

## Equities

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# European Steel Update

## We Need To Talk About Steel...

### ■ Industry Overview

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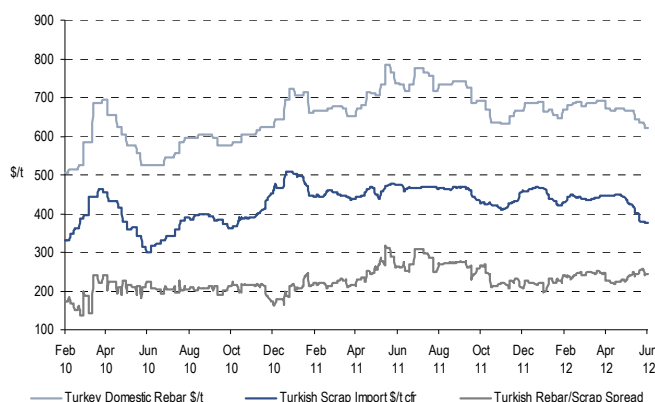
- **Problem Child** — The steel market globally is lacking discipline. Capacity cuts in Europe and the US are offset by new approvals in China. Rather than downsizing we are seeing capacity transfer from West to East. The result: global utilisation remains below that required for pricing power (traditionally around 80-85%) and mills battle to stay afloat of raw material costs, which are arguably now more volatile than ever. Profitability will remain suppressed in our opinion.
- **Negative Earnings Momentum Ongoing** — Yes the equities look cheap – trading on 0.5x Price to Book is always tempting, but we urge caution; steel prices continue to weaken, with HRC at down \$60/t from Q1 peaks of \$700/t. Scrap prices are heading downwards and we're entering the Q3 seasonal lull. The industry is facing a tough summer and we expect mills will face tough decisions over capacity. End markets are weakening; automotive markets – a previous bright spot – are turning south and consensus earnings for the auto manufacturers are following suit. With little evidence of steel pricing catalysts, against a shaky macro backdrop, we expect consensus downgrades for the steels to continue working through. Beware of potential value traps.
- **On The Scrapheap** — Calls for trade barriers tend to occur when things get very difficult. European mills have apparently been campaigning to restrict the flow of scrap exports from the continent in order to ensure sufficient supply for domestic mills. Our interpretation here is 'Please stop selling cheap scrap to Turkey'; Roughly around 50% of European ferrous scrap exports head to Turkey, a country whose steel production is c.75% scrap based. Traditionally a large exporter of construction steel to North Africa and the Middle East, the Arab Spring has seen that market dry up somewhat and Turkish exports have since been directed towards other markets, Europe in particular. Meanwhile, scrap prices continue to head lower, dropping to around \$376/t cfr Turkey. At that price we think Turkish mills could wear another \$20-40/t reduction in rebar prices, which currently sit at \$620-640/t.
- **Cost Support Irrelevant in the short term** – The marginal cost of production is a useful measure of where price support may lay for industrial commodities. However, it is trickier for steel, the cost base for which is currently 70% composed of raw materials. Cost support is therefore a constantly moving platform. More importantly we think it's largely irrelevant on a short-term basis; our generic blast furnace model calculates a marginal cost of HRC at \$680-690/t. We have therefore already broken the marginal cost support barrier, but inventory levels at mills and stockists cloud the picture; these businesses are likely to be run on a 'cash flow over profits' basis in the short term, a scenario under which marginal cost support is redundant.
- **How to play the sector** – We remain neutral on steel in the near-term given the headwinds mentioned. We are looking for signs of scrap price support, stabilisation in macro indicators and indications that consensus downgrades for key end sectors – construction and autos – are close to completion, before we can warm up to the sector.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

## A Difficult Summer Looms

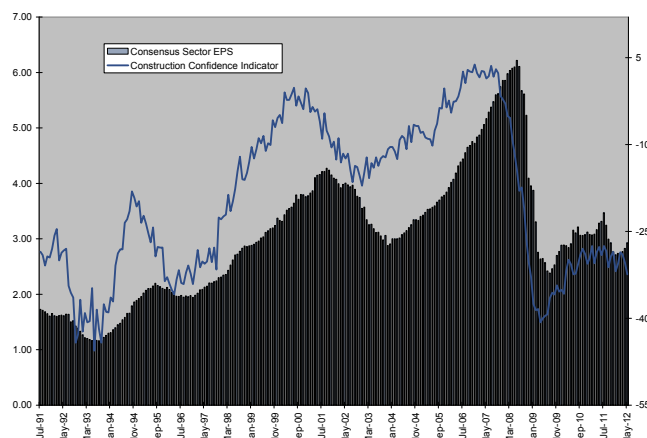
Scrap prices this week dipped to \$376/t cfr Turkey. The average spread between scrap and rebar prices has been \$200-220/t, suggesting Turkish mills could wear another \$20-40/t reduction in rebar prices based on current scrap costs (Figure 1). Rebar prices are \$620-640/t in Turkey and the EU. The key end-use sector, construction, remains in the doldrums; the latest report from our European Construction team highlights their view that there is more downward pressure on European earnings and if macro conditions deteriorate further, consensus earnings may have further to fall (Figure 2). The same report also highlights Euroconstruct's deteriorating outlook for the European construction market, with output growth for 2012 now expected at -2.3% vs -0.4% previously and growth of only 0.5% in 2013 vs 1.9% previously. (See [European Construction Outlook](#), 20 June)

Figure 1. Turkish Scrap Import Prices vs Rebar \$/t



Source: Bloomberg, Citi Investment Research and Analysis

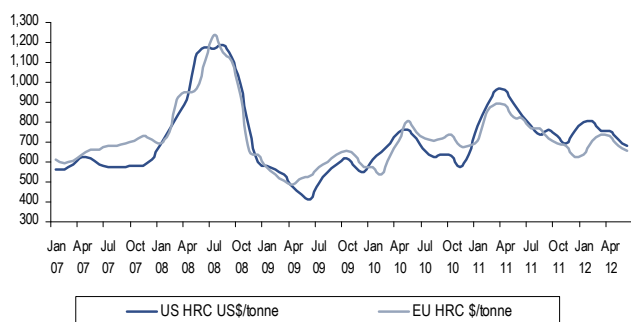
Figure 2. EU Construction Confidence Indicator vs Sector Consensus EPS Proxy



Source: Datastream, Citi Investment Research and Analysis

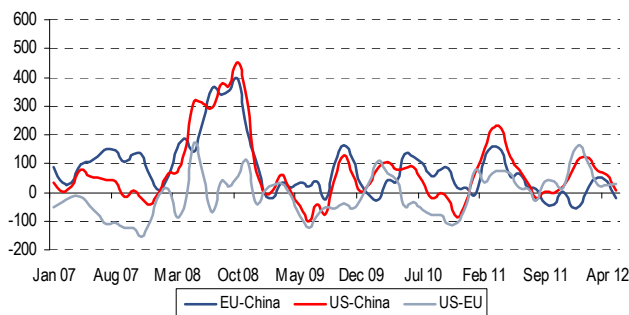
HRC prices have dipped to ~\$680/t in the US and \$655/t in Europe. Price spreads between the US, Europe and China are now minimal (Figure 4).

Figure 3. EU and US HRC prices \$/tonne



Source: CRU, Citi Investment Research and Analysis

Figure 4. HRC Regional Price Spreads

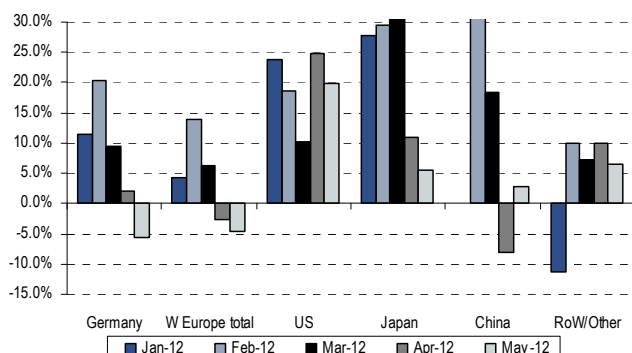


Source: CRU, Citi Investment Research and Analysis

The key read across for flat products comes from a weakening in sentiment in the automotive sector, even premium autos which was previously a bright spot. Our

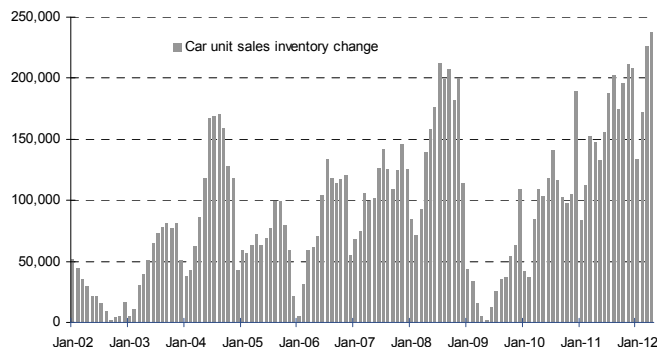
automotive team has recently downgraded earnings forecasts and notes that producers are facing a synchronised global sales slowdown in all regions except for the US (so far). Crucially China, which has up until now been a vital growth engine for the European autos producers, has seen a sharply decelerating trend since March as overproduction has caused inventories to accelerate and build at a monthly record rate, with pricing also being impacted (see [Daimler - Too many headwinds for guidance?](#), 14 June)

Figure 5. Mercedes Regional Sales Growth



Source: Company Reports, Citi Investment Research and Analysis

Figure 6. China Car Inventory Change (Vehicles)

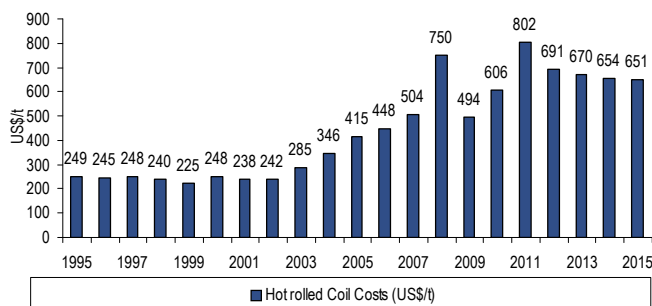


Source: CAMA, Citi Investment Research and Analysis

## Cost Support Irrelevant in Near Term

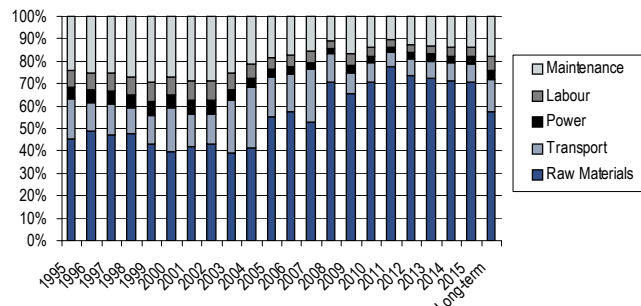
Our generic blast furnace suggests marginal cost support in the region of \$690/t (Figure 7). Given up to 70% of the cost base is raw materials (Figure 8), the pricing of which is arguably set to be more volatile than ever, this is a constantly moving platform. Nevertheless, it would suggest at current HRC prices we have dropped below marginal cost support. However, a destocking in global inventories could see prices below marginal cost for some time if mills and stockholders take the short-term stance of running their business for 'cash flow over profits'.

Figure 7. Citi Generic Blast Furnace – HRC Costs \$/t



Source: Citi Investment Research and Analysis

Figure 8. Citi HRC Cost Breakdown



Source: Citi Investment Research and Analysis

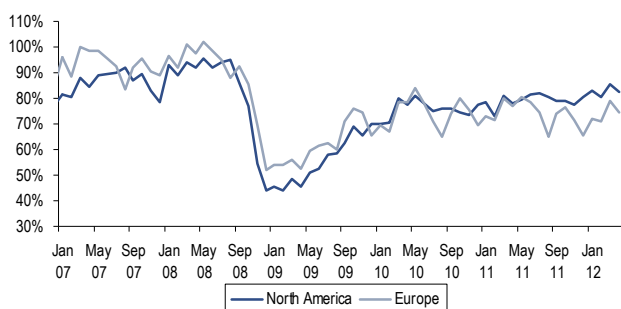
## Global Utilisation Rates

**US Capacity elimination:** The recent filing for Chapter 11 by RG steel and the idling of its Sparrow's Point mill in late May will go some way to support an oversupplied market. The facility has annual capacity of ~3.4mt and has been the swing capacity in the domestic market due to its logistically disadvantaged location

in Baltimore (badly placed for the domestic market). We estimate the facility was only operating at a run rate of around 2mt, but any supply reduction and elimination of a weak competitor should be supportive.

**China Capacity Additions:** The NDRC in late May approved a further ~19mt of crude capacity, comprising Baosteel's Zhanjaing project with 10mt capacity and WISCO's Fangchengang project with 9.2mt capacity. The combined cost of these projects will be Rmb134bn (~\$21bn). In our view this capacity is unwarranted (see Scarlett Chen's note [Vicious Cycle – the More Losses, the More Stimuli](#), 28 May), with the approvals seemingly given as part of China's stimulus measures rather than a need for additional steelmaking capacity.

Figure 9. Europe and North America Utilisation Rates



Source: WSA, Citi Investment Research and Analysis

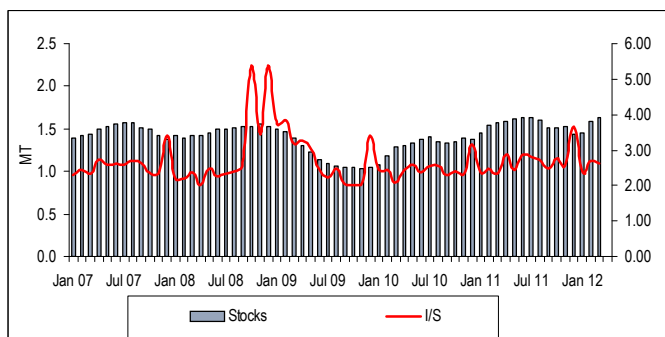
Figure 10. China and World Ex China Utilisation Rates



Source: WSA, Citi Investment Research and Analysis

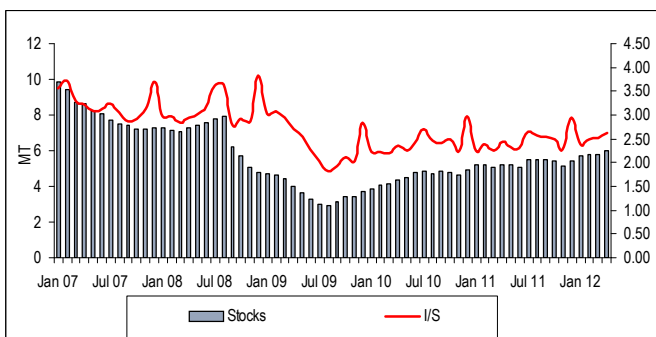
## Inventories are relatively stable

Figure 11. Germany sheet stocks to shipments



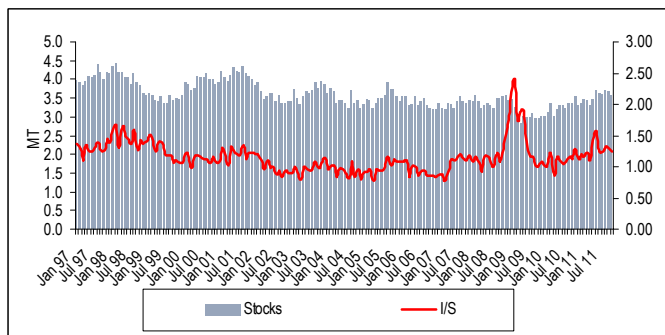
Source: CRU, Citi Investment Research and Analysis

Figure 12. US sheet stocks to shipments



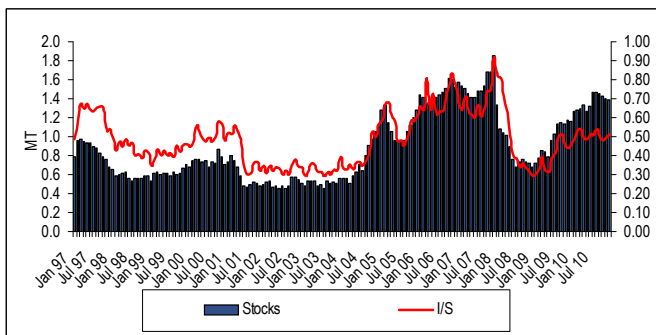
Source: CRU, Citi Investment Research and Analysis

Figure 13. Japan Sheet Stocks to Shipments



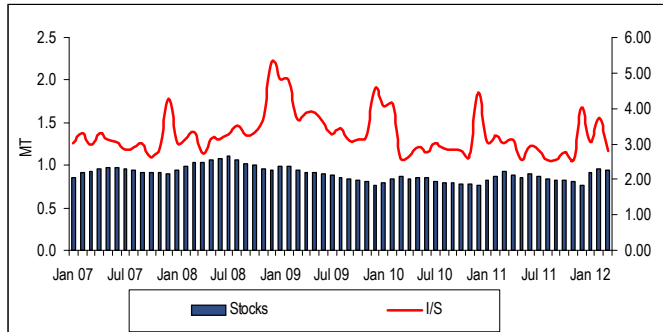
Source: CRU, Citi Investment Research and Analysis

Figure 14. South Korea Sheet Stocks to Shipments



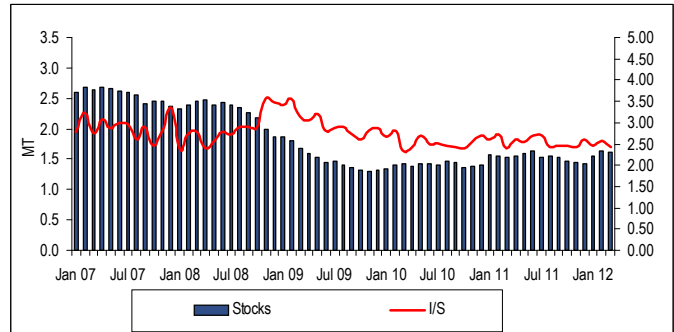
Source: CRU, Citi Investment Research and Analysis

Figure 15. Germany Long Stocks to Shipments



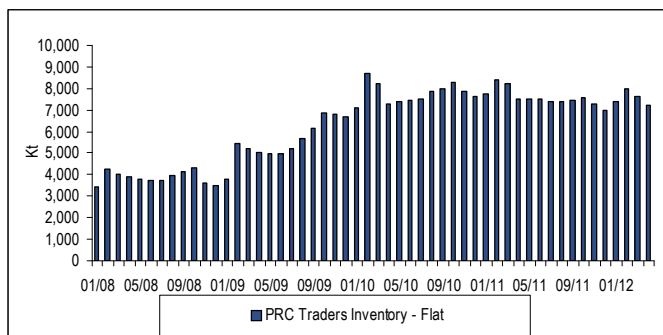
Source: CRU, Citi Investment Research and Analysis

Figure 16. US Long Stocks to Shipments



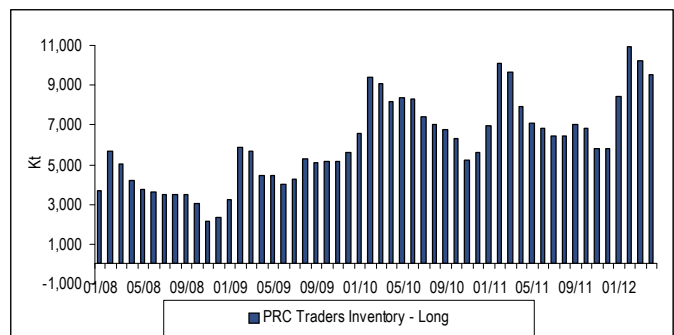
Source: CRU, Citi Investment Research and Analysis

Figure 17. China Trader Inventories - Flats



Source: CRU, Citi Investment Research and Analysis

Figure 18. China Trader Inventories - Longs



Source: CRU, Citi Investment Research and Analysis

## Appendix A-1

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