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China's steel industry needs structural readjustment: Valin Steel

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- **We summarise key takeaways from our interaction with Director of Securities of Valin Steel, the seventh largest steel producer in China**
- **While Chinese steel margins are seeing initial signs of recovery with realignment of raw material prices, their sustainability is a question**
- **Chinese steel industry has been in a downcycle since CY22 and this could extend up to CY26/CY27 until China effectively rebalances supply**

China steel demand started on a weak note: Q1CY24 steel demand has been weak from both the infrastructure, real estate and related construction machinery segments. Demand strength is visible in select pockets such as shipbuilding, new energy, household appliances, containers, etc. While there are early signs of improvement in April, underlying demand is still weak in YoY terms.

Stimulus details still awaited: While government has announced stimulus in the form of infrastructure investments and incentive schemes to promote equipment upgrades and trade-in of consumer appliances, details for the latter are still awaited for its implementation.

China steel margin under pressure: With weak steel margins in Q1, 80% of steel industry was loss making in Q1. This has resulted in a supply response with crude steel production declining 8% YoY in March. Iron ore prices have corrected in anticipation of this supply response. This, together with reduction in coking coal prices, are resulting in some improvement in margins. While the company believes steel margins have bottomed out, its sustainability remains a question, with raw material prices seeing a recovery last week and the possibility of return of supplies.

Weak steel cycle could extend up to CY26-CY27: China's steel industry has entered a downcycle from CY22 with the shrinkage of domestic demand and is seeing increased exports along the lines of CY15. While exports rose to ~10% in CY23, it still is below the 16% level seen in CY15. The company expects a gradual decline in domestic demand to 800mt levels over 8-10 years. The company sees a possibility of the downcycle extending up to CY26/ CY27 until China's steel industry balances capacity with underlying demand. While China has initiated consolidation, more is needed for structural adjustment.

Our Ferrous sector view: We expect Indian steel margins to stay at mid-cycle level over the next two years. While we expect global steel demand to stabilise gradually, we believe supply pressure from a likely surplus in China will keep a lid on margins.

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We hosted Liu Xiafoi, Director of Securities Department at Valin Steel (Not Rated), the seventh largest steel group in China operating from Hunan province. Key takeaways:

China steel demand started on a weak note in CY24

Weak start for steel demand: Q1CY24 steel demand has been weak from both the infrastructure and real estate segments and related construction engineering and machinery segments. Regarding the weak start in infrastructure, the company highlighted that new commitments to infrastructure projects are down 40% YTD in Hunan province.

Weak real estate impacting 50% of steel demand in China: Demand for steel from real estate and related indirect demand for real estate equipment manufacturing generally accounts for ~50% of steel consumption in China.

Weakness in long products and flat products used in construction: Weak construction demand has also impacted demand for heavy plates besides long products. Heavy plates are generally used in constructing bridges and high-rise buildings as well as in manufacturing of construction equipment.

Government has planned stimulus to offset weakness: China's government is following a two-pronged approach to offset weakness in real-estate construction. First, the government is supporting infrastructure investment through CY24 and has issued special government bonds of CNY 1trn to support infrastructure projects at the start of the year. Second, it has initiated an incentive scheme to promote equipment upgrade and trade-in of consumer appliances. However, the government is yet to roll out detailed policy to clarify the financing of the incentive scheme.

Early signs of sequential demand in April: While the company is seeing initial signs of demand improvement post the Lunar holidays, the underlying demand is still weak relative to the same period last year. While steel demand from shipbuilding, new energy, household appliances and containers is strong at this time, demand from most other sectors is weak.

China's domestic steel margin under pressure

80% of China's steel industry was loss making in Q1CY24: Weak steel demand leading to weak steel prices in China, coupled with high raw material prices, drove 80% of the steel industry into losses in Q1.

Chinese steel supply gave in to margin pressure in March: Losses have prompted curtailments in Chinese steel industry. Crude steel production declined -8% YoY to 1,040mt annualised level in March driven by -7% decline in pig iron or production from blast furnace. Supply response has come through right after the Chinese Lunar holidays.

Weaker demand from China steel industry resulted in drop in raw material prices: Iron ore prices have dropped sharply ahead of Chinese curtailments, reflecting weak demand from Chinese steel players. Coking coal prices also dropped sharply to US$

230/t levels from US$ 300/t levels, following improved supply from Australia and lower demand from China.

Signs of margin improvement in April: Profit margin for Chinese steel mills improved in April with the pullback in raw material prices. This could enable a higher number of steel mills to achieve break-even profits, according to Valin Steel.

Margin sustainability remains a question: However, with some recovery in demand in April, there has been an increase in raw material prices last week. At this juncture, raw material suppliers are in a better position to capture any upside in end consumer demand than steel producers themselves. The company still feels that steel margins have likely bottomed out.

No production restrictions from government yet: While it is possible for China's central government to restrict production, the company is not yet aware of any government plan or policy mandating production restrictions and market balance is left to players' own discretion. Any measures by the central government could help industry improve profitability.

Weak steel cycle could extend up to CY26-CY27

Steel downcycle commenced from CY22. After a peak in CY21, Chinese steel industry entered a downcycle from CY22 and the weak domestic demand environment continued to exert challenges for the steel industry. The company sees a possibility of the downcycle extending up to CY26/ CY27 until China's steel industry balances capacity with underlying demand.

Current cycle has parallels with a similar downcycle in CY15. Chinese industry is experiencing a similar domestic demand contraction and consequent increase in exports as in CY15. In CY23, exports increased to ~90mt or ~10% of Chinese steel production. Even back in 2015, exports were high at 130mt although its share was much higher at 16% of steel production then.

Domestic demand to decline gradually to 800mt level over next decade. The company expects Chinese steel demand to continue to decline gradually over the next 8-10 years and shrink to 800mt.

Industry product mix needs to change. Besides contraction, product composition is likely to move away from construction/infrastructure to manufacturing/ industrial usage.

Chinese steel industry needs to exit capacity. According to the company, the industry needs a structural adjustment to align capacity with the domestic demand level. We understand from the company the industry looks up to the government to take steps to reduce the surplus. At this juncture, demand supply balancing is largely left to the market, impacting margins for steel industry.

Consolidation initiated, but more is needed. China government has already initiated consolidation in the industry mandating large steel groups to consolidate capacity within China. Baowu Group has delivered its initial target of 200mt of capacity with consolidation but is currently completing integration. Market-oriented consolidation started in CY23, for example, Xinyegang Steel increased its stake in Nanjing Iron and

Steel. With significant challenges ahead of the steel industry over the next two to three years, the company sees a good possibility for further consolidation within the industry.

Industry capex focused on product/plant upgrades

China's steel industry is focused currently on capital expenditure for upgrading product portfolios and lowering emissions following the deadline of CY25 set in the 14th Five-Year Plan. High capital expenditure could continue even post 2025 for the players who would continue to focus on product upgrade to align with downstream demand. However, capital expenditure could ease for the players focused on low-cost strategies.

Amid the challenging environment in the steel industry currently, Valin Steel is focusing on the following to improve profitability.

- **High-end products:** Focus on wide and heavy plates, automotive sheet and silicon steel.
- **Green steel:** Aims to closely follow instructions of Ministry of Ecology and Environment and target to achieve possible lower emissions by CY25. Further, the company aims to develop roadmaps for carbon peak and carbon neutrality.
- **Smart manufacturing:** It is working on deploying more automation, improving process control systems, digitalisation and promoting more robots to improve labour productivity.
- **Improve dividend payout:** The company plans to increase payout to above 30%. The reduction in capex post CY26 should support the company's endeavour to increase the payout ratio.

Decarbonisation

- **Targets:** The Chinese steel industry is currently following the target of peak emissions by 2030 and carbon neutrality by 2060
- **Unifying emission standards across provinces:** Presently China is focusing on promoting standard statistics for emissions and certification based on footprints across provinces.
- **China steel industry currently focusing on improving technical KPIs:** In line with instructions from relevant government authority, China steel industry is working on improving process efficiency, key performance indicators (KPIs), increasing usage of waste heat for captive electricity/energy.
- **Exploring different pathways for decarbonisation:** Chinese steel industry is working on assessing different pathways like the use of coal for direct reduction of ore or use of hydrogen for decarbonisation. At this stage, none of these solutions have matured enough for industry use.

Other pointers

China export markets for steel products

- **Major destinations:** South East Asia, Middle East, Japan, South Korea
- **Products:** Wide and heavy plates, cold rolled coils, hot rolled coils, seamless tubes

China may not follow western route of focusing on EAFs

- **Focus on increasing scrap consumption in blast furnaces.** While China is focusing on increasing scrap consumption in existing blast furnaces, China may not necessarily go down the route of increasing electric arc furnaces.
- **Domestic scrap availability is still limited.** While Chinese steel consumption increased to more than 900mt by CY21, 55% of steel products were consumed in the construction sector over the past 20 years. This scrap is difficult to recover and recycle.

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