Citi Research
Equities

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Metals - Steel (Citi)
Europe

European Steel Outlook

Groundhog Day: The title cliché for 2013

- Industry Overview

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- **Limping into 2013** — After a difficult year of weak margins, stretched balance sheets, divestments and dividend cuts, we take a look to the year ahead and share a few thoughts on the outlook. The European steel industry faces many challenges and we do not expect to see much of an improvement in 2013; the industry will remain significantly oversupplied to the tune of 30-40mt, while demand will be around 2% or 3-4mt lower than 2012, in our view.

- **Construction Drag** — The two key end-markets are construction, which accounts for ~28% of steel demand in Europe, and automotive, making up 16% of demand. We estimate a 2.3% (1.1mt) decline in construction steel demand, 3% (0.9mt) decline in automotive steel demand, and a 2.1% decline in fixed investment in 2013, indicating demand for other steel-intensive products should be sluggish.

- **Another Weak Earnings Year** — We forecast EU 27 capacity utilisation in 2013 at 70%, below the 75-80% at which we estimate many blast furnace operations can breakeven at EBIT. Blast furnaces, which melt iron ore, account for around 60% of EU steel production and have higher fixed costs than Electric Arc Furnaces (EAFs), which recycle scrap. With a moderate decline in demand in 2013, blast furnaces will continue to struggle, with low utilization rates and weak earnings, in our view. EAFs should also suffer, though, particularly in Southern countries where capacity uitilisation rates have been the lowest in the region.

- **Self-Preservation Focus** — With industry gearing (net debt/equity) expected to be 45% in 2013, there will be continued pressure on the most leveraged entities to take action to preserve cash. All options will be on the table in our view — debt, dividend cuts, divestments. We think rights issues would be a very last resort, though cannot completely be ruled out if the environment deteriorates beyond our forecasts.

- **The recent rally is running out of steam** — We remain neutral on the sector on a 12-month view and the Q4 rally of ~20% — largely in anticipation of a seasonal Q1 restock — has pushed the sector to the top of its trading range, in our view. At 6.5x 2013E EBITDA we now think this restock is priced in. We don't think the restock will turn out to be particularly aggressive and as such any positive earnings momentum into 1Q and 2Q earnings is likely to fade into 2H13. Our supply/demand outlook contained in this report supports our view — another year of 70% capacity utilization, ~2% decrease in demand and weak earnings suggests that any positive momentum is likely to be purely seasonal. Our favoured names in the space are Voestalpine (high-quality product) and Salzgitter (strong balance sheet). We are more neutral on ArcelorMittal (balance sheet concerns) and Kloeckner (restock priced in).

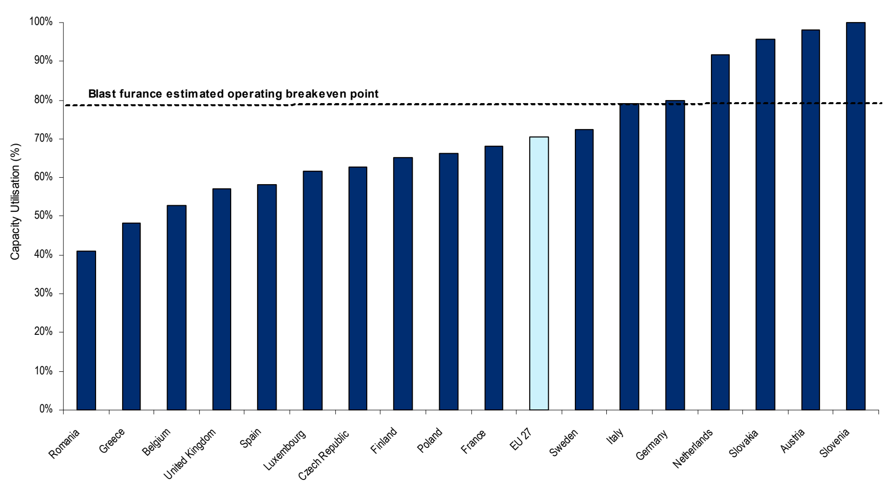
Capacity Remains a Key Overhang

Capacity cuts needed but unlikely

The European market is chronically out of balance; EU27 capacity is in the region of 220mt, while demand has been more in the region of 160mt. We estimate the European steel industry has operated at 70% of capacity in 2012.

We estimate that the EU27 steel industry has in 2012 operated at a capacity utilization rate of 70%. This is below the level where we estimate a blast furnace can on average breakeven at EBIT. This is unsustainable in our view

Figure 1. European 2012E Capacity utilization and blast furnace breakeven point



Source: World Steel Association, Citi Research

Despite the need for capacity reduction in Europe, the issue is highly politically charged. This is likely to complicate the process of rationalisation.

Idled capacity aside, we estimate the region still needs to lose up to 40mt of capacity to bring the market into balance. We don't foresee a swift resolution to these problems — the recent protectionist sentiment emanating from France, with the government trying to prevent the closure of ArcelorMittal's Florange melt shop, suggests that the rationalisation of the region's capacity could be long-winded and challenging as governments step in to protect jobs. Likewise, despite the ongoing disruption surrounding Riva's Taranto facility — Europe's largest plant — we don't think it is likely to close down; the plant employs 11,000 people. A sudden closure of this magnitude would be regarded as a social and political disaster.

Blast furnaces will be under continued pressure

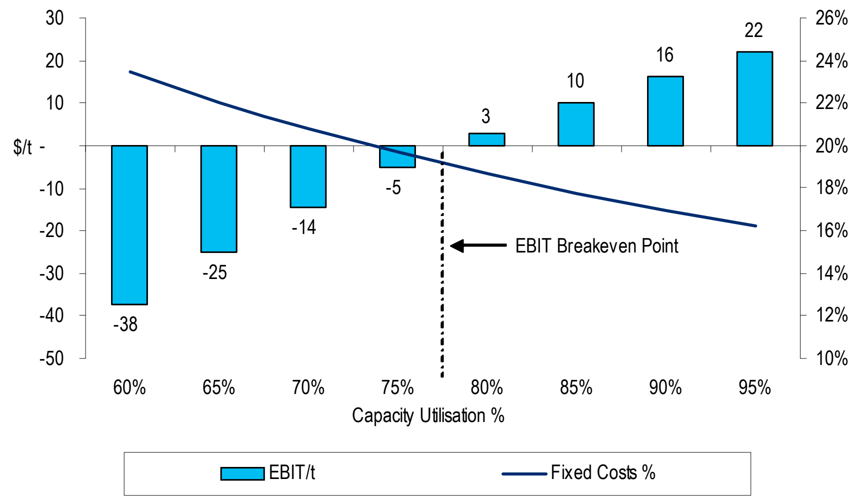
Blast furnaces have a higher fixed cost component which puts them at a competitive disadvantage to electric arc furnaces in weak or volatile demand environments

Under a weak or volatile demand environment, blast furnaces, which process iron ore into steel, are at a disadvantage to electric arc furnaces (EAF'S), which recycle scrap. EAF's are more flexible facilities that can be adjusted for required volumes much more quickly than blast furnaces and also tend to have shorter lead times. Blast furnaces therefore have a higher fixed cost component. Historically blast furnaces had a quality advantage over EAF's, producing high-quality flat steel products while EAF's produced more commodity grade material for construction purposes. However, EAF's have become increasingly advanced and can now compete with blast furnaces in most product suites.

We expect 2013 capacity utilisation levels across the region will be similar to 2012 at ~70%, leading to another year of weak earnings, particularly for blast furnaces, which we estimate need utilisation levels of 75-80% to breakeven at EBIT. This is based on our forecast of $120/t iron ore, $200/t coking coal and $650/t hot rolled coil.

Our blast furnace model suggests that on average a blast furnace in 2013 will require utilisation rates of 75-80% to breakeven. This looks like a tall order given a difficult demand outlook and little movement on the supply side

Figure 2. $ EBIT per tonne vs capacity utilisation



Source: Citi Research

But EAF's also at risk in Southern Europe

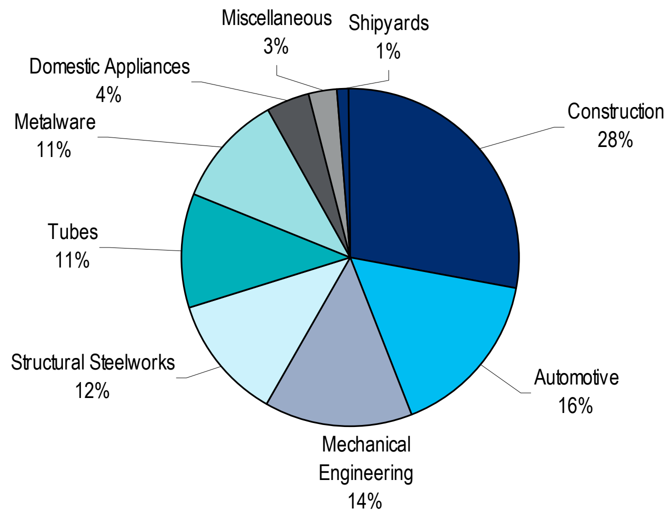
Blast furnaces struggle more with low utilisation levels than electric arc furnaces. However, the geographical distribution of EAF's in Europe means some of these facilities could also be at risk. While EAF's have become more technologically advanced and can now produce many of the high-end products traditionally made through the blast furnace route, they have generally been used for more commodity grade steel, particularly with a construction sector focus. It happens that much of Europe's EAF capacity is located in the Sothern European countries, which have been badly hit by the construction downturn in the region. As a result we have seen some low levels of utilisation in these countries in 2012: Greece (48%), Spain (58%), Portugal and Italy all have the majority of their steel coming from EAF's and these have been some of the weakest end-markets. Given the ongoing difficulties in the Southern European countries, we think that capacity — blast furnace or EAF — is potentially at risk here.

Demand Could be 2-3% lower in 2013

The key end-markets for steel demand — construction and automotive — both look sluggish for 2013. We estimate a 2.3% decline in construction steel demand and 3% decline in automotive steel demand. In addition, Citi's -2.1% fixed investment growth forecast for 2013 indicates demand for other steel intensive products should also be slow.

Construction and automotive are the two key end-markets for steel demand in Europe

Figure 3. European Steel Demand by End Use

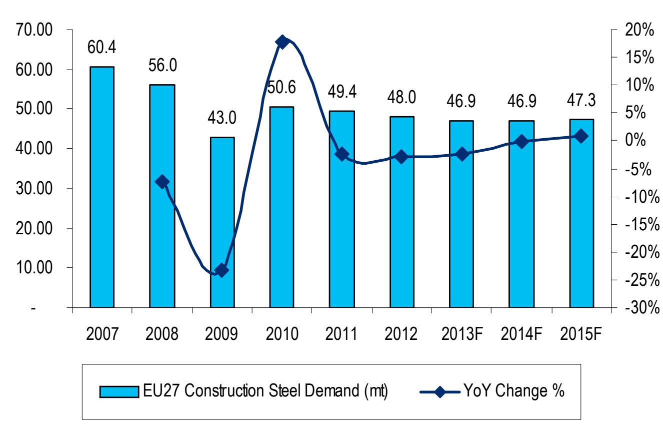


Source: Eurofer, Citi Research

Construction – 28% of EU steel demand, 1mt lower in 2013

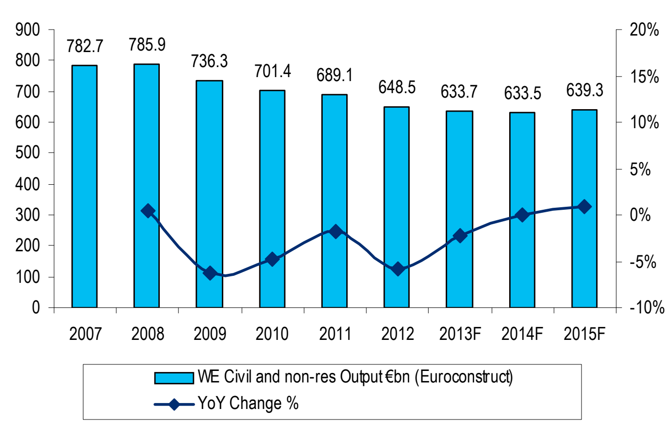
Eurconstruct is forecasting a 1.5% decline in Construction output in Europe in 2013. More importantly for steel demand, it is forecasting Civil Engineering and Non-Residential output to decline 2.3% to €634bn. We calculate that expenditure on steel accounts for around 3.5% of Civil Engineering and Non-Residential output. Construction accounts for ~28% of European Steel demand. As a result, we think construction steel demand could be just over 1mt lower in 2013.

Figure 4. Estimated EU27 construction steel demand



Source: Citi Research

Figure 5. Euroconstruct's construction output forecasts (€bn)



Source: Euroconstruct, Citi Research

The automotive sector accounts for ~16% of European steel demand and we estimate total finished steel tonnages to this sector to decrease to 26mt in 2013, after assuming lower light vehicle registrations and the projected 2% decline in fixed investment.

Autos – 16% of EU Steel Demand, 0.9mt lower in 2013

Citi's Autos team estimates light vehicle registrations to decline 4.3% in the EU 27 in 2013 from 15.25m units to 14.6m units. There is approximately 1,800lbs, or 0.82 tonnes of steel in the average light passenger vehicle. This would suggest that the steel industry can expect around 0.5mt less demand from the sector in 2013.

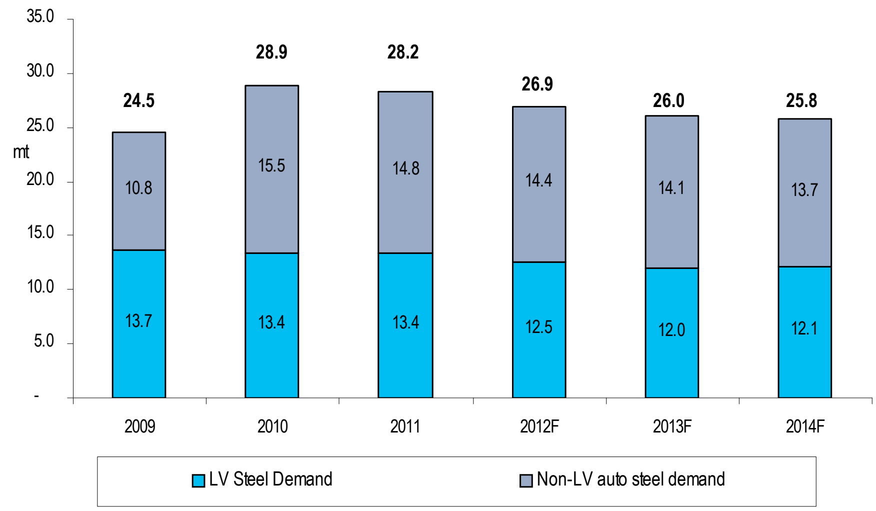
Figure 6. Light vehicle registrations forecast and corresponding steel demand

EU 27 Auto outlook		2009	2010	2011	2012F	2013F	2014F
Light Vehicle Registrations	000 units	16,734	16,302	16,373	15,250	14,600	14,800
Steel per unit	t	0.82	0.82	0.82	0.82	0.82	0.82
LV Steel Demand	mt	13.7	13.4	13.4	12.5	12.0	12.1

Source: Citi Autos Research Team, Citi Research

On the medium/heavy vehicle outlook, this is more difficult to quantify given the wider variety of size, shape and weight of vehicle. We therefore prefer to look at this subsector in the context of fixed investment in business equipment. Citi's economists forecast fixed investment growth in Europe to be -2.1% in 2013.

Figure 7. Estimated Automotive steel demand



Source: Citi Autos Research Team, Citi Research

Other Steel Demand

In 2012 we calculate another 97mt of finished steel demand in Europe outside of construction and automotive. As we have used above, the fixed investment into business equipment forecast is a useful indicator with which to look ahead, in addition to the Eurozone GDP forecast:

Figure 8. Citi's Economic Forecasts – Euro Area

Economic Forecasts	2012F	2013F	2014F
Real GDP	-0.40%	-0.70%	-0.40%
Fixed Investment			
Business Equipment	-3.10%	-2.10%	-2.40%
Construction	-3.90%	-1.90%	-0.50%

Source: Citi Research

We could therefore see Steel demand outside of construction and automotive a further 1-2mt lower.

ArcelorMittal

(ISPA.AS; €13.21; 2)

Valuation

We have a €11.30 target price for ArcelorMittal. We use an equal-weighted combination of DCF value, Residual income, EV/EBITDA and FCF analysis.

Our DCF-based model calculates a value of €9.4 per share. We use 5 x 2013E EBITDA to calculate our multiples value of €5.8 per share. Our FCF and residual income models suggest fair value of €16.7 and €13.3, respectively.

Risks

ArcelorMittal's net debt reduces investment flexibility.

ArcelorMittal shares are sensitive to spot steel prices, contract renegotiations and raw material input costs.

ArcelorMittal has high fixed costs, and high net debt overlays financial gearing to already high operational gearing to the cycle. The group is the key steel stock to own if you're positive the cycle, and key one to avoid if your negative the steel cycle.

If the impact of these risk factors is more negative than we currently anticipate, then the share price would be impeded from reaching our price target.

Klöckner & Co.

(KCOGn.DE; €9.29; 2)

Valuation

Our weighted €9.5 target price is set using 35% DCF (€16.4), 15% multiples (€3.3), 15% free cash flow (€3.3) and 35% residual income (€7.9) valuation methods. Given trough earnings we have weighted the valuation towards metrics that better capture the longer term value of the company. We use a 4.5x EBITDA multiple for Europe and a 5.0x multiple for the US based on peer multiples. Our DCF uses a 3.75% equity risk premium, a 3% terminal growth rate and a WACC of 9%.

Risks

We consider several risk factors, including an assessment of industry-specific risk, financial risk and management risk. In particular, we see the following key risks to the share price reaching our target price:

KCO's business model carries inherent inventory risk. Cash conversion days are over 100 at the moment and a sharp decline in the steel price could trigger inventory losses. KCO has, in the past, taken a proactive view on the steel price, such as reducing inventories when it has perceived prices to be at a peak or close to a peak. In 2010 for instance, this helped avoid severe inventory losses in Q3 and Q4.

KCO's growth partly relies on acquisitions. This creates the risk of overpaying for assets and buying assets at the wrong time in the cycle. Given some of the deals

are fairly sizeable (€200-400m), this can stress the balance sheet and require a capital injection (as was the case in 2009). So far, most acquisitions have been small to mid-sized deals, but recent deals such as BSS and MacSteel indicate an increased appetite for larger deals. We think this implies a higher likelihood of paying close to fair value multiples and relying on cost cutting and synergies in order to crystallise value.

KCO has not had much competition so far from mills, as it executes its strategy of consolidating the distribution sector. The area has been relatively non-core for mills, but if this were to change, KCO would be forced to pay higher multiples for acquisitions. We think this risk is fairly unlikely as mills have indicated that M&A is likely to focus on either mining assets or on mill assets.

Salzgitter AG

(SZGG.DE; €40.02; 1)

Valuation

We set our target price of EUR43 for SZG using an average of four valuation methodologies: DCF (EUR50), multiples (EUR19), free cash flow (EUR70) and residual income (EUR34).

Additionally, we include Salzgitter's 6mn treasury shares in our diluted share count (in addition to 3.6mn shares from the convertible).

Our multiples/sum-of-the-parts valuation uses multiples that are consistent with our European steel and distribution coverage - 5.5x EBITDA for steel assets and 6.0x EBITDA for distribution.

Risks

Salzgitter and other participants in the steel industry are subject to significant external risks that could affect the results of the business. The major external risks are:

Steel Price Risk: We believe steel prices will remain volatile in the near term, despite the consolidation of the industry. Steel companies have high capital intensity and their cash flows are exposed to steel price fluctuations.

Contract Sales Structure: Salzgitter sells a high proportion of its flat carbon steel (60%) and large diameter tubes sales (70%) on longer-term contracts. A mismatch in the movement of raw materials and contract price adjustments can materially affect margins.

Acquisitive Growth: The group intends to invest the cash on its balance sheet in growth opportunities. Although the group allocates cash conservatively, the risk remains that the cash is spent at the top of the cycle.

If the volatility of these factors proves to be more or less negative than we currently anticipate, then the stock price might deviate significantly from our target price.

voestalpine AG

(VOES.VI; €27.73; 1)

Valuation

We have a €34 target price for voestalpine. We use an equal-weighted combination of DCF, multiples, residual income and free cash flow to equity.

Our DCF-based model calculates a value of €34 (WACC of 7.9%, beta 1.18x, risk-free rate 3.5%, equity risk premium 4.5%, terminal growth 2%).

The steel sector has historically traded at 5x EV/EBITDA. We use a 10% premium to this to reflect the average excess margin generated by VOE vs. its European peer group. Our SOTP valuation suggests a €29 valuation. We also use a residual income model and a free cash flow model which value VOE at a fair value of €26 and €44, respectively.

We arrive at our €34 price target as a rounded average of the four methods.

Risks

voestalpine is exposed to industry- and company-specific risks:

Inland Location: voestalpine's major production sites have land-locked locations, which increases the comparative transportation cost of raw materials. This risk is partly offset by the group's closer proximity to finished product customers.

Steel Price Risk: voestalpine focuses on high-strength steels and processing activities to minimise the impact of volatile steel prices and volumes.

Raw Material Costs: Higher iron ore, coking coal, scrap steel, ferro-alloy and energy costs are major cost risks.

Industry Exposure: voestalpine strategically targets increased processing activities directed at the automotive sector in several of its divisions.

If the impact of these risk factors is more or less negative than we currently anticipate, then the share price could fail to reach or rise above our target price.

Appendix A-1

Analyst Certification

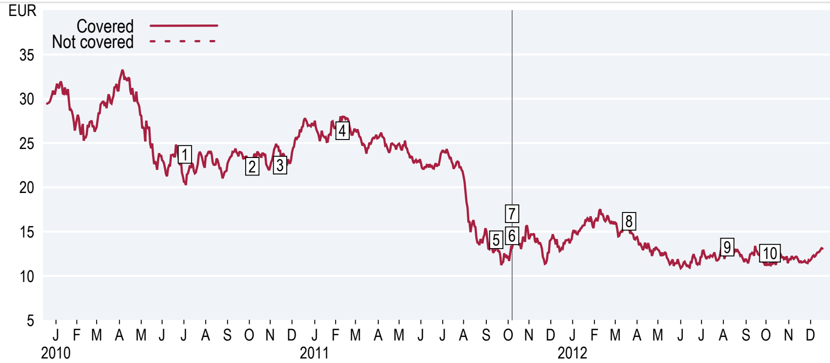
The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

ArcelorMittal (ISPA.AS)

Ratings and Target Price History
Fundamental Research

Analyst: Thomas O'Hara
Covered since May 23 2012



	Date	Rating	Target Price	Closing Price
1	2-Jul-10	1M	*24.70	20.58
2	6-Oct-10	1M	*23.75	22.95
3	15-Nov-10	*2M	23.75	24.23
4	10-Feb-11	2M	*25.00	27.98
5	15-Sep-11	*1H	*20.00	13.44
6	7-Oct-11	Stock rating system changed		
7	7-Oct-11	*1	20.00	13.20
8	21-Mar-12	1	*19.00	15.44
9	7-Aug-12	1	*17.00	13.09
10	5-Oct-12	*2	*11.30	11.40

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

ArcelorMittal (ISPA.AS)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Thomas O'Hara
Covered since May 23 2012

	Date	Rating	Target Price	Closing Price
1	11-Feb-11	*ADD LP	-	27.98
2	15-Nov-11	*REM LP	-	13.59
3	14-Feb-12	*ADD MP	-	16.72
4	15-May-12	*REM MP	-	11.90

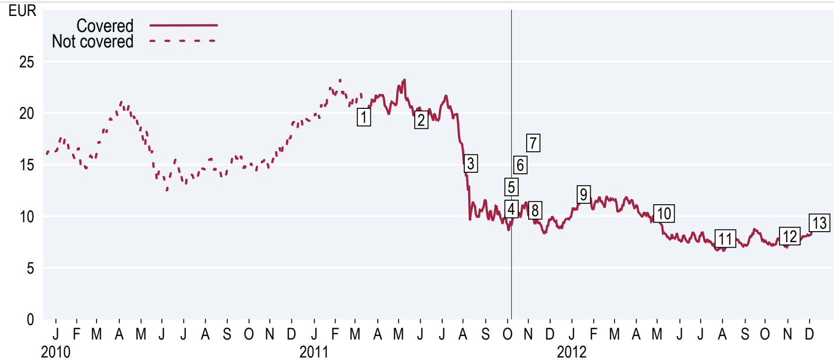
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Klockner & Co. (KCOGn.DE)

Ratings and Target Price History
Fundamental Research

Analyst: Michael E Flitton
Covered since March 1 2012



	Date	Rating	Target Price	Closing Price
1	14-Mar-11	*1M	*28.25	20.29
2	2-Jun-11	1M	*25.00	20.08
3	11-Aug-11	*1H	*18.00	10.39
4	7-Oct-11	Stock rating system changed		
5	7-Oct-11	*1	18.00	9.09
6	20-Oct-11	1	*16.00	9.85
7	8-Nov-11	1	*14.00	10.22
8	10-Nov-11	1	*12.00	9.25
9	18-Jan-12	*2	12.00	11.76
10	10-May-12	2	*9.30	8.40
11	6-Aug-12	2	*7.60	6.90
12	5-Nov-12	*1	*9.20	7.56
13	17-Dec-12	*2	*9.50	9.00

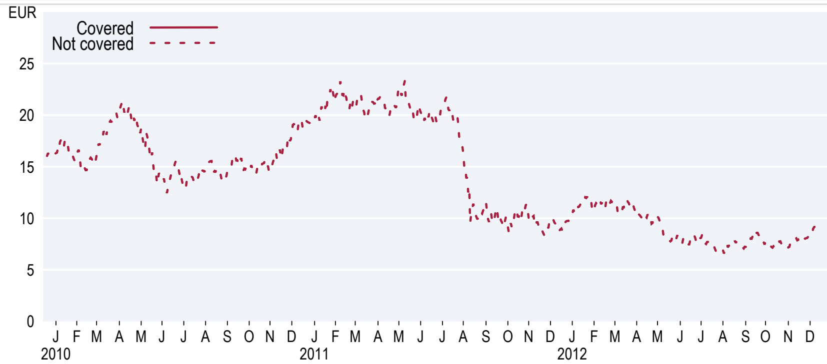
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Klockner & Co. (KCOGn.DE)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Michael E Flitton
Covered since March 1 2012



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Salzgitter AG (SZGG.DE)

Ratings and Target Price History
Fundamental Research

Analyst: Michael E Flitton
Covered since May 23 2012

	Date	Rating	Target Price	Closing Price
1	14-Jul-11	1M	*66.00	52.73
2	7-Oct-11	Stock rating system changed		
3	7-Oct-11	*1	66.00	37.78
4	10-Oct-11	1	*64.00	38.71
5	2-Nov-11	1	*63.00	39.24
6	9-Feb-12	1	*55.00	47.81
7	5-Mar-12	1	*54.00	42.88
8	28-Jun-12	1	*46.00	31.37
9	6-Aug-12	1	*45.00	30.57
10	14-Aug-12	1	*46.00	31.53
11	15-Nov-12	1	*43.00	32.52

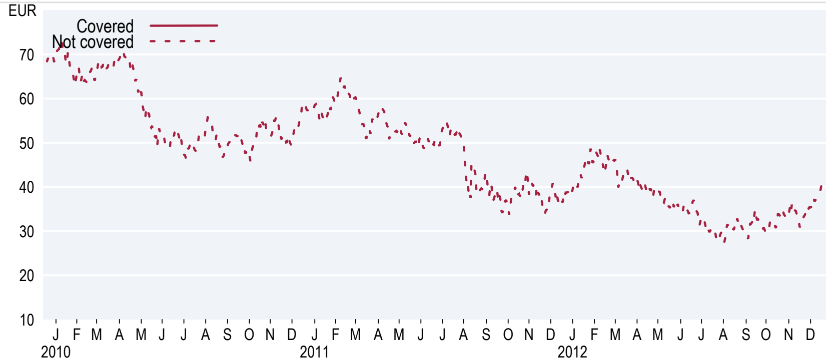
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Salzgitter AG (SZGG.DE)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Michael E Flitton
Covered since May 23 2012



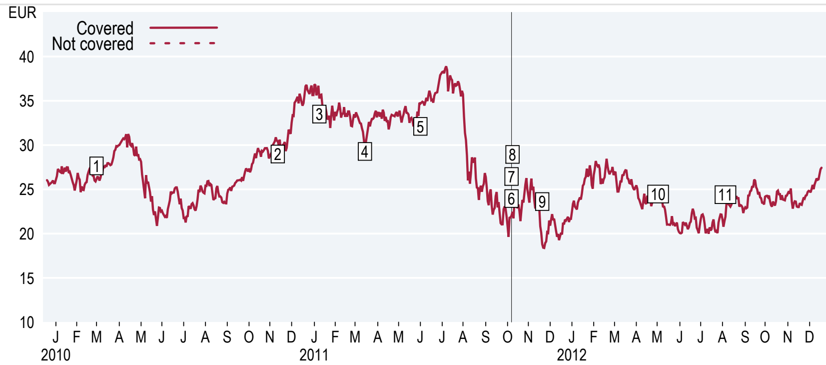
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

voestalpine AG (VOES.VI)

Ratings and Target Price History
Fundamental Research

Analyst: Thomas O'Hara
Covered since May 23 2012



	Date	Rating	Target Price	Closing Price
1	1-Mar-10	1M	*34.00	26.15
2	11-Nov-10	1M	*35.00	30.43
3	10-Jan-11	*2M	35.00	35.26
4	15-Mar-11	*1M	*37.00	29.28

	Date	Rating	Target Price	Closing Price
5	1-Jun-11	1M	*40.00	34.68
6	7-Oct-11	Stock rating system changed		
7	7-Oct-11	*1	40.00	22.04
8	10-Oct-11	1	*38.00	22.46

	Date	Rating	Target Price	Closing Price
9	20-Nov-11	1	*35.00	20.10
10	2-May-12	1	*36.00	24.04
11	6-Aug-12	1	*34.00	21.90

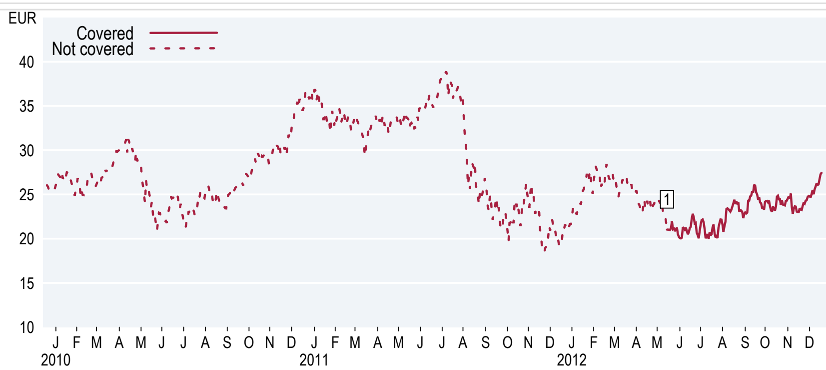
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

voestalpine AG (VOES.VI)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Thomas O'Hara
Covered since May 23 2012



	Date	Rating	Target Price	Closing Price
1	15-May-12	*ADD MP	-	21.02

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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	12 Month Rating			***Relative Rating***		
Data current as of 4 Oct 2012	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
Citi Research Global Fundamental Coverage	51%	38%	11%	7%	85%	7%
% of companies in each rating category that are investment banking clients	50%	47%	45%	59%	47%	50%

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