Steel:
Spreads to remain healthy, despite probable price correction

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Riding on the back of various stimulus packages, a sharp re-bound in global demand had significantly widened the demand-supply gap, resulting in an upsurge in steel prices. However, CARE Ratings believes, the current up-cycle witnessed in steel prices over the last one year, is likely to show some respite now, largely on account of the improving supply-side situation. While the demand continues to remain robust, normalcy in the economic activity, post relaxation of lockdown restrictions, has resulted into higher finished steel output across all major steel-producing economies.

Essentially led by China & India, albeit at a lower base-effect, global steel production during the first five months of CY21 has recorded a Y-o-Y growth of around 15%. CARE Ratings believes that the improving supply-side situation is expected to abate any further increase in the steel prices; however, it is unlikely that the global prices may witness any steep correction from its peak levels. The decline in prices will only be gradual largely supported by the continuing robust growth in steel demand and higher iron ore prices. CARE Ratings expects that the global steel prices are likely to follow the trend in iron ore prices, which means that despite an expected decline in steel prices during the second half of CY21, the spreads for the steel players may continue to hold, thereby ensuring a firm profitability of steel players.

On the domestic front, while the second wave had slowed down the demand for steel momentarily, CARE Ratings expects domestic demand is likely to bounce back post the end of the monsoon, largely driven by the infrastructure and construction sector. Domestic steel prices are currently hovering around a marginal discount to international prices as domestic steelmakers believe any further increase in prices may weigh down their domestic sales volumes. This discount is likely to get evaded post the moderation in international prices. Large integrated domestic steel players would continue to benefit from the export markets as they remain lucrative owing to lower export volumes from China and the cost advantage gained by Indian steel makers owing to lower domestic iron ore prices.

Change in momentum!

Taking cognizance of the pandemic impact, the last few quarters have witnessed a new sense of urgency by the policy makers, both in domestic as well as global platforms, to aggressively target the hindrances to economic recovery through announcement of large stimulus packages. While these steps have surely helped economies in buying time to find a sustainable long-term solution, the impact of these measures has resulted into a significant up-turn in global commodity cycle.

The difference though this time around was that the world witnessed a much sharper recovery in CY20, when compared with the global financial crisis (in CY08-09). No doubt, the action was much more judicious and the size of the stimulus much higher in CY20. The upswing witnessed in global steel prices during the second half of CY20 has virtually continued its momentum in CY21 as well. The rally has not only achieved new peaks (surpassing the decadal-high prices witnessed during CY08) but has also shown strong resilience in terms of decline from the peaks.

Global steel prices kept inching up, largely driven by demand-supply mismatch, which was a result of a sharp re-bound in demand, while the steel mills were not only late to anticipate the sudden spike in demand, but also grappled with the supply-side logistics in sourcing of key raw materials. This apart, supply shortage for sea-borne iron ore also resulted into global iron ore prices surging up, breaching the historically higher peaks.

Post the pandemic effect, global commodity markets witnessed a sharp rebound during the second half of CY20. Continuing its momentum in the first half of CY21 as well, the prices just kept moving northwards; so much so they have not just recovered, but virtually peaked, recording a decadal high. The sharp recovery in prices is rather astonishing as the world demand saw a recovery in second half of the year; however, barring China, it remains much lower as compared to the pre-covid levels. What fueled the rally in global steel prices can be attributed to the demand-side recovery as well as the supply-side constraints. While the demand recovery, especially in China and other economies, was on the back of substantial government stimulus, the lockdowns & restrictions caused significant supply-side headwinds in terms of difficulty in procurement & movement of key raw materials resulting into reduced production across steel mills. The double whammy effect resulted in one of the sharpest and perhaps the fastest recoveries in the global steel prices, which was considerably beyond the markets expectation. World steel exports prices (HRC) increased from an average of US$ 443 per tonne during H1CY20 to US$ 835 per tonne in the first half of CY21. During May 2021, the same has crossed the US$ 1050 per tonne mark.

Global steel prices remain hot, achieving higher peaks!

Source: Steel Benchmarker

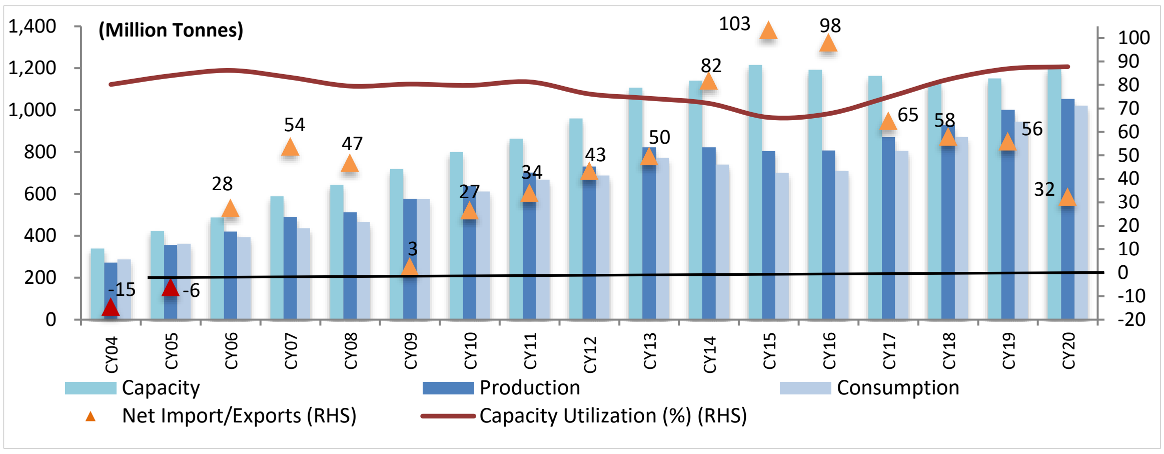
As stated above, it is the likely combination of different factors that has garnered its support to the rally in global steel prices.

China led factor

China continues to remain the focus point when it comes to a commodity rally. It was in China that the world first witnessed the spread of the Covid-19 virus, followed by a quick response from the Chinese government in the form of a giant package to help curtail the impact on the economy. The outcome of the stimulus resulted into significant growth in Chinese steel demand, which according to the World Steel Association grew by around 9% in CY20 (over CY19), whereas the production increase was around 5%.

What has really helped the global steel prices is the declining gap between Chinese production and consumption, thereby reducing the exportable surplus to around 32 million (mn) tonnes in CY20, as compared with 103 mn tonnes during CY15. Furthermore, China remained a net importer of steel for a few months in the second half of CY20, a scenario not seen in the past decade or so, which triggered the upside in global steel prices.

China now accounts for a global share of more than 55% in both steel production & consumption



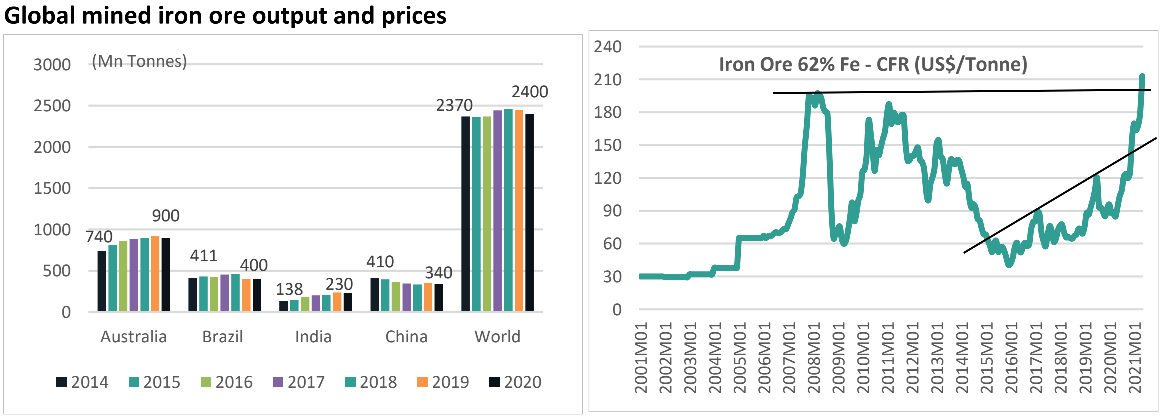
Source: World Steel Association, OECD, CARE Ratings

Supply-side constraints impacting the raw material prices

Along with the improving Chinese demand, another important factor that has been supporting the steel price rise, is the global iron ore prices. Being the key raw material and available in large quantities only with a select few countries, the price of sea-borne traded iron ore has been at historically higher levels. This can be fundamentally attributed to the declining iron ore mining output over the past few years.

Major miners in Brazil and Australia, owing to the declining iron ore prices (since August 2014 to March 2019, when iron ore prices kept declining and remained US$ 90 per tonne) in the past few years have not sufficiently invested in expanding their capacities leading to a shortfall in global iron ore mining output. While the world steel production increased from 1,673 mn tonnes in CY14 to 1,870 mn tonnes in CY20, global iron ore mining output only increased from 2,370 mn tonnes to 2,400 mn tonnes. The drop in CY20 iron ore mining output is also on account of the pandemic impact, however, CY19 drop can be attributed to Brazil, on account of the cutdown in production by Vale (Brazil's largest miner) post the disaster at one of its operating mines.

Global mined iron ore output and prices



Source: USGS, World Bank, CARE Ratings

Taking cognizance of trend in world steel production, one can be very much assured that the current rally in iron ore prices is not demand driven as the demand for the red dust has not increased drastically over the last one year. However, prices during the same period have more than tripled, which is largely on account of lower mining output.

CARE Ratings believes that the miners in Australia and Brazil are likely to rise to the occasion and we may see increasing supply of the ore coming in from these countries in the latter half of the year, which will eventually result in the rationalization of iron ore prices. However, it is unlikely that the supply-side correction will happen in the short-term period, and CARE Ratings expects that the global iron ore prices may continue to average around US$ 130-150 per tonne during CY21.

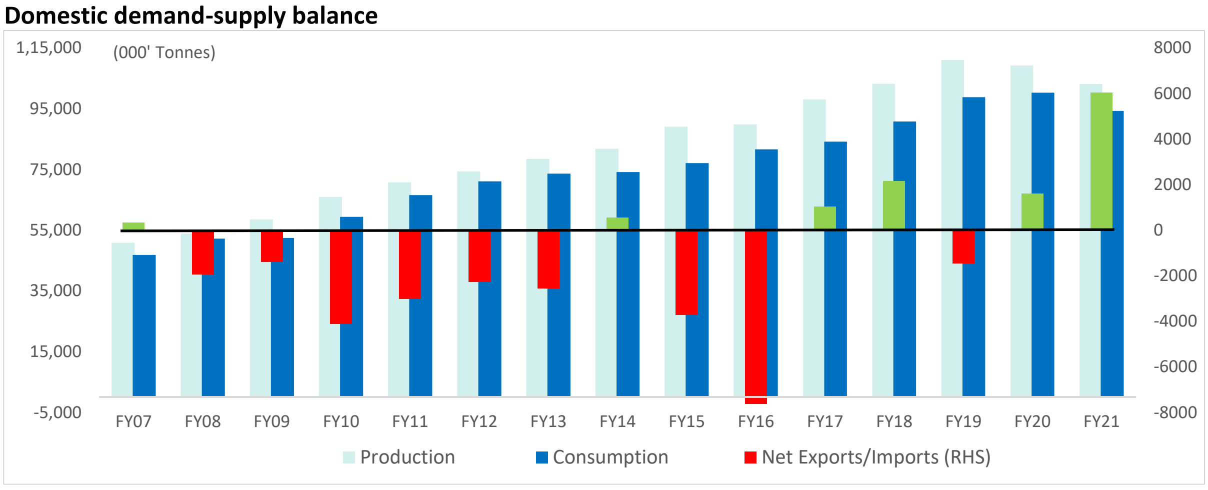
Domestic markets witnessed strong demand recovery

Domestic demand for steel was impacted by slowdown in manufacturing activities during FY20. Owing to the slowdown in domestic demand, Indian steel players resorted to higher exports volumes, which resulted into India becoming a net exporter of steel during FY20 as compared with being a net importer of steel during FY19. Furthermore, domestic requirements of steel were largely met from domestic supply as imports fell sharply by around 13.5%.

Slowdown in domestic demand was further aggravated by the Covid-19 pandemic. Towards the end of FY20, the country went under lockdown and most of the end-user industries witnessed a halt in their production activities. Steel production also took a substantial hit in the first quarter of FY21.

As the lockdown measures were eased, domestic demand started picking up, being an essential activity, production for steel also started increasing. By August 2020, the Indian steel industry was able to reach the pre-covid levels of about 9 mn tonnes of monthly production. This time though, apart from a gradual recovery in domestic demand, steelmakers were positively surprised with the opening of the export window, which provided the much-required support in improving their sales volumes.

Domestic demand-supply balance

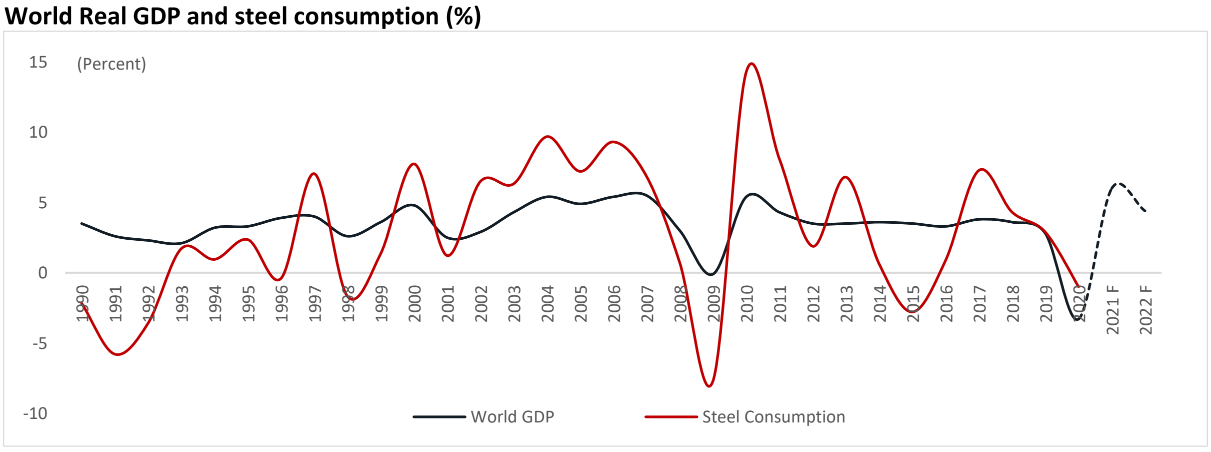


Note: red indicates net imports, green indicates net exports
Source: CMIE, JPC, CARE Ratings

Sector outlook

The global markets on the back of large stimulus packages, have recorded a healthy revival, both in production and consumption of steel. Although much of the credit goes to China (which alone accounted for a global share of almost 56%), the fact that other economies of the world have also started picking up in the second half of CY20 is encouraging. During CY20, according to the IMF estimates, while the world GDP is likely to have contracted by 3.3%, global steel consumption declined only by about 0.2%. IMF predicts Global Real GDP to grow by about 6% in CY21 (mainly on account of lower base effect of CY20) and stabilize at around 4.4% in CY22. Accordingly, the World Steel Association estimates global steel demand to increase by around 5.8% in CY21 and further by around 2.7% in CY22.

World Real GDP and steel consumption (%)



Source: IMF; World Steel Association, CARE Ratings

With regard to the domestic market, pushing back the developed world, India is now not just the second-largest producer of steel but also the consumer. Over the past decade, Indian steel industry has responded well to the increase in domestic steel demand leading to significant capacity addition in the Indian markets. The domestic steel capacity now stands at around 142 mn tonnes and is likely to add another 15 mn tonnes during the next 2-3 years. CARE Ratings expects some delay in commencement of these capacities as restrictive movement of goods and labour is likely to delay some of the capex plans.

On the demand front, CARE Ratings expects the domestic steel demand to grow at a CAGR of about 7.5% during the next 2-3 years. While the demand for flat products in the domestic market is likely to be supported by the pipe manufacturing, roofing and the automobile sectors, demand for long products will continue to increase largely on the back of the infrastructure spend. The housing and construction activity is also likely to witness some amount of recovery. CARE Ratings believes the government-targeted infrastructure spend is likely to be the key monitorable when it comes to domestic demand outlook for the steel sector.

Focus on infrastructure and government initiatives such as ‘Make in India’ are expected to boost steel demand growth. In addition, the government’s focus on accelerating the rural economy and plans for building smart cities, affordable housing and dedicated freight and high-speed rail corridors are expected to create significant demand for steel.

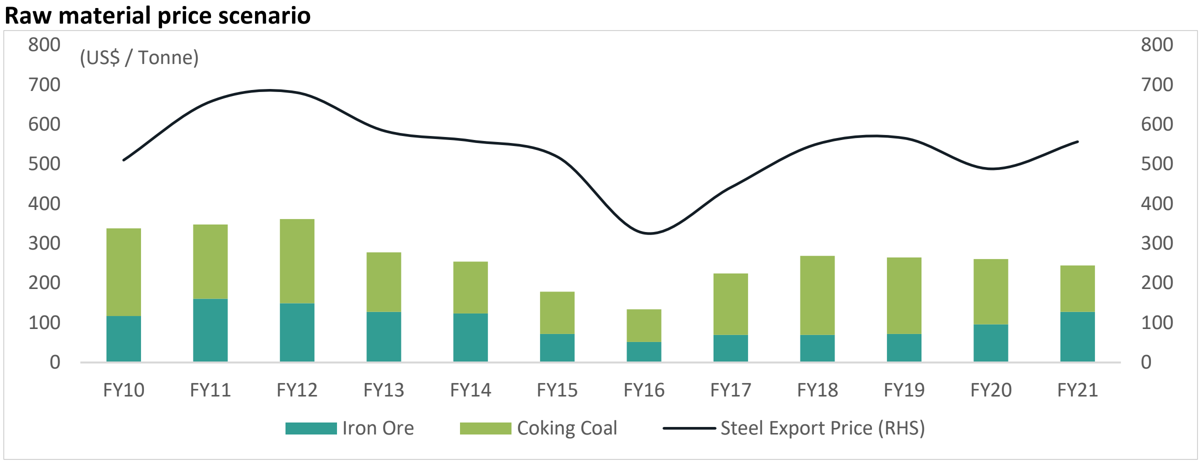
While the demand has been on an improving trend, CARE Ratings remains cautious in terms of the likely impact of the second and third wave of the pandemic. Although probabilities of a complete lockdown are gradually fading away, any kind of partial lockdowns/restrictions does have its impact on the manufacturing and infrastructure building activity.

Credit outlook for the Indian steel Industry

Indian Steel Industry is structurally fragmented marked by presence of few major integrated players and numerous small and mid-sized players. The credit quality of the players varies significantly depending upon their presence across the value chain. The credit quality of the domestic steel manufacturers has seen an improving trend over the last three quarters of FY21, largely on account of improving cash flows arising due to significant improvement in net sales realizations (NSR). Despite decline in sales volumes for most of the players, the profitability in absolute terms has only improved, as the increase in realizations more than compensated the fall in volumes.

While the players got the benefit of higher international prices supporting the NSR, lower domestic raw material prices especially iron ore, further boosted the profitability of integrated players. Though iron ore prices are lower in the domestic market, availability of the same is different for each player. Among the integrated players, those with captive mines were able to garner the maximum profitability, however, those without them found it difficult, since post the auctioning of the mines in Odisha, very few of them were able to commence commercial production. This has led to a scarcity situation in the domestic market and the domestic iron ore prices have also more than doubled during the last six months. However, despite an increase in domestic iron prices, they continue to be significantly lower than the international prices.

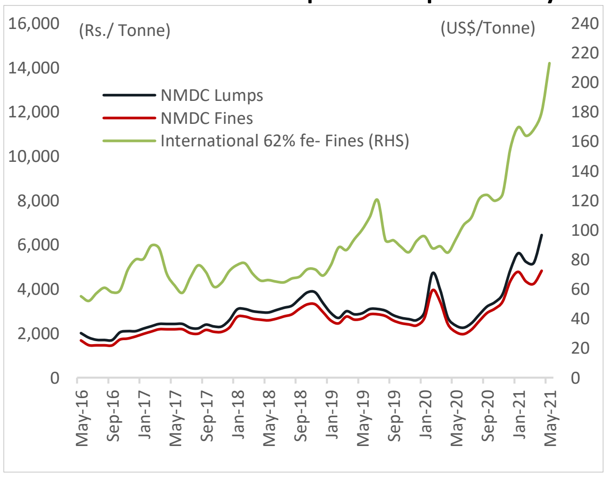
Raw material price scenario

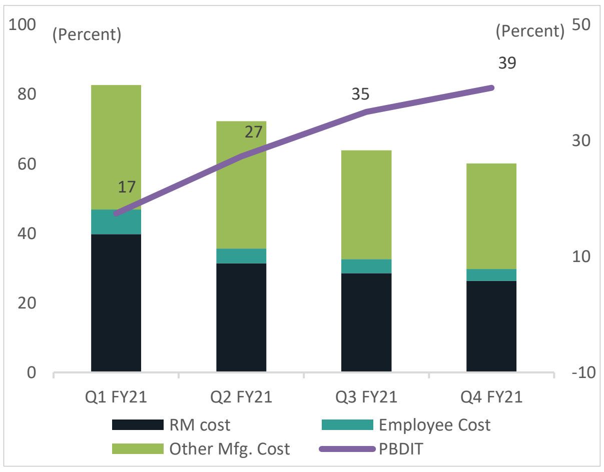


Source: World Bank, Steel Insights, Steel Benchmarker, CARE Ratings

As seen in the graph above, the widening of the gap between raw material prices and the NSR is reflective of the margin expansion for domestic steel manufacturers. Although during FY21, domestic players have shown significant improvement in their profitability, the markets continue to remain highly volatile. CARE Ratings has analysed the Q-o-Q movement of a few large integrated players as shown in the graph below.

Movement in raw material prices and profitability





Source: World Bank, NMDC, CMIE, CARE Ratings
Note: Standalone financial of JSW Steel Limited, Tata Steel Limited and Jindal Steel & Power Limited considered for the purpose of analysis (cost as % of net sales for FY21)

CARE Ratings expects NSR's to remain healthy, though a downside risk cannot be ignored on account of the onset of monsoon and the possible impact of second wave on the domestic prices. However, expectations of higher export orders and lower raw material prices are likely to support the profitability margins of players during FY22 who are witnessing M-o-M volatility in domestic demand owing to the pandemic-led restrictions/lockdown. As far as volumes growth is concerned, demand improvement and low base effect of FY21 is likely to help improve the volumes of the domestic players. The solvency ratios of steel companies are expected to improve on account of accretion to net worth and healthy cash accruals.

Contact:

P. S. Bhagavath	Senior Director, Ratings	ps.bhagavath@careratings.com	+91-22-6754 3407
Hitesh Avachat	Associate Director, Ratings	hitesh.avachat@careratings.com	+91-22-6837 3510
Sharmila Jain	Director, Ratings	sharmila.jain@careratings.com	+91-22-6754 3638
Mradul Mishra	Media Relations	mradul.mishra@careratings.com	+91-22-6754 3573

CARE Ratings Limited
Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022
Tel. : +91-22-6754 3456 I CIN: L67190MH1993PLC071691

Connect :