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China's Q2 steel results signal slower demand recovery

- **China's Q2CY22 steel sector performance flags subpar demand in Q3 and only a gradual recovery from Q4**
- **Auto and infrastructure seeing signs of revival, but industry must align steel production with softer demand amid protracted real estate slump**
- **We expect margins to gradually stabilise over H2FY23; prefer defensive play TATA amid volatile environment**

Kirtan Mehta, CFA
research@bobcaps.in

Q2CY22 results flag demand weakness: China's steel sector performance in Q2CY22 highlights a challenging environment through H2CY22 given weaker domestic demand and declining profitability. With high-cost inventory, Chinese steel margins are likely to be under pressure in Q3CY22. The industry has shifted its focus toward improving operational efficiency, curtailing production and cutting costs to work through the downturn.

Gradual demand recovery from Q4: Management commentary suggests the easing of Covid-led restrictions and revival in infrastructure demand as stimulus feeds through the economy could aid demand recovery by the year-end. While Baosteel expects real estate demand to remain anaemic, it highlights strong demand from the transformer segment, recovery underway in auto and a gradual rise in infrastructure offtake over H2CY22. We believe these segments have the potential to partly offset the weakness in real estate and arrest the decline in Chinese steel demand to lower single digits.

Supply cuts key to rebalancing Chinese industry: With real estate demand failing to gain traction, it is imperative that the Chinese steel industry align production with underlying demand. Baosteel and some other players are looking to shutter less profitable operations. However, the Chinese industry has recently increased steel production amid a seasonal pickup in demand coming through from September. We believe rebalancing in China is important for the stabilisation of regional margins.

Read-across for Indian steel players: With Chinese demand likely to make a gradual recovery from Q4CY22, we believe steel prices will also see only a marginal recovery. Raw material prices have already corrected sharply. We expect steel margins to stabilise over H2FY23 as rebalancing in China reduces export pressure on regional markets.

Prefer defensive play TATA: Amongst our steel coverage, we prefer TATA (BUY, TP Rs 140) for its ability to generate sector-leading margins via better integration all the way to iron ore and its focus on downstream and retail to capture value-add. We also have a BUY on JSP (TP Rs 460) which has scope for a gradual rerating as the company demonstrates capital discipline and delivers on the next wave of growth.

Recommendation snapshot

Ticker	Price	Target	Rating
JSP IN	418	460	BUY
JSTL IN	661	655	HOLD
SAIL IN	79	90	HOLD
TATA IN	106	140	BUY

Price & Target in Rupees | Price as of 2 Sep 2022

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Read-across from Q2 results of China steel players

We summarise our key takeaways from the Q2CY22 results of Baosteel, Hunan Valin Steel, and Angang, as well as recent commentaries from other steel players in China. Baosteel recently highlighted a more challenging environment for H2CY22 emanating from weak demand, falling steel prices and declining profitability. Zhu Guosen, Vice Director at Shougang Group's Technology Research Institute, acknowledged that "the third quarter will be the most difficult time for the industry," and "we should abandon any illusions about the market and focus on what we can do ourselves".

Demand revival lagging expectations

Several steel producers – Baosteel, Hunan Valin Steel, Shougang Group – have expressed concerns over anaemic demand thus far in Q3CY22. Real estate is the primary culprit, and Baosteel's commentary suggests continued weakness through H2CY22.

Scope for gradual demand recovery from Q4CY22

Baosteel and Angang anticipate gradual recovery in steel demand from Q4CY22 as Covid is gradually brought under control and the government stimulus takes effect. Demand for steel from the transformer segment is running strong, the automotive sector has turned around and infrastructure offtake is expected to grow over H2. Collectively, these segments account for ~30% of steel consumption and could partially offset the weakness in real estate.

Fig 1 – Segment-wise demand outlook

Growth YoY (%)	H1CY22	H2CY22 outlook	Segment weight in steel consumption
Real estate	(9.4)	(7.3)	~40
Infrastructure	Slight decrease	Increase	~20
Automotive	Passenger vehicles: some increase, Commercial vehicles: sharp decline	8.8	~7-10
Machinery	-	-	~17
- Transformer	Strong demand with 90%+ capacity utilisation	Strong demand	-
- Excavator	(27.1)	(5.0)	-
Home appliances	(6.8)	(6.9)	~1-2

Source: Baosteel, Bloomberg, BOBCAPS Research

Industry focusing on cost cuts to counter challenges

While China's steel industry is hopeful of further policy support from the government, it is aware that the downturn in real estate could lead to protracted demand weakness. S&P's recent credit note on the Baowu Group aptly highlights downside margin pressures over the next two years. Its EBITDA/t estimate for the Baowu Group is at RMB 700-730/t for CY22 and CY23, lower than the RMB 922/t reported in CY21 but higher than the RMB 660/t for CY20.

Baosteel also highlights that the Chinese steel industry is better placed in this downcycle than in 2008 and 2015. The company has significantly lower capital locked into inventory in this cycle, with iron ore inventory at 41 days (vs. 128 days in 2008) and finished product stock at 25 days (vs. 33-39 days in previous downturns).

Both Baosteel and Angang have initiated self-help measures to weather the ongoing challenges, including improving operational efficiency to reduce raw material usage, increasing the use of scrap, deepening energy conservation, working on procurement to transfer margin pressure to upstream raw material suppliers (iron ore, coking coal), and improving the alignment between the production base, R&D, and sales teams to optimise costs in line with the market environment.

Supply-side cuts key to rebalancing steel markets in China

Back in June, the CISA (China Iron and Steel Association) Secretary acknowledged that the real solution lies on the supply side even though the problem is on the demand side. Baosteel believes that the government policy announcement in Apr'22, which requires industry to deliver an annual output reduction in CY22, is still applicable. Hence, the company expects crude steel output to be 3-5% lower YoY in H2 on top of the 6% YoY reduction seen in H1.

Baosteel has asked its subsidiaries to cut back on unprofitable production. As an example, the company aims to shut down one blast furnace out of five at its Qingshang production base. Some other mills in Northwest and Southwest China have also pledged to reduce output.

However, physical markets are showing contrasting signals. While Chinese steel production had declined to a run rate of ~0.96bn tonnes in July from a peak of 1.14bn tonnes, Mysteel surveys are noting signs of an increase in production in August ahead of a seasonal uptick in demand from September. During the week of 26 August, blast furnace capacity utilisation has increased for the fifth straight week by another 1.6% WoW to 86.8%, resulting in 2.34mtpd of hot metal output from the sample of 247 Chinese steel mills.

In our view, supply-side cuts in line with underlying demand are key to rebalancing steel markets in China.

Industry downturn could accelerate consolidation

With Chinese steel industry valuations at a bottom, Baosteel believes that the market environment is conducive for domestic mergers & acquisitions and, in turn, consolidation of the steel industry.

Potential carbon tax by CY24

Baosteel sees the possibility of a carbon tax on the steel industry by CY24 considering government expectations of a levy during the 14th five-year plan (CY21-CY25). The company highlights that levying carbon tax on the steel industry is much more complex than taxing the electricity industry due to the multitude of steel products.

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Fig 2 – Peer comparison

Ticker	CMP (Rs)	Rating	Target price (Rs)	Upside (%)	EV/Sales (x)		EV/EBITDA (x)		Net income (Rs bn)		P/B (x)		P/E (x)	
					FY23E	FY24E	FY23E	FY24E	FY23E	FY24E	FY23E	FY24E	FY23E	FY24E
TATA IN	106	BUY	140	32.7	0.8	0.9	4.1	4.2	221	190	1.1	0.8	5.8	6.7
JSTL IN	661	HOLD	655	(1.0)	1.3	1.3	7.7	5.8	122	175	2.4	1.8	13.1	9.1
JSP IN	418	BUY	460	10.0	0.9	0.9	4.4	4.0	53	59	1.2	0.9	8.1	7.2
SAIL IN	79	HOLD	90	13.6	0.5	0.5	4.3	3.3	49	67	0.6	0.5	6.7	4.9

Source: BOBCAPS Research

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Recommendation scale: Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

HOLD – Expected return from -6% to +15%

SELL – Expected return <-6%

Note: Recommendation structure changed with effect from 21 June 2021

Our recommendation scale does not factor in short-term stock price volatility related to market fluctuations. Thus, our recommendations may not always be strictly in line with the recommendation scale as shown above.

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