Rekindled optimism in domestic steel industry

Synopsis

The Indian steel industry has been struggling over last couple of years due to rising imports particularly from China, relatively subdued domestic demand, excess domestic capacity and decline in realizations due to availability of cheaper imported steel. However, there have been some positive developments in recent times with government intervention in the form of imposition of minimum import price (MIP) in February 2016 for a period of six months and levy of 20% safeguard duty in September 2015, which has been further extended till March 2018. These measures have arrested the rise in imports to a large extent thereby leading to improvement in realizations for the domestic players. Furthermore, the lower prices of key raw materials have also supported the improvement in realizations of steel products. However, the continuation of protection measures for some more time and sustained revival in the demand would remain crucial for the prospects of domestic steel industry in the medium to long-term.

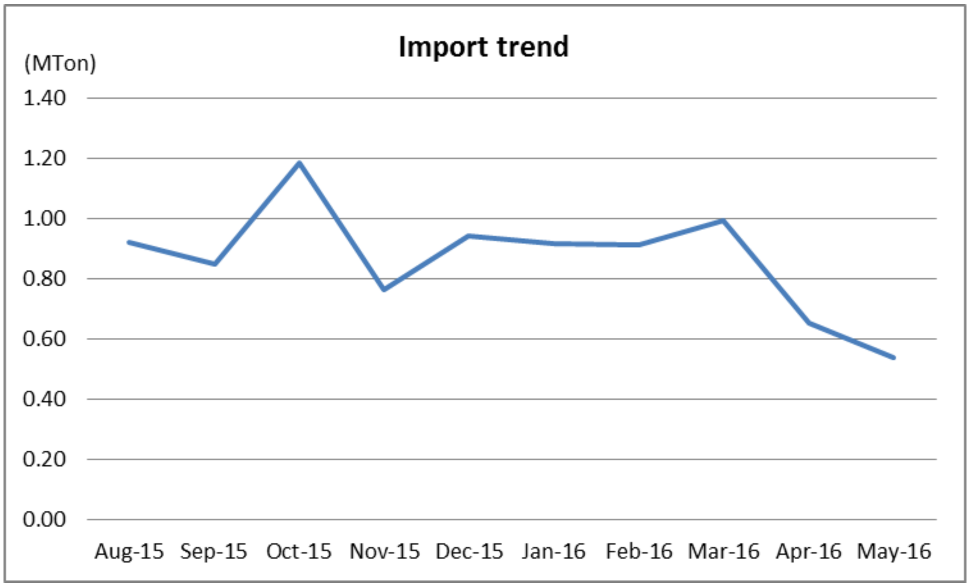
Reduction in steel imports post imposition of MIP

With demand carved out of declining imports passed on to domestic producers, imposition of MIP on 173 different steel products in February 2016 has provided the desired shot in the arm for domestic steel industry to start on the path of gradual recovery. The Government has imposed MIP on a large spectrum of steel products ranging between USD 341 and USD 362 on semi-finished steel, between USD 445 and USD 500 for hot rolled products, USD 560 for cold rolled products and up to USD 752 on some coated or treated products.

Products	Pre MIP Prices*	MIP Prices*
Hot rolled coil (2.5mm)	437	500
Billets	305	362
Cold rolled coil (<1mm)	504	560
HR Plates	363	445

**Prices in USD per tonne as on February 4, 2016*

The imposition of MIP appears a more comprehensive measure to tackle with the cheap imports as against the safeguard duty levied in September 2015 which was only applicable for few hot rolled products.

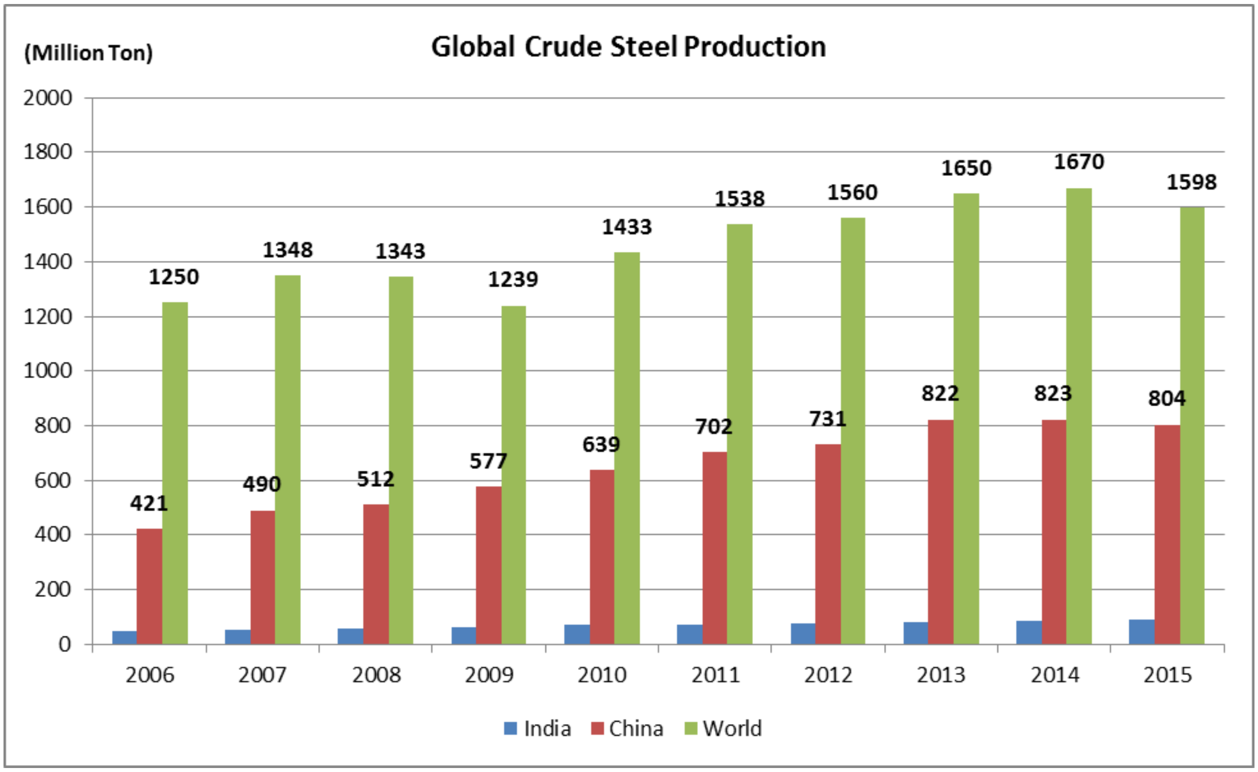


(Source: JPC)

It can be concluded from the above chart that imports have declined only after the imposition of MIP coupled with firming up of global steel prices largely due to production cuts in China. The full impact of MIP is expected to be seen in the coming months as MIP restrictions is not applicable on Letter of Credit (LCs) already opened before the notification of MIP. As per the Joint Plant Committee (empowered by Ministry of Steel), growth in steel imports cooled down; however, the imports grew at 25.7% y-o-y during FY16 (refers to the period April 01 March 31) as against 71% in FY15 due to controlling measures taken by the central government. Notably, India had emerged a net exporter of steel in FY14 after a long time, however, it became a net importer in a big way from FY15 again, courtesy significant increase in steel imports from China, Japan and Korea.

China remains a major player in global steel industry

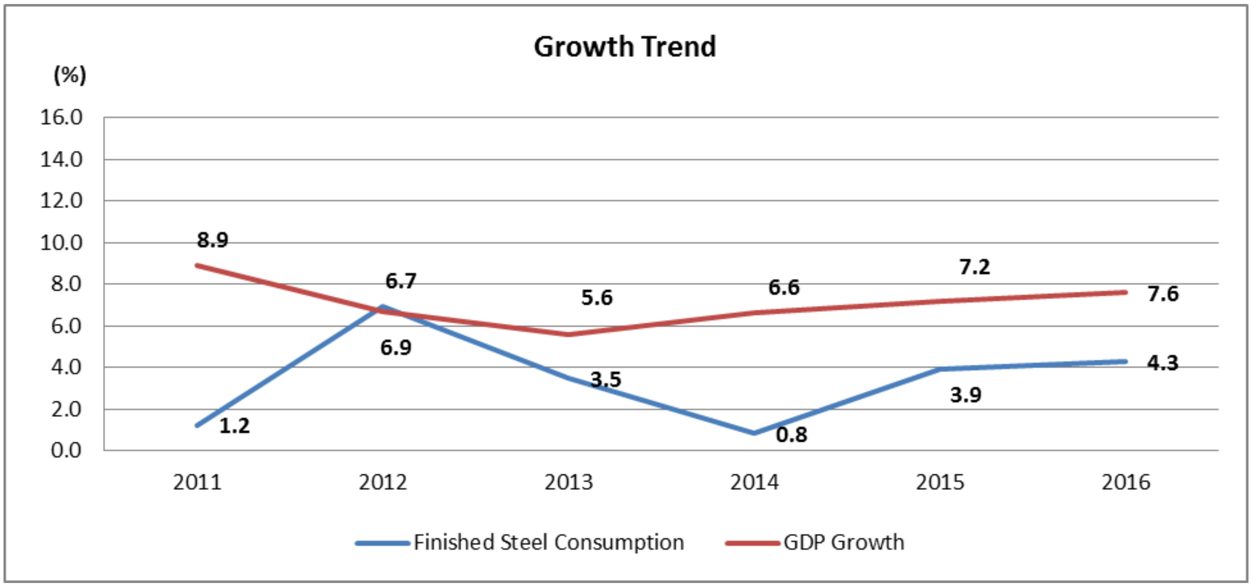
Since early FY15, steel industry was struggling due to softening of domestic steel prices on account of imports from China, which was exporting its excess production due to weak demand in the China's domestic market. Correspondingly, global prices were following the same trend as China controls close to 50% of steel production worldwide. Over the period from CY05 (refers to the period January 1 to December 31) to CY15, China's economy was growing at an average of 9.7%, supporting the high production and consumption of steel, but post 2011, its economy started witnessing a slowdown and the GDP growth moderated to 7.3% over CY13-CY15. The slowdown resulted in tapering of the steel consumption over last couple of years leading to decline in China's steel consumption to 5.4% in CY15 from a CAGR growth of 8.04% over CY08-13. The trend is expected to continue for another two years with International Monetary Fund (IMF) predicting China's GDP growth of 6.3% in CY16 and 6% in CY17.



(Source: World Steel Association)

Domestic demand remains sluggish

India's domestic steel demand continues to remain sluggish with the demand showing signs of marginal improvement. The domestic finished steel consumption grew by 4.3% in FY16 as against a growth of 3.9% during FY15. Looking at monthly data, the growth rate of 3.7% in finished steel consumption in March 2016 is attributed to improved demand with infrastructure industries growing at 6.4% in March 2016 as against 2.9% in January 2016. Furthermore, the marginal improvement in steel demand during FY16 was fueled by the growth in construction sector which according to latest GDP data grew by 3.7% y-o-y in 9MFY16 (refers to the period April 1 to December 31). Nonetheless, the growth rate of steel consumption is still on a lower side when compared with the average growth rate of 10.3% over the FY07-FY11, the period which was marked with healthy pace of economic growth reflected by average GDP growth of 8.6%. Notably, when the economic growth started to move downwards from FY12, steel consumption rate fell at a reasonably higher pace with growth rate falling to as low as 0.8% in FY14. Since then, steel consumption started to pick up with 3.9% growth registered in FY15 corresponding to GDP growth of 7.2% largely on the back of government's thrust on infrastructure.

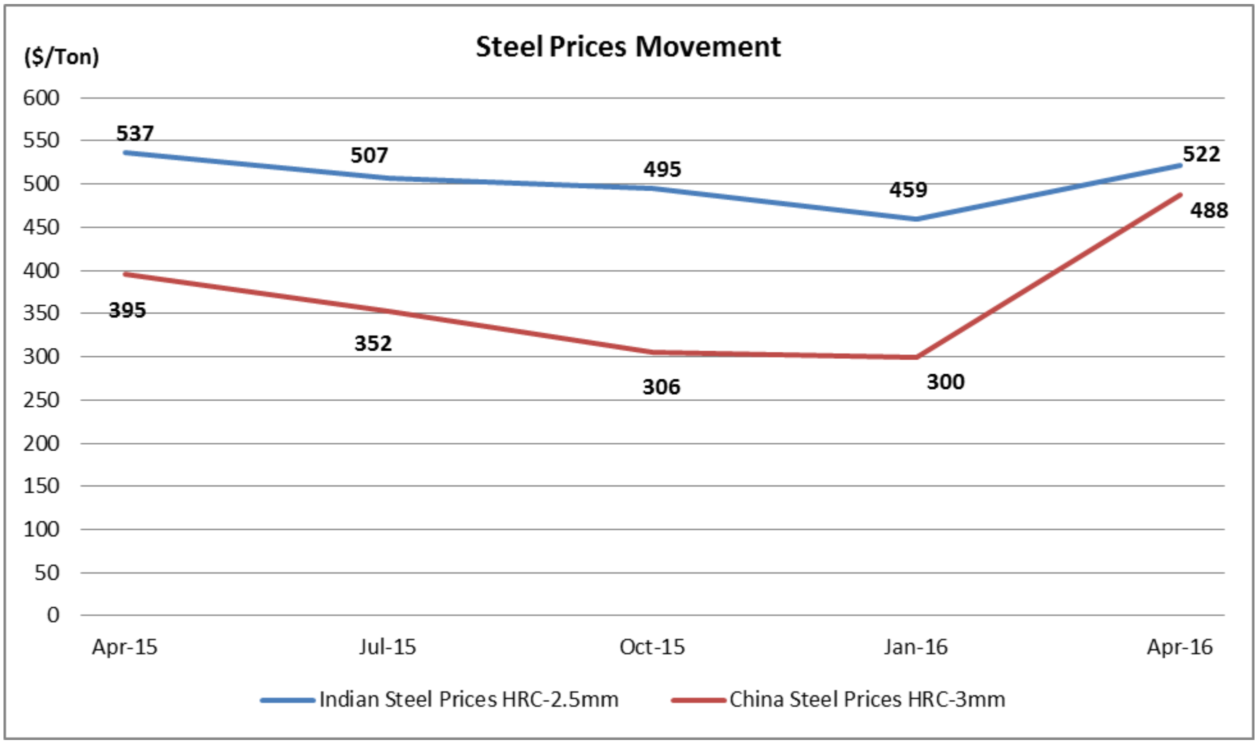


(Source: JPC and MOSPI)

The growth trend in steel consumption is expected to continue in medium term with central government's key initiatives such as "Housing for All by 2022", development of 100 smart cities, dedicated freight corridor and launch of National Infrastructure and Investment Fund giving impetus to growth of infrastructure sector. However, it will be important to see, that the key initiatives of central government are implemented as planned within the stipulated time-frame to provide the necessary boost to the demand in the economy over medium term. The latest Index for Industrial Production (IIP) data for FY16 is not very encouraging with muted growth in IIP at 2.4% as against 2.8% during FY15. Also, the growth in key industries over the same period was on the lower side with growth in capital goods industry in negative territory and basic goods industry registering a rise of just 3.5% compared with 6.9% over the same period last year (Source: CARE Economics Division).

Firming up of steel prices

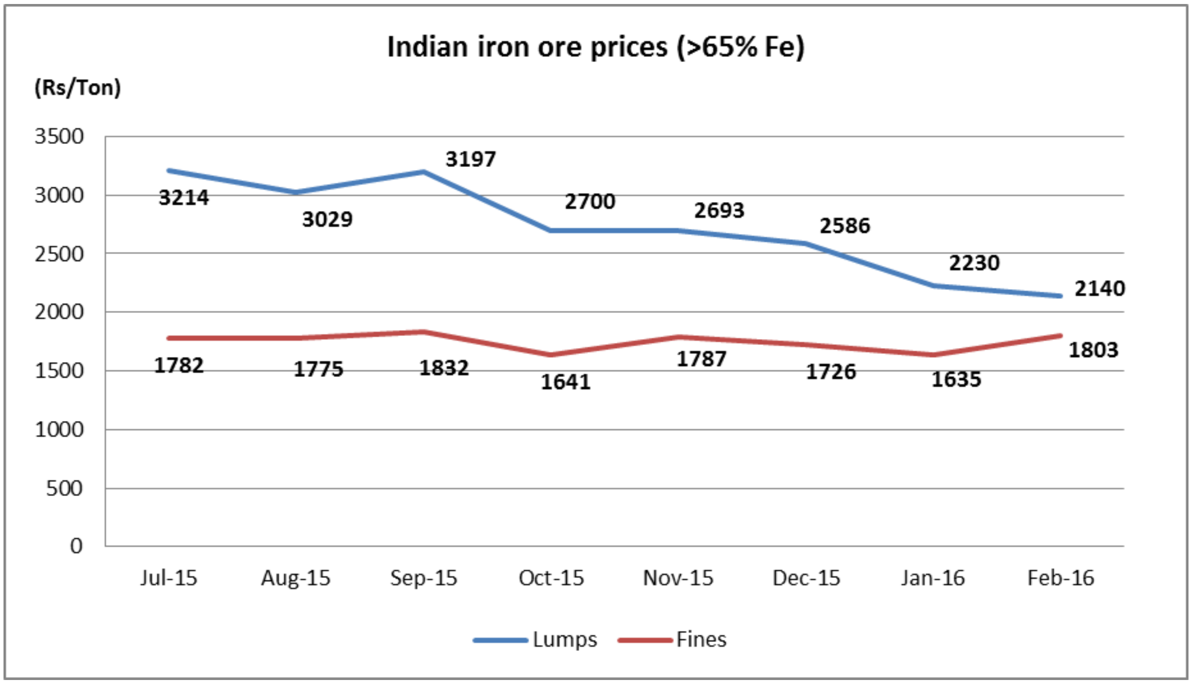
After continuous decline, the global steel prices have strengthened largely driven by increase in prices in China which is considered to be on account of production cuts and restocking for meeting the demand of peak season in Q2CY16. The price differential between imported steel and indigenously produced steel post implementation of MIP provides the much needed headroom to major steel producers for increasing prices between Rs.3,350 and 5,025 per ton depending on various types of the product.



(Source: JPC and Industry Research)

Sustenance of lower inputs prices crucial for steel players

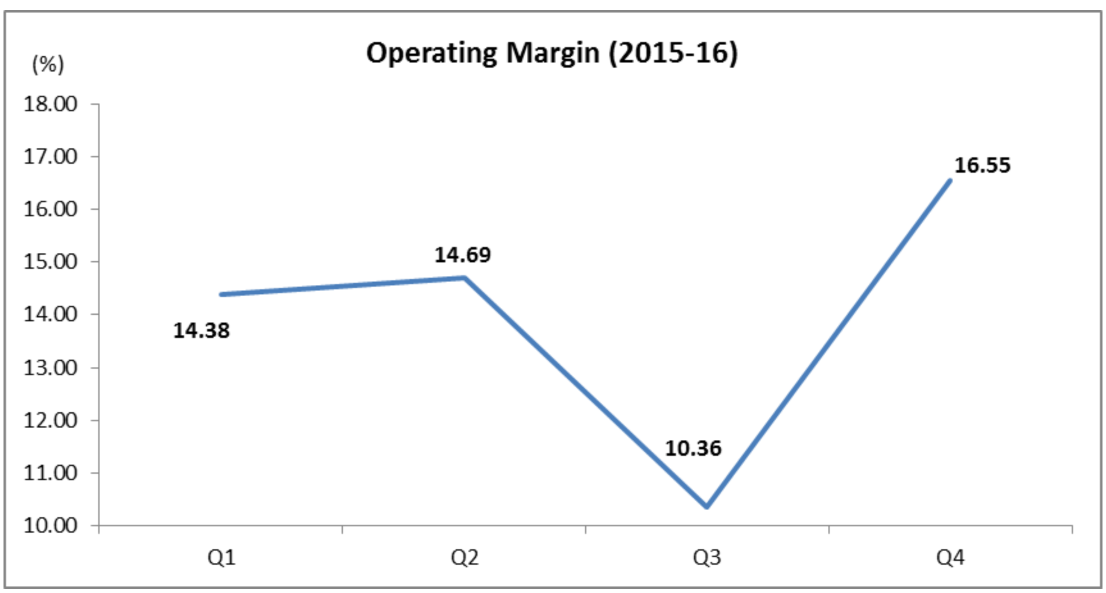
Improved realizations on account of steel price differential are further aided by low input prices, namely, iron ore and coking coal. Iron prices have been witnessing downward trend since early CY15, largely on account of softening of steel prices, lower demand and abundance of supply in domestic market. Falling iron ore prices coupled with re-bound witnessed in steel prices after January 2016, is positive for the profitability margins of domestic steel producers. Iron ore prices for lumps of more than 65% Fe content fell 33.4% from Rs.3,214 per ton in July 2015 to Rs.2,140 per ton in February 2016. NMDC, India's largest iron ore producer reduced prices for its high grade lumps to as low as Rs.1,660 per ton in early May 2016 indicating the downward trend in the prices. Meanwhile, global iron ore prices witnessed a temporary upward of 19% in March, however, the same slumped again during April 2016 by 9.28% as the rally in iron ore prices was considered more on account of restocking demand created in China on account of expected revival of demand. The case of coking coal is no different with global demand for steel declining the prices have declined from more than $136 per tonne in early 2014 to less than $85 per tonne in May 2016. This trend may persist in short-medium term with lower demand and higher supply.



(Source: Industry Research)

Conclusion

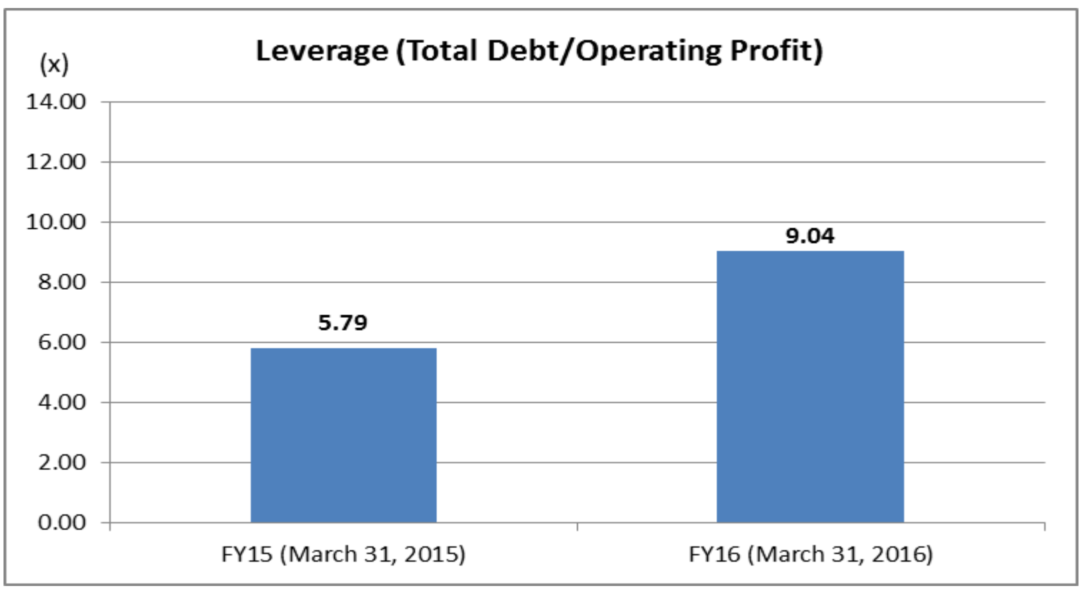
In a nutshell, it can be concluded that lower input costs and improvement in domestic realizations due to reduction in imports could be the laying stone for gradual recovery in Indian steel industry. The reduction in imports and resultant increase in domestic realizations has positively impacted the combined operating margins of the major domestic CARE rated steel producers* as depicted below:-



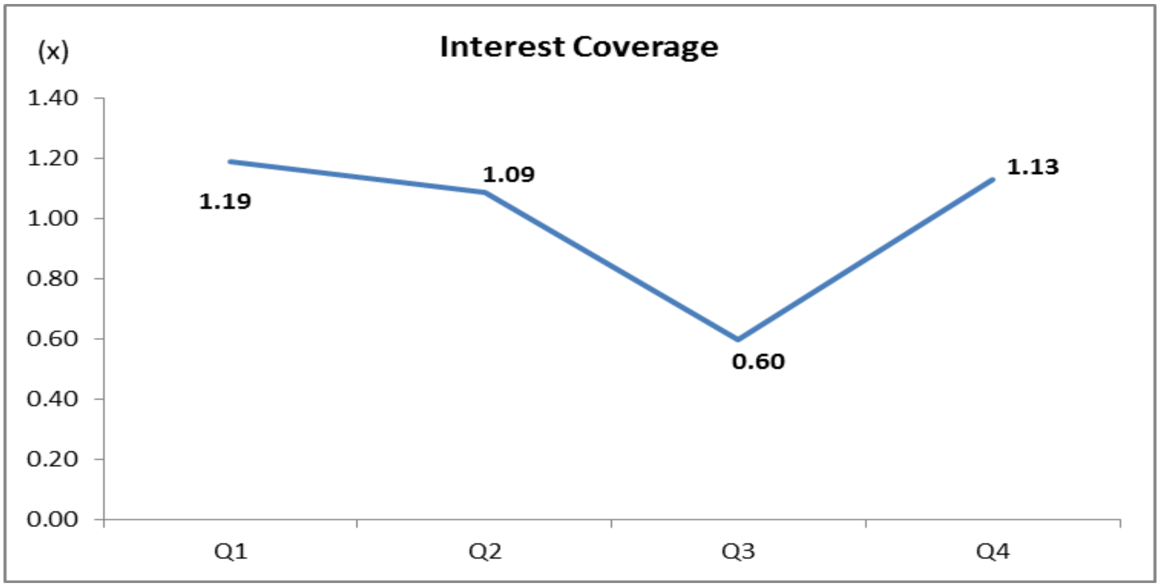
*(*Includes SAIL, JSW Steel, Tata Steel, Bhushan Steel and JSPL) (Source: BSE)*

It is evident from the above chart that the major steel producers reported improvement in the margins during Q4FY16. The MIP was imposed in February 2016 and the full impact of the same on the domestic realization due to reduced imports would be seen in Q1FY17. Therefore, it is expected that majority of the steel players would report improvement in the operational performance during Q1FY17. However, the sustenance of improvement in realizations and margins going forward would depend on sustained recovery in domestic demand conditions which remained sluggish during May 2016 with a growth rate of 3.8% during May 2016 on y-o-y basis.

The recovery in steel industry assumes high systemic importance not only for the steel producers but also for the Banking system as the Banks have total advances of approximately Rs.3 lakh crore in the steel industry out of which Rs.54,051 crore was under corporate debt restructuring at the end of December 2015. The combined financial leverage of major CARE rated steel producers* reached elevated levels due to sigificant decline in operating margins and high debt levels on acount of various capital expenditures undertaken by these companies over the years.



*(*Includes SAIL, JSW Steel, Tata Steel, Bhushan Steel and JSPL) (Source: BSE)*



*(*Includes SAIL, JSW Steel, Tata Steel, Bhushan Steel and JSPL) (Source: BSE)*

The huge interest cost due to high debt levels and slump in the operating profitability resulted in significant deterioration in interest coverage of major steel producers which fell below unity in Q3FY16, but improved in Q4FY16. Though government measures, viz, MIP, safeguard duty etc. are providing relief to the industry players in the short term, the long-term prospects of steel players would depend upon sustained and meaningful recovery in domestic demand and deleveraging of stretched balance sheets of some of the large steel producers.

Contact:

Ajay Dhaka
Senior Manager
ajay.dhaka@careratings.com
91-11-45333218

Manish Sharma
Deputy Manager
manish.sharma@careratings.com
91-11-45333279

Disclaimer

This report is prepared by the Rating Division of Credit Analysis & Research Limited [CARE]. CARE has taken utmost care to ensure accuracy and objectivity while developing this report based on information available in public domain. However, neither the accuracy nor completeness of information contained in this report is guaranteed. CARE is not responsible for any errors or omissions in analysis/inferences/views or for results obtained from the use of information contained in this report and especially states that CARE (including all divisions) has no financial liability whatsoever to the user of this report.