

METALS & MINING

28 April 2023

China industry discipline to continue: Baosteel

- Baosteel guides for continuation of production discipline in CY23 and only a modest decline in raw material prices
- Over the medium term, consolidation in China's steel industry will improve production discipline, lowering pressure on global markets
- Steel margins likely to settle at mid-cycle level in FY24; earnings accretion from next expansion wave key to watch. Prefer TATA and JSP

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Q1CY23 sees sequential improvement but still weak: Baosteel (600019 CH, Not Rated) reported Q1 EBITDA at US\$ 399mn, showing a sequential 221% lift-off from a low base to post a margin of US\$ 31/t. However, EBITDA was still down 42% YoY with 14% YoY lower sales prices.

Deeper downturn: Baosteel acknowledged sharper spread contraction in H2CY22 with a double whammy of lower steel prices and high coal costs. The company sees this downturn to be longer than the ones in 2008 and 2015 and expects a flatter recovery slope. Baosteel flags significant divergence within the industry this cycle, with top players likely to maintain resilient profits and the bottom end facing deeper losses. Baosteel focusses on cost initiatives and value-added products to improve resilience.

Production restraint to continue: Baosteel does not expect steel production to increase this year and believes hot metal production will continue to decline. China's steel association CISA has asked the industry to curtail output from high production levels of 1.1bnt at a recent meeting on 24 April.

Slight correction likely in raw material prices: The Chinese steel major expects iron ore prices to hover around the CY22 average, coking coal to remain stable with a slight decline and scrap prices to stay relatively weak with slight fluctuation.

Domestic consolidation to manage industry surplus over medium term: Baosteel considers the CY20 steel production level of 1,065mt as the ceiling for the industry, expects market share of the top 10 players to improve from 43% to 65% over 3-5 years, and environmental protection and low-carbon to become key constraints. On the back of consolidation and overseas expansion, the company aims to increase production from 51mt in CY22 to 80mt by CY24 and 100mt by CY27. With consolidation, steel majors will play a key role in production discipline by closing weaker furnaces.

Constructive on Indian ferrous players: We expect (i) margins to stabilise at mid-cycle levels in FY24 as recovery in China takes hold, and (ii) investor focus to shift to delivery of the next expansion wave. BUY TATA (TP Rs 140) and JSP (TP Rs 670).

Recommendation snapshot

| Ticker | Price | Target | Rating |
|---------|-------|--------|--------|
| JSP IN | 583 | 670 | BUY |
| JSTL IN | 725 | 715 | HOLD |
| SAIL IN | 83 | 95 | HOLD |
| TATA IN | 108 | 140 | BUY |

Price & Target in Rupees | Price as of 28 Apr 2023



Additional takeaways

Rising confidence toward overseas expansion

Baosteel began construction at its first overseas green steel project in Saudi Arabia during CY22. Further, the company aims to accelerate the pace of “going out” by building or equity participation in overseas steel bases. Baosteel aims to focus on building low-carbon/zero-carbon production lines in regions with low-cost energy and higher market demand to succeed in an emerging environment with carbon border tax.

China focusing on oligopoly in iron ore

China is focusing on a global oligopoly driven by the four iron ore majors. The country instituted a central establishment, China Mineral Resources Group (CMRG), in CY22 to act as a central purchaser of iron ore and negotiate with the Big 4. It also aims to develop overseas iron ore projects to increase its voice in negotiations with international miners.

Focusing on value-added products for margin gains

With a focus on value-added products, auto steel and silicon steel accounted for a third of Baosteel’s product portfolio in volume terms and 80% in profit contribution in FY22.

- **Auto sheets:** The company dominates the cold-rolled sheet segment in China and has total auto sheet production of 12mt with 9mt of cold-rolled sheets. It is targeting both domestic and global markets. In China, Baosteel sees the automotive market maturing with a 27mn-28mn vehicle capacity, and plans to focus on deepening its penetration with additional products. It is developing auto aluminium sheets and has also built the first full-process low-carbon auto sheet line in China.
- **Silicon steel:** Baosteel is focusing on extra-high voltage power transmission, electric vehicle and other markets, and aims to expand applications in transformer, EVs, high-efficiency motors and inverter compressors. It has developed 0.5mt of capacity in CY22 and aims for another 1mt increase in CY25.
- **Long steel:** Here, the thrust is on differentiated long material products, development of steel pipes, industrial bar and wire products. Baosteel will target applications in oil and gas development, transmission pipes, and high-end automobile rod wires, while expanding product applications in hydrogen energy, energy storage, CCUS (Carbon Capture Use and Storage) and new EV industries.

For the other two-third of its product basket, the company aims to carry out a differentiated strategy targeting energy transition in China. It is working on specific products in three directions – (a) new energy exploration (wind, solar, hydro power) with temperature resistant and erosion resistant steel applications, (b) transmission of energy from the west to east of China, and (c) improving energy efficiency usage.

Focusing on cost initiatives to improve profit resilience

The Chinese major is aiming to deliver additional cost savings of RMB 3bn (or US\$ 450mn) in CY23 by focusing on optimisation of coal and ore blending, use of economic material (reduce domestic coal usage, develop more alloy suppliers), lean production (manage molten iron temperature, heating furnace oil consumption), and lowering of working capital.

Progressing on green steel

Baosteel is making credible progress on developing green steel:

- Demonstrated a breakthrough in hydrogen-rich carbon cycle blast furnace (BF) technology with a 21% reduction in carbon emission in a 400m3 BF. Baosteel wants to now implement the same in a 1000m3 BF.
- Targeting implementation of a 1mt net zero hydrogen base shaft furnace by the end of CY23, which will support a 1.8mt net-zero carbon auto sheet production line by CY25.
- Launched a 10mt CCUS project in China with Sinopec, Shell and BASF.
- Produced the first roll of electric-galvanised low-carbon (under the brand name BeyondECO@-30%) under cooperation with Beijing Benz, reducing carbon by more than 30%.
- Target to produce 2bn kwh from green energy over medium-term.
- Target to realise ultra-low emission A-grade level at all its four bases. Its Baoshan base and Dongshan base have completed creating A-grade enterprise, while the Qingshan and Melshan bases will complete ultra-low emission assessment monitoring in CY23.

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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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