METALS & MINING

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Market rebalancing underway: ArcelorMittal

- **Global steel spreads saw sharp compression in Q3CY22, per MT. We expect Indian steel margins to bottom out in the Sep quarter**
- **MT sees market rebalancing underway in Europe and does not perceive China as a threat to structural market balance**
- **Looking beyond near-term uncertainty, we prefer defensive play TATA (BUY, TP Rs 140) in the current volatile environment**

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We summarise takeaways from meetings with Hetal Patel, the European IR Head of ArcelorMittal (MT EN, Not Rated).

Bottoming out of steel spreads to differ across markets: MT highlights significant compression in steel spreads across markets in Q3CY22. As Europe and the US have contractual price mechanisms, their margin decline is likely to be spread over 2-3 quarters. We currently expect Indian steel margins to bottom out in the Sep'22 quarter given the limited contractual framework. Coking coal prices also need to correct for margins to stabilise at mid-cycle levels.

Market rebalancing underway: While MT is seeing slower recovery in China, it does not perceive China as a threat to structural market balance as production discipline has improved. MT is noticing weaker demand in Europe, but the industry has already responded with 15-20% capacity curtailments and MT is prepared to do more. Other markets including the US are also facing a steep decline in apparent demand with destocking underway. We believe stabilisation in China is essential for steel prices/ margins to bottom out and are watching US demand for the possibility of a soft landing.

Decarbonisation journey needs government support: MT has developed a US$ 10bn capex plan till 2030 to lower its emission footprint by 35% in Europe and by 25% globally. The company is waiting for EU approval for 50% government funding support of its US$ 6bn proposals to kickstart investments.

India – material growth underway: MT's India JV is progressing on its US$ 10bn capex drive that involves doubling of capacity to 15mtpa by mid-CY26, downstream expansion focused on flat products, and US$ 2.4bn of infrastructure development.

Constructive on Indian ferrous players: MT plans to stick to its balanced growth plus returns strategy through the downturn. We believe this reflects its confidence in the return of a structural balance in the steel market. 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 (TP Rs 140) remains our top pick.

Key takeaways

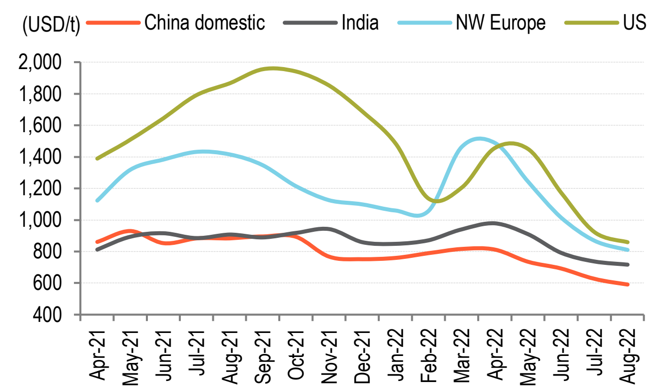
We summarise key takeaways from our meeting with Hetal Patel, General Manager – Corporate Finance and Investor Relations, Europe, with ArcelorMittal (MT). We also compare his inputs with our Indian steel sector themes.

Bottoming out of steel spreads to differ across markets

Read-across for Indian players: While we expect Indian steel margins to bottom out in the Sep'22 quarter, European and US steelmakers will likely see continued margin declines for one or two quarters as spot prices feed through to regional contract prices. Globally, coking coal needs to correct in line with steel prices for margins to stabilise to mid-cycle levels. Supply issues are keeping the coking coal market tight.

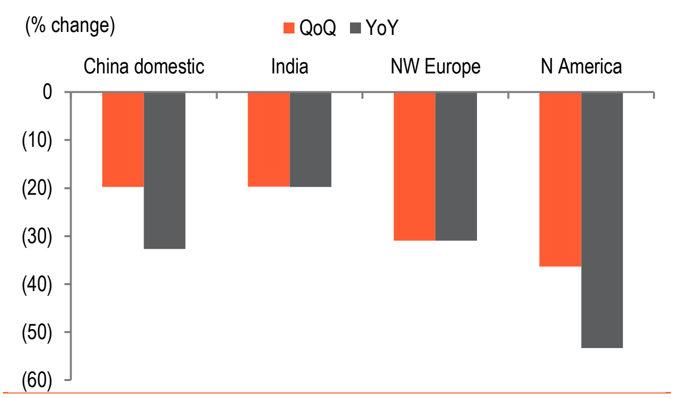
- According to MT, **Q3CY22 spreads have been compressed across regional markets** amid the economic slowdown, destocking and high-cost raw material inventory. While European and US steel companies have a profitability buffer by way of contractual prices, their spot markets have seen a sharper correction than prices in China and India. Europe faces the additional impact from lower volumes during seasonal summer holidays as well as higher energy costs. The US faces a sharper price decline owing to a higher base but will see a lower impact from energy cost challenges.

Fig 1 – Regional HRC spot price trend (monthly average)



Source: Bloomberg, BOBCAPS Research

Fig 2 – Europe and US spot prices have corrected sharply during the Jul-Sep'22 quarter



Source: Bloomberg, BOBCAPS Research

- **We believe European margin decline is likely to be spread over couple of quarters** as spot prices flow through contracts with price resets, and higher energy prices also impact the cost base with only partial hedging practices. The European industry has attempted to take a price hike from US$ 700/t to US$ 770 which has seen a subsequent modest correction to US$ 750. Consumer sentiment is improving led by energy price caps and industry response. Coking coal price adjustment, however, is taking time to catch up.

- **US margin decline is also likely to continue over couple of quarters** as spot prices feed through contractual prices.

Market rebalancing underway

Read-across: Slower recovery in China is delaying the stabilisation of steel prices. Outside China, the key monitorable will be whether regional markets can find a balance amid local demand weakness. While Europe is showing good signs of rebalancing, its progress needs to be monitored closely given economic challenges from higher energy prices. US import demand has started to decline, easing the pull effect on steel prices. We are watching US demand to see whether it could deliver a soft landing. At present, non-residential construction starts are apparently offsetting the decline in residential starts, although from a much higher base.

- **China is seeing slower recovery.** MT acknowledged that demand recovery continues to run slower with extended lockdowns. Benefits of the infrastructure stimulus still need to percolate into the economy to offset weakness in real estate.
- **China may not disrupt global market balance.** MT believes that China does not pose a major threat to stability of the global steel market. Over the past four months, the Chinese industry has used production curbs to draw steel exports down to a more manageable level of 6.2mt in August from the recent peak of 7.8mt in May. Although production has started inching up in September, domestic inventory remains under control.
- **Europe has cut production to balance the market.** MT and the European industry have responded to domestic demand weakness with 15-20% production cuts. MT remains prepared to reduce more high-cost capacity if demand weakens further.
    - The company is experiencing additional demand weakness in September following school holidays. The recent decline also seems to be driven by a slowdown in construction which was hitherto strong. Automotive demand is relatively stable on a weaker base.
    - While the industry hedges part of its energy requirements in Europe, energy cost challenges are also leading to curtailments.
    - Europe will not do away with safeguards against China and other importing partners to tame inflation as these will harm the domestic industry.
- **Other markets are also experiencing demand declines.** Most markets including the US are going through a sharp decline in apparent demand with destocking underway. Amongst the markets that MT caters to, Brazilian demand remains resilient on a relative scale. MT is seeing substantial weakness in the CIS market following the impact of the Ukraine-Russia war.

Decarbonisation journey needs government support

Read-across: Indian industry has initiated IRR-positive decarbonisation steps such as setting up coke oven and pellet plants, as well as investments in renewable power plants which will help lower effective energy inputs and reduce carbon intensity. Indian industry is in a wait and watch mode for green technologies to stabilise and become cost effective.

- **MT aims to lead the decarbonisation journey** with targets to cut emissions by 35% in Europe and by 25% globally by 2030 supported by US$ 10bn in capex. To make the transition economically viable, the company is looking for government support by way of 50% funding.
  - MT's proposal for 60% of the capex plan has found support in several countries and is now awaiting the final EU nod.
  - Key milestones to track progress on the decarbonisation journey include: (a) government approvals, (b) finalisation of the Carbon Border Tax Mechanism to provide a level-playing field to European industry against imports, (c) completion of a full-scale steel plant with zero emissions by MT, and (d) economic viability of green hydrogen.

India – Material growth underway

- **MT considers its Indian JV a strategic growth option** and is pleased with the turnaround and performance of the existing plant and management team after acquisition. MT has a ~US$ 10bn capex plan for the JV which includes:
  - US$ 0.8bn for debottlenecking the Hazira steel plant from 7.6mtpa to 8.6mt
  - US$ 0.5bn for investment in a coke oven to reduce natural gas exposure for the existing plant
  - US$ 5.1bn for expanding by 5.4mtpa to 15mtpa by mid-CY26 – this would involve two blast furnaces, a coke oven plant and hot strip mills
  - US$ 1bn investment in downstream with a 100% focus on flat products
  - US$ 2.4bn to develop infrastructure

  The plan has a potential to double upstream EBITDA by CY27 and deliver further growth from downstream value addition and efficiency improvements. MT expects the India JV to fund expansion through its own cash flows and debt without any support from the parent.

- For the **next leg of growth beyond CY26**, the JV is considering two options to raise total capacity to 30mtpa – (a) expansion of the Hazira steel plant by another 5mtpa to 20mtpa and (b) a 10-12mtpa greenfield plant in east India.

MT to stay true to its strategy through the downturn

Read-across: MT's guidance of continuing with its balanced growth plus shareholder returns strategy is indicative of its confidence in the return of a structural balance in the steel market. In the absence of material surplus capacity in global industry, we believe the downturn is unlikely to be protracted.

- MT highlighted that **its balance sheet is much stronger today** with over US$ 4bn of debt and US$ 300mn of interest cost. This is significantly below gross debt of US$ 22bn and interest cost of US$ 1.9bn a decade ago.
  - MT intends to continue to invest US$ 1bn-1.2bn annually in growth as part of its investment plan through the cycle.
  - The company highlighted that its free cash flow generation in Q4 and CY23 will be supported by the release of US$ 9.5bn of working capital as steel and raw material prices ease.
  - MT also plans to continue with the use of 50% free cash flow for returns to shareholders and 50% for strategic growth. It believes that the capital allocation policy balances the growth versus return expectations of shareholders.

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Note: Recommendation structure changed with effect from 21 June 2021

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