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Expert call with Valin Steel on China steel outlook

- **Valin Steel's CY22 outlook points to stable steel margins in Q2 and Q3CY22**
- **Key drivers include expected recovery in China steel demand from June/Q3, production restrictions and easing of RM prices**
- **Valin's strategy confirms ongoing industry-wide structural transformation and shift in focus away from volume growth**

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We hosted a call with Wang Yin, IR Manager of Valin Steel (000932 CH, Not Rated), a listed arm of Valin Group, China's eight largest steel producer. Key takeaways:

Steel margin to remain stable in Q2 and Q3 from Q1 levels: Key margin supports are: (a) expected recovery in China's demand from June/Q3CY22 (led by policy relaxation in real estate, infrastructure push, auto recovery), (b) production restrictions, and (c) easing of raw material prices with improved supply of coal and iron ore. Uncertainty over raw material prices does, however, pose a risk to margins.

CY22 demand to remain stable or dip only marginally: After weaker demand in Q4CY21 and restricted offtake over Jan-Apr'22, Valin expects demand to recover from June or Q3CY22 on the back of improving investment activity in real estate and infrastructure. The Covid situation has started easing in Shanghai and Jilin.

Production curbs to support market balance: With China announcing additional output cuts for CY22 in Apr'22, production trends are likely to be balanced with evenly spread cuts. Last year, the sharp reduction in H2 stemmed from an overshooting of H1 targets and the government's late decision to implement restrictions only from August.

Exports down but inquiries on the rise: With government policy discouraging exports and significant trade barriers, Valin has been focusing on domestic markets (exports at a mere 4% in CY21). However, it is considering to tap into overseas demand given increasing inquiries, though this would depend upon policy measures, production restrictions and profitability.

Structural transformation well underway: Chinese steel capacity and production have peaked. The industry has been asked to move away from volume growth to high-quality development and is hence focusing on M&A for consolidation. Bigger players are looking at value-added products to improve margins.

Valin's outlook consistent with China's largest player Baosteel: Please refer to two of our recent notes: **Expert call with Baosteel on China steel outlook** and **Read-across from Baosteel and Vale analyst calls.**

Additional takeaways

Near-term sectoral demand drivers

- **Demand from real estate to gradually stabilise:** Valin Steel is noticing positive changes from policy relaxation (e.g. Zhengzhou has lifted restrictions on housing purchase) and cuts in interest rate for developers and buyers. However, transmission of policy is taking time and there is limited improvement so far.
- **Infrastructure demand to increase from June/Q3:** On 26 April, China's Central Committee for Financial and Economic Affairs emphasised the importance of comprehensively advancing modern infrastructure development. Funding has been arranged by the issuance of RMB 12tn of special bonds in Q1. As China recovers from Covid-19, demand from infrastructure is likely to rebound.
- **Offtake from manufacturing relatively stable barring auto:** Demand is particularly stable for medium & heavy steel plates and cold & hot rolling sheets. However, demand is particularly weak from the auto segment (April output down 30% YoY) as Covid-impacted provinces such as Shanghai, Jilin and Jiangsu are major hubs for auto operations. Demand is likely to rebound as Covid eases.
- **Order book strong for flat products, weak for long products:** Steel demand is likely to be better for industrial rather than construction applications. Profits have significantly weakened for long producers.

Coal – China taking steps to improve domestic supply

China has relaxed restrictions on domestic production and withdrawn the import tariff from May to improve supply. Additionally, supply from Russia and Indonesia may also improve from June.

Valin believes that high coking coal prices are not sustainable in the longer run. While these prices generate gross profit margin of 50% and net profit margin of 20% for coking coal producers, they disrupt margins for other players in the steel chain and reduces affordability for end consumers.

Medium-term drivers

- **China steel demand to remain high till 2030:** While demand is likely to remain high, the share of steel consumption in China's GDP will continue to shrink.
- **Decarbonisation:** The Chinese steel industry is focused on improving coal/fuel consumption closer to the benchmark level, raising the pig iron-to-steel ratio, augmenting the use of scrap in existing steel plants, increasing recycling levels, and using more self-generated electricity. Beyond these, the industry is awaiting a breakthrough in technology such as the use of hydrogen in blast furnaces.

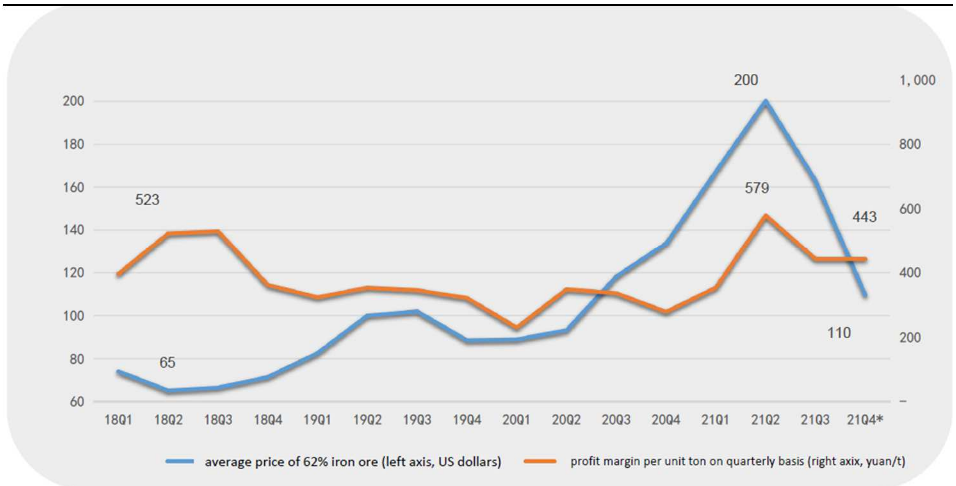
Valin's strategy illustrates clear focus shift away from volumes

Valin aims at achieving a regional leadership position by way of:

- three reforms: quality, efficiency and shift to renewable power
- three strategic support systems: lean manufacturing, integrated production-sales-R&D, and becoming a comprehensive steel service provider.

Valin's profit has remained above US$ 40/t

Fig 1 – Valin Steel's historical profit margin trend



Source: Company, BOBCAPS Research

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