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Key takeaways from call with Baosteel

- **China steel demand remains in a downward trend as market transforms from construction to manufacturing led demand**
- **China steel sector recovery to take time as China needs to implement structural solution to surplus domestic capacity**
- **Baosteel's comments tie in with our view of cap on steel margins for Indian ferrous players, we have a neutral stance on ferrous sector**

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Steel recovery in China to take time: Unlike past, Baosteel expects steel downturn to last longer. Without support of demand, China needs to deliver on effective control and reduction of steel production. In the interim, there is a possibility of a seasonal margin recovery in Q4 if annual limits are imposed amid a modest seasonal rebound in demand and pullback in raw material prices. However, this will not pull the sector out of the current downturn.

Structural solution needed: We estimate surplus capacity in China above 100mt. China is currently using market-based mechanism to address this surplus, pulling down prices/ margin to make it uneconomical for marginal capacity to continue. A structured solution is needed to reduce overhang on the industry. Decarbonisation policy has a potential to become a tool to control production with use of carbon-tax.

Steel demand in a downward trend: Near-term, Baosteel expects demand to decline in real-estate and related machinery and commercial vehicles and slow-down in infrastructure segments. China is transforming from construction to manufacturing led demand, which will take time. Within manufacturing, auto is supported by electric vehicles, machinery and appliances supported by equipment upgrade and trade-in policies and shipping from global demand.

Steel raw materials prices under check: Steel weakness and consequent lower production in H2 in China are likely to impact demand for raw materials. Further iron ore face pressure from seasonally better supply in H2 and high China port inventory.

Strategy to deal with downturn: Preparing for a long downturn, Baosteel is focusing on cost reduction, value-added products, optimisation of product portfolio, expansion of overseas sales and even diversification into aluminium auto steel.

Read-across for Indian ferrous players: We have a neutral stance on Indian ferrous players with stocks largely pricing in future volume growth. Baosteel's comments ties in with our view of cap on steel margins until steel capacity surplus is addressed in China.

Key takeaways

We hosted Mr. Shang, Securities Representative of Baosteel along with the Investor Relations team. We summarise the key takeaways from the meeting as well as Baosteel's earlier analyst call on 28 August.

Recovery not in sight yet

- **Current downturn is like a harsh winter:** The company expects this downturn to last longer. Unlike in the past, recovery will not come with time as steel demand is in a long-term decline trend. The market needs effective control and reduction of steel production in China, which will take time to implement. Industry concentration may also rise as a result.
- **China steel margin recovery possible in Q4…:** Q3CY24 was weak with seasonal slowdown in traditional off season during rains and summer season. Funding constraints with local governments further impacted demand. With the possibility of production restrictions in China, a modest seasonal rebound in demand in Q4 along with pullback in both iron ore and coking coal prices, margin could potentially recover in Q4.
- **… but won't pull market out of downturn:** However, this will not pull the sector out of the current downturn. Annual production limits are not sufficient to effectively reduce supply pressure. China's steel market needs more supply discipline as well as policy to rationalise supply.
- **Flat products are poised better than long products:** With a sharp decline in construction demand, long products are under higher pressure. The industry is attempting to move towards higher production of flat products (HRC, sheets, thick plates), however, transformation will take time.

China needs to structurally address domestic steel surplus

- **China's industry in surplus:** We estimate China's surplus at around 0.1bnt (billion tonnes) based on China's capacity estimate of 1.2bnt as per Baosteel, China's demand levels of 0.9bnt and typical utilisation level of 90%.
- **Lower prices/margins essential to keep production in check:** China is currently addressing surplus with market-based mechanisms. Production curtailments arise from unsustainable cash losses for steel mills but not necessarily from book losses. More than half of the steel industry had book losses in Q3.
- **Decarbonisation policy could become a potential tool to control production:** Policy intervention is currently limited to the announcement of explicit decarbonisation targets till CY25, focusing more on improving efficiency and usage of renewables. China also announced the inclusion of the steel industry in the national unified carbon market this year. With the use of carbon tax, this can become a future tool to separate out weaker mills to drive them towards permanent closure.
- **Timing for more stringent production control is uncertain:** More stringent production capacity restrictions are only a possibility. At this point, there is no certainty on approach and its timing on implementation.

Plan for carbon reduction in steel sector

In May'24, China announced a 2024-25 action plan for the reduction of carbon in the country with an aim to accelerate actions for reaching the energy efficiency targets during China's 14th Five-Year Plan. The following measures were proposed at the country level:

- Reduce energy consumption by 2.5%, reduce CO2 intensity by 3.9% by the end of CY24
- Increase non-fossil energy consumption to 18.9% in CY24 and to 20% in CY25
- Reduce the energy intensity of large industrial enterprises by 3.5% in 2024
- The plan targets total reduction of 50mt of standard coal and decrease in emissions of 130mt of CO2.

Measures for the steel sector

- Provincial governments have been instructed to implement steel production control in CY24 and also strictly implement production capacity replacement scheme
- Provincial governments have been instructed to restrict the export of iron, and steel products with high energy intensity and low added value
- Encourage the use of short process electric arc furnace steelmaking to increase its proportion to 15% in steel production and increase utilisation of scrap steel to 300mt by end of CY25
- Set energy consumption standards for the steel sector
- The steel industry will be included in the national unified carbon tax market in CY24
- Accelerate the upgrading of energy-intensive equipment

Targets for the steel sector

China has specified the following targets for CY25 to kickstart the carbon reduction process:

Energy consumption: (a) Reduce energy consumption per tonne of steel production by more than 2% by CY25 from the CY23 base. (b) Increase the use of self-generated waste heat and pressure by at least 3% by the end of CY25 from the CY23 base.

Coal consumption: Reduce its standard coal use by about 20mt (million tonnes) from CY24 to CY25.

Carbon dioxide emissions: Reduce by ~53mt from CY24 to CY25.

By the end of 2030, China aims to further improve the energy efficiency of major processes in the iron and steel industry.

China steel supply remains high

- **Blast furnace utilisation has remained range-bound:** Blast furnace (BF) utilisation in China has so far remained at 70-80% levels despite the downturn in demand. The brunt is borne by electric arc furnace (EAF) producers. Their utilisation drops to 10-20% in a downturn from 70-80% at peak.
- **Competition is emerging in value-added space:** China is seeing higher supply competition of varying degrees in several value-added products like cold rolled sheets and silicon steel.
- **Current inventory levels are high:** Inventory of HRC, thick plate and CRC are all at the historical high level for the same period.

Exports likely to get capped

- **Exports growth has a limit:** Exports have surged with Chinese players resorting to exports amid weak domestic demand. However, higher exports out of China reduces the differential between ex-China and China prices, lowering the incentive to export for Chinese players.
- **Target export markets:** South East Asia has been the largest traditional export region for Chinese steel players. With the development of One Belt, One Road, exports into Africa, South America and the Middle East have grown.
- **Difficult export markets:** There is less scope to grow exports to Europe and the US due to ongoing trade disputes.

Steel demand in a downward trend

- **New demand pillars:** Demand from China is transitioning from its earlier focus on long products to flat products. The new energy and manufacturing sectors are the main forces of demand, including photovoltaics, wind power, electric vehicles, etc. The growth in manufacturing exports will likely lead to an increase in indirect steel exports.
- **Real estate demand decline to continue near term:** This has impacted related demand from machinery and equipment as well as commercial vehicles. National policy has attempted to address risks in the real-estate sector, accelerate delivery of completed houses to improve consumer confidence, focus on affordable houses for demand creation and work on liquidating house inventories through its conversion to affordable houses. Despite this policy interventions, real estate demand is not likely to return to its previous levels.
- **Infrastructure slowing down:** The growth rate of infrastructure investments has been slowing due to funding constraints at local governments. With traditional infrastructure having limited scope for further investments, the current focus is on power and energy sectors.

Manufacturing demand improving

- **Automotive – remains high:** Demand from automotive has picked up with strong pick-up in new-energy vehicles (EVs). While demand is likely to continue at a high level with strong EV penetration (increased to 50% recently), there is a modest pullback from last year's high.

- **Appliances – Flat and healthy demand:** China's government policy of trade-in of consumer goods have helped offset the impact of weakness currently in the real estate markets. Further, the focus on housing completions have helped domestic appliances demand. With Chinese players displaying strong competitiveness in global markets, global demand has also remained resilient.
- **Shipping – Strong:** The shipping industry in China is benefitting from strong demand, with an upgrading cycle underway. The global competitiveness of the Chinese shipping industry has also risen, supporting growth of steel demand from the segment.
- **Machinery and equipment – policy support:** While demand for construction equipment remains weak, manufacturing equipment for other industries have found support in government policy for the promotion of large-scale equipment replacement.

Steel weakness to keep raw materials prices in check

- **Need to transfer pressure to upstream:** The company believes that upstream raw materials are likely to face downward pressure as they share some of the pressure on steel industry.
- **Iron ore prices will remain under pressure:** This is likely to be driven by (a) abundant supply in H2, (b) high port inventory in China (150mt), (c) reduction of iron ore demand from China with cut in steel production in off-season (Q3CY24) and possibility of production limitation in Q4, (d) pressure on rebar steel prices limiting ability of Chinese players to pay.
- **Coking coal price to remain soft:** This is likely to be driven by (a) scope for incremental coking coal production in China, and (b) lower blast furnace production in China during Q3 due to production cuts and in Q4 due to the possibility of production limitation.
- **Scrap prices weak:** Sharper production cut in EAF and lower benefit of adding scrap to blast furnace in current environments has lowered scarp demand.
- **Steel raw materials to lose concentration advantage eventually:** Upstream raw materials with high concentration levels gain during periods of volatility in steel margins. However, this could change when (a) Simandou comes onstream improving iron ore supply, or (b) China's steel industry is rebalanced either through market force or government efforts.

Strategy to deal with the downturn

- **Focus on cost reduction:** Baosteel focused on potential reduction in the direction of economic furnace charge, energy efficient improvement and spare parts which helped reduce costs by RMB 4.6bn. The full process manufacturing cost stood at RMB 143/t or US$ 20/t, with a US$ 13/t reduction in variable costs and US$ 7/t reduction in fixed costs.

- **Focus on value-added products – silicon steel:** The focus is on improving the differentiation levels of silicon steel by adjusting the structure. The aim is to expand overseas high-end users and increase export levels to 400kt of high-end silicon steel. The company also targets to raise total capacity to 1.6mtpa. The company is currently working to add 200kt of non-oriented silicon steel, 220kt of ultra high-grade oriented silicon steel green manufacturing at Boashan base and 220ktpa of high-end oriented silicon steel green manufacturing at Qingshan basin.
- **Focus on other value-added products:** The company is currently constructing a 1.8mtpa high-grade thin-steel plate at Dongshan base and increasing plate thickness up to 160mm at Dongshan base.
- **Optimisation of variety structure:** The company is targeting 2.2mt YoY growth in 1+1+N products sales volume to 30mt in 2024.
- **Expand overseas market:** Of the 6mt of overseas target set by the company, 3.5mt was achieved in H1FY24.
- **Global exports debut of value-added products:** Baosteel has started focusing on high-end exports, though on a small scale.
- **Diversification to aluminium auto sheet:** Baosteel sees that there is high dominance of overseas players in China's aluminium auto sheet market. The company is actively exploring the parts market. The focus will be on high surface, high strength and other key varieties. The company believes that it can seize opportunities to supply aluminium into new auto model development opportunities.

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