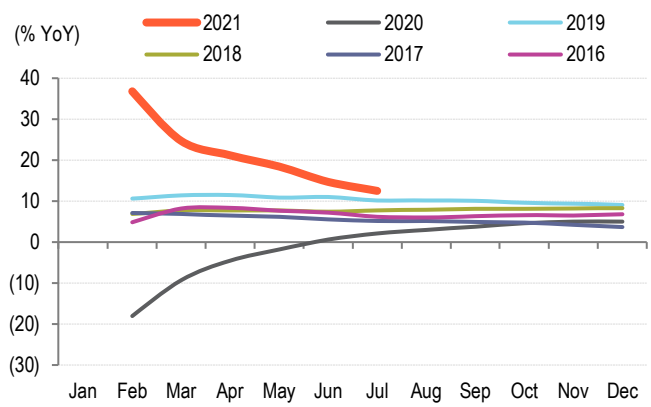
Source: Bloomberg, National Bureau of Statistics, BOBCAPS Research | FAI – Fixed Asset Investment

Fig 12 – China steel PMI



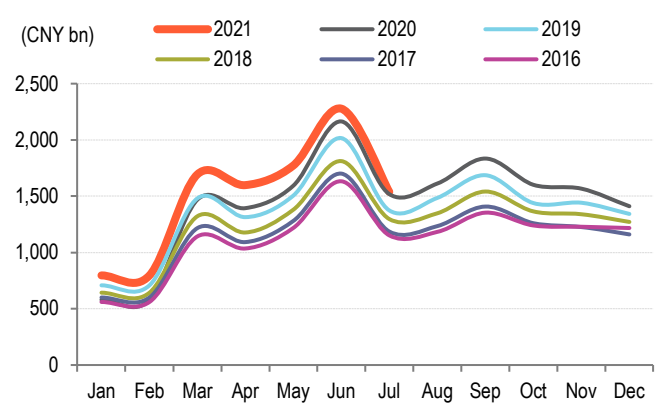
Source: Bloomberg, Steelhome, BOBCAPS Research

Fig 13 – China real estate FAI, YTD growth



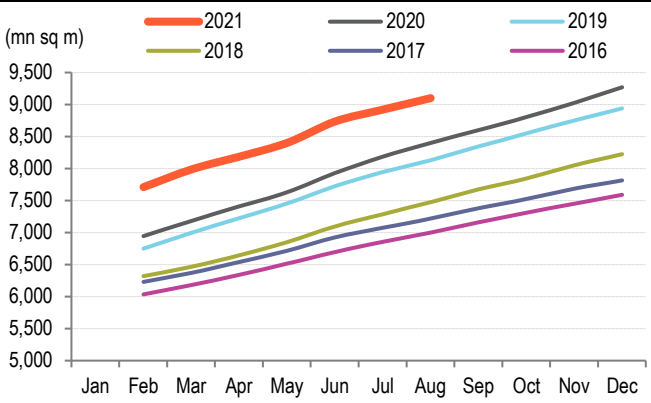
Source: Bloomberg, National Bureau of Statistics, BOBCAPS Research

Fig 14 – China real estate FAI



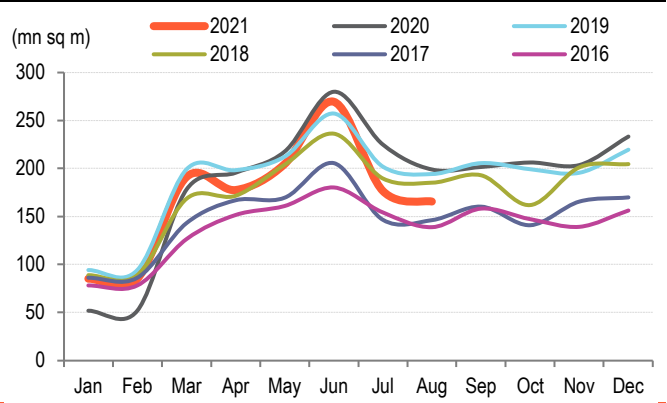
Source: Bloomberg, National Bureau of Statistics, BOBCAPS Research

Fig 15 – China real estate floor space under construction



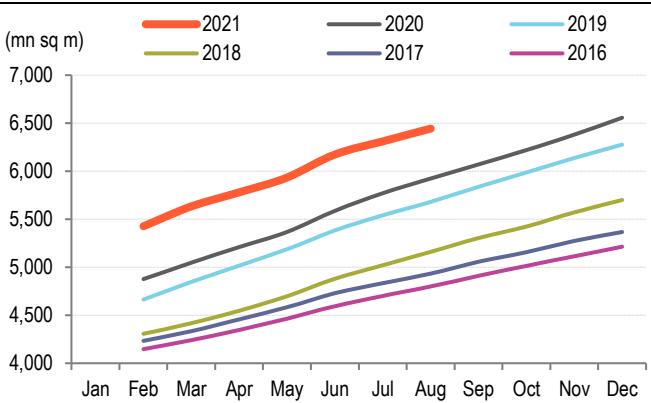
Source: Bloomberg, National Bureau of Statistics, BOBCAPS Research

Fig 16 – China real estate floor space newly started



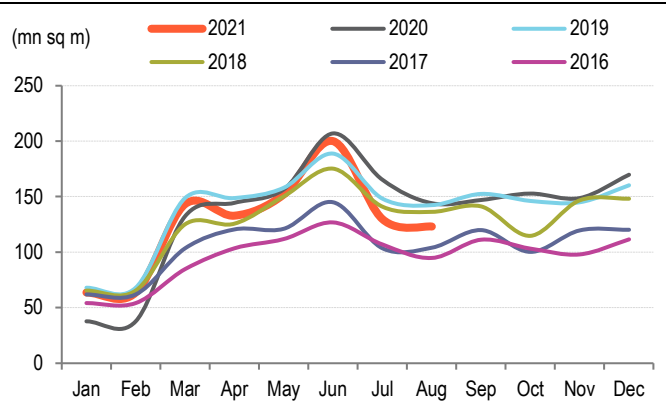
Source: Bloomberg, National Bureau of Statistics, BOBCAPS Research

Fig 17 – China residential floor space under construction



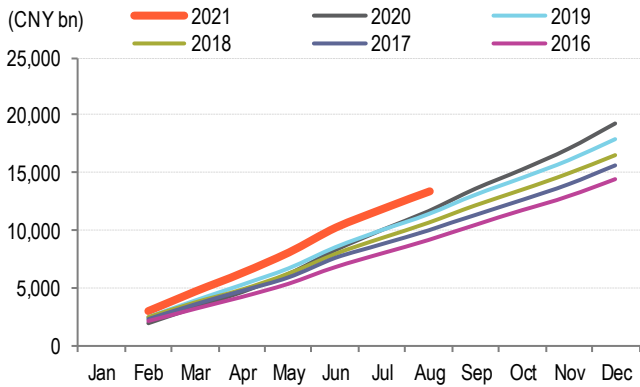
Source: Bloomberg, National Bureau of Statistics, BOBCAPS Research

Fig 18 – China residential floor space newly started



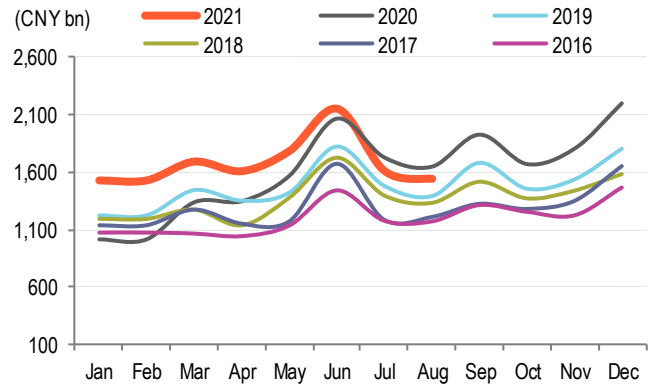
Source: Bloomberg, National Bureau of Statistics, BOBCAPS Research

Fig 19 – China real estate – total funds cumulative



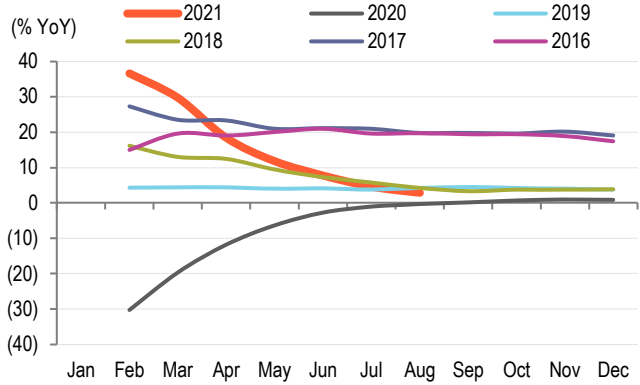
Source: Bloomberg, National Bureau of Statistics, BOBCAPS Research

Fig 20 – China real estate – total funds monthly



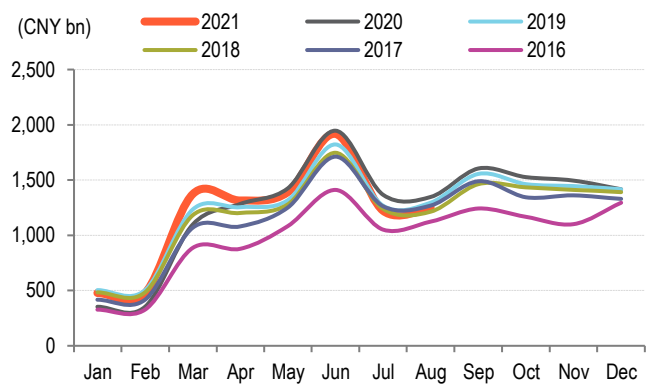
Source: Bloomberg, National Bureau of Statistics, BOBCAPS Research

Fig 21 – China infrastructure FAI excluding electric power, heat power, gas and water, YTD growth



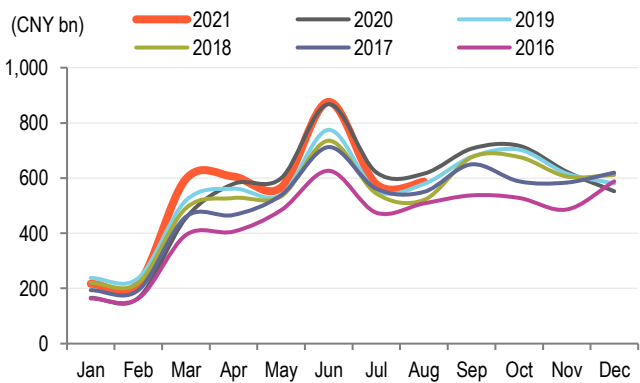
Source: Bloomberg, National Bureau of Statistics, BOBCAPS Research

Fig 22 – China infrastructure FAI excluding electric power, heat power, gas and water



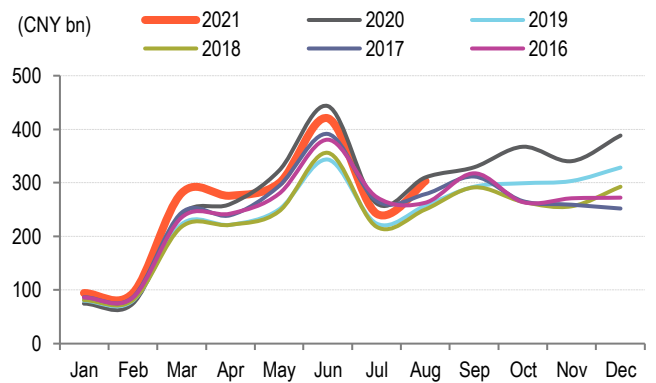
Source: Bloomberg, National Bureau of Statistics, BOBCAPS Research

Fig 23 – China transport, storage, posts FAI



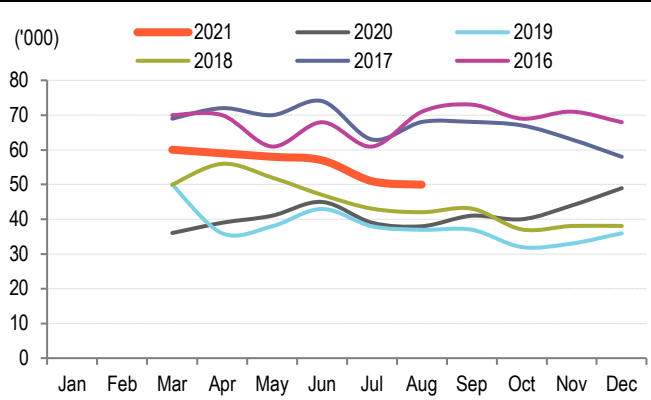
Source: Bloomberg, National Bureau of Statistics, BOBCAPS Research

Fig 24 – China power, gas and water FAI



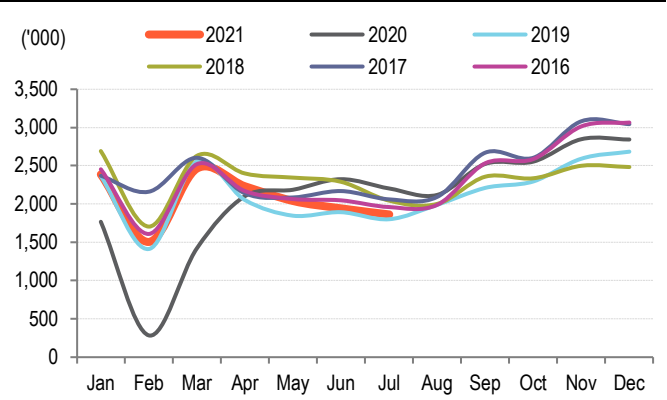
Source: Bloomberg, National Bureau of Statistics, BOBCAPS Research

Fig 25 – China machinery: Metal cutting machine production



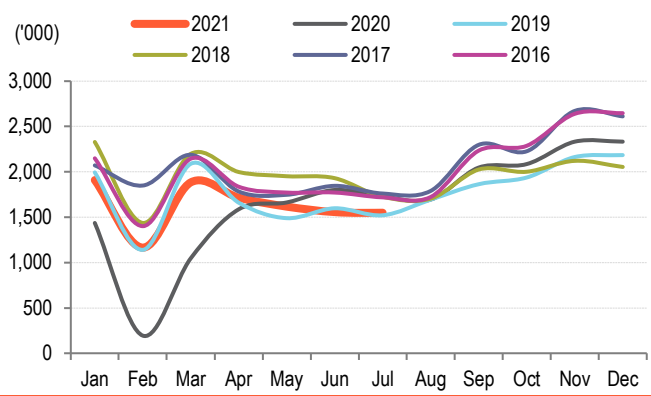
Source: Bloomberg, National Bureau of Statistics, BOBCAPS Research

Fig 26 – China automobiles: Vehicle production



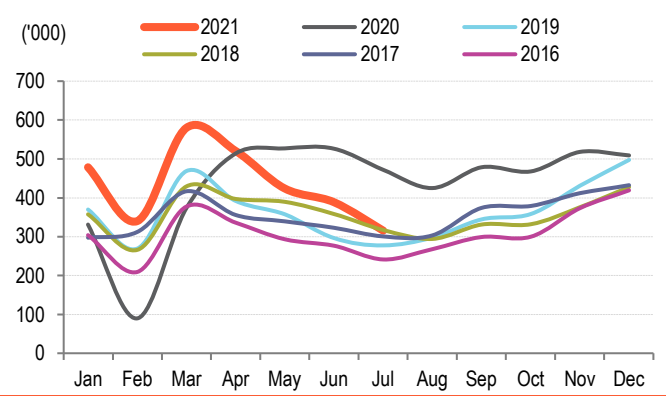
Source: Bloomberg, China Automotive Information Net, BOBCAPS Research

Fig 27 – China automobiles: Passenger vehicle production



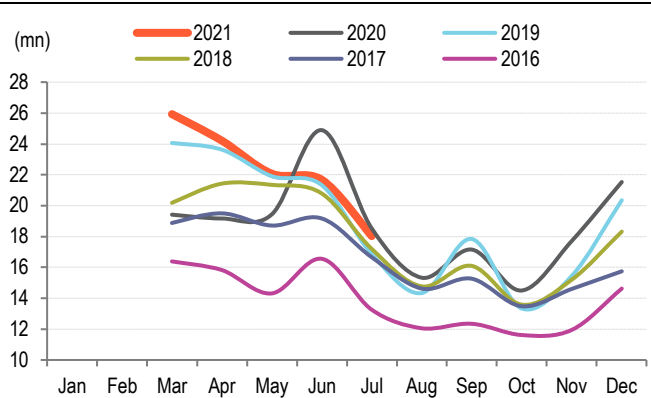
Source: Bloomberg, China Automotive Information Net, BOBCAPS Research

Fig 28 – China automobiles: Commercial vehicle production



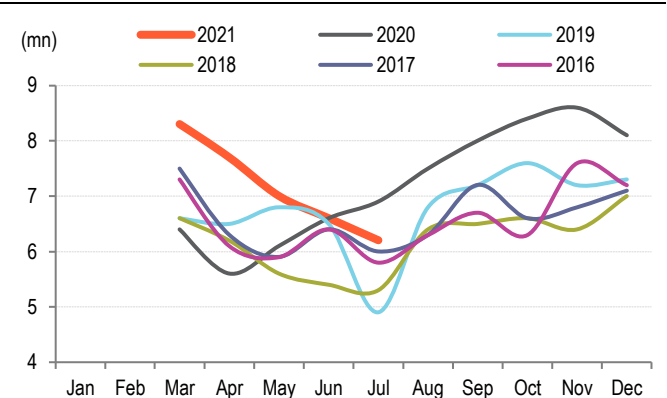
Source: Bloomberg, China Automotive Information Net, BOBCAPS Research

Fig 29 – China appliances: Air conditioner production



Source: Bloomberg, National Bureau of Statistics, BOBCAPS Research

Fig 30 – China appliances: Washing machine production



Source: Bloomberg, National Bureau of Statistics, BOBCAPS Research

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 31 August 2021, out of 105 rated stocks in the BOB Capital Markets Limited (BOBCAPS) coverage universe, 48 have BUY ratings, 25 have HOLD ratings, 10 are rated ADD*, 2 are rated REDUCE* and 20 are rated SELL. None of these companies 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 Institutional 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 act as market makers or 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.

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 in the past 12 months. 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.