

METALS & MINING

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Expert call with Baosteel: Margin outlook cautious

- Global steel margin could improve in Q4CY23 with seasonal demand uptick in Sep-Oct and potential production cap in China
- Medium-term margin for China steel industry to remain below historical cyclical average owing to surplus in China
- Indian ferrous players should benefit from brownfield expansion-led earnings growth, while margins remain mid-cycle; prefer TATA

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We hosted a call with Mr Sheng of Baosteel (600019 CH, Not Rated), a listed arm of China Baowu Group – the world's largest steel producer. Key takeaways:

Limping demand recovery in China: After a slump in steel demand since H2CY22, Baosteel does not see visible signs of recovery even after a year. While China's recent wave of policy measures could extend some support to the real estate sector (40% of steel demand), the key to stabilisation is revival of confidence in private developers. Baosteel believes the slowdown in real estate is being offset by counter-cyclical demand from infrastructure, a likely pickup in offtake from auto in H2CY23, and sustained demand from appliances, ship building and new energy applications.

China industry divided on production cuts...: Though the Chinese steel industry is divided, Baosteel expects the government to continue with its policy of implementing a yearly production cap but expects a relaxation to allow for output above last year's level. A cap has the potential to contract production by a monthly average of 4-5mt YoY and could translate to a more than 10mt cut per month from August levels.

...but can aid margin improvement in Q4CY23: Curtailments can benefit industry margins by improving steel prices (due to a better demand-supply balance) and reducing raw material costs (due to lower demand from China).

Near-term support possible: We see the possibility of near-term margin support from seasonal demand recovery in China during September-October, followed by potential production cuts in the country during Q4CY23.

Medium-term margin outlook soft: Baosteel believes the industry margin will remain below the historical cycle average owing to surplus in China. The industry must deliver on consolidation, particularly in rebar capacity, to restore the demand-supply balance.

Read-across for Indian ferrous sector: We are constructive on Indian ferrous players given earnings prospects from ongoing expansion projects but continue to see margins at only mid-cycle levels over the medium term. We have a BUY on TATA (TP Rs 145).

Recommendation snapshot

Ticker	Price	Target	Rating
JSTL IN	778	840	HOLD
SAIL IN	94	90	HOLD
TATA IN	128	145	BUY

Price & Target in Rupees | Price as of 21 Sep 2023



Key takeaways

We hosted a call with Mr Sheng, Representative of Security Affairs at Baosteel, a listed arm of China Baowu Group – the world's largest steel producer with 53mt of capacity. Outlined below are the key takeaways.

Demand recovery to be slow

- **No clear signs of recovery yet:** Baosteel indicated that it is yet to encounter visible recovery signals after the steel demand slump that began in H2CY22. Though steel prices improved in March, this was fuelled largely by positive sentiment on recovery that has since evaporated.
- **Current downcycle differs from the past:** China's steel industry has undergone three cycles of weakness this decade – in 2008, 2015 and the ongoing one from mid-2022. The current cycle is the weakest of the three with no recovery in sight even after a year owing to the turmoil in China's real estate sector, which has historically accounted for 40% of the country's steel demand. During the previous two steel cycles, the economy had recovered within a quarter or two supported by strong stimulus policies focused on real estate.
- **Real estate downturn yet to bottom out:** This time round, the Chinese government has initiated several policy measures to stabilise the real estate industry which could provide short-term support, but Baosteel believes only a revival of consumer confidence in real estate developers will hold the key to stabilisation.
- **Infrastructure industry providing countercyclical support:** Steel demand from the infrastructure and manufacturing industries has increased this year, supported by government policies, offsetting some of the decline from the real estate industry. The funds raised through special bonds will likely continue to support steel demand growth from infrastructure in Q3CY23.
- **Healthy demand from most quarters....:** Baosteel expects steel demand momentum to pick up in the automotive segment in H2, following significant destocking by the industry in H1, and anticipates 3% YoY growth in CY23. Demand has also been strong from the home appliances industry due to hot weather, and from shipbuilding with the pickup of global trade. The new energy sector continues to exhibit robust demand for solar PV modules, wind power, energy storage and oil and gas exploration.
- **...with only some laggards:** Steel demand from the engineering machinery and container industries is weak. While the former has been hampered by the slowdown in real estate, the latter is retracing to mean from a high base last year.
- **Flat products better placed:** Due to the real estate slump, China's steel market is oversupplied. Demand for long products has slackened due to the pullback in construction. Flat products, and particularly cold rolled steel, are relatively better placed.

Production cuts: Domestic industry divided on outcome

- **Q4 output to contract if restrictions set in:** China's steel production over January-August has increased 20mt YoY to 713mt. For output to remain within the CY22 level of 1,013mt, in keeping with past caps, steel output must average 75mt during September-December. This amounts to a 4-5mt YoY reduction from a lower base last year. If this production cap is indeed implemented, it could translate into a sharp 11mt drop in monthly average volumes produced from September through December versus that reported in August.
- **Production cap likely, believes Baosteel...:** Though Baosteel expects production restrictions to be applied in CY23 akin to earlier years, it does see the possibility of a more relaxed cap allowing for output above CY22 levels.
- **...but domestic industry divided on its application:** Baosteel acknowledged that other key players within the industry believe that far softer restrictions are necessary to facilitate recovery.
- **Exports to remain high in CY23:** Baosteel foresees high export volumes in CY23 due to the price arbitrage between domestic and export markets, projecting a full-year level of 80-90mt that implies a run-rate of 5-7.5mt a month over Sep-Dec'23. We believe the wide range reflects uncertainty over the application of production restrictions for CY23. Separately, the company aims to structurally increase its own exports from 5mt in CY22 to 6mt in CY23 and 8-10mt over the medium term.
- **Average profitability indicators for Baosteel:** Over the past five years from CY18 to CY22, Baosteel's operating cash flow has ranged from CNY 30bn to CNY 50bn, with average OCF at CNY 40bn driven by average net profit of CNY 18bn and depreciation of CNY 19bn. Even after accounting for capex, free cash flow has also averaged at CNY 8.5bn. This translates to an average OCF per tonne of ~US\$ 130/t and FCF of ~US\$ 25/t.

Margin to run below cyclical average for 2-3Y

- **Industry profitability dampened...:** Though Q2 was slightly better than Q1, 50% of Chinese steel players were lossmaking in H1CY23 and the profitability of China's ferrous industry crashed 90% YoY, as per China Iron and Steel Association.
- **...but Baosteel resilient:** During the ongoing weak cycle, Baosteel has been profitable in each of the past four quarters, which the company attributes to improved risk management capabilities. This is a far better outcome than the loss of CNY 10bn booked in one quarter during one of the prior two downcycles in 2008 and 2015.
- **China facing surplus capacity:** Oversupply is particularly high in the rebar industry and some of this capacity will have to be closed or reconfigured for the production of sheets.
- **Q4 margins could gain from production curtailment:** If an output cap is imposed in China, global steel industry margins could benefit from better prices and lower raw material costs.

- **Medium-term margins to remain below historical range:** Baosteel acknowledged that average margins of China's steel industry could remain below normal over the next 2-3 years, driving the exit of small players.
- **Consolidation needed to improve margins:** By CY24, Baosteel aims to increase its capacity from 53mt to 80mt and is evaluating options within and outside the Baowu group.

Raw material outlook linked to China production

- **Raw material prices dependent on output cap:** If production restrictions in China are strictly implemented, raw material prices could ease from current levels. If not, prices could find support from good production levels in China.
- **Coking coal largely supplied by Mongolia:** China is meeting a majority of its coking coal requirements from Mongolia following the easing of Covid restrictions. In terms of Australian coal, China has partly lifted the informal ban on imports as per media indications.

Decarbonisation without stranding current furnaces

- **Carbon reduction targets over next 10-15 years:** China is evaluating combining a couple of technologies to achieve 50% reduction in carbon emission of existing blast furnaces (BF). Baosteel has successfully tested ~20% emission reduction in its smaller 400m³ BF and is looking to implement a larger scale pilot on a 2500m³ BF.

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