Daiwa Capital Markets

Sector

Materials / China
26 September 2012

The 10-second briefing

Penetrating China's steel heart

- We visited the centre of the country's steel-producing region to meet with steel companies large and small
- Steel prices highly affected by steel-trader sentiment; low inventories should support a price rebound in next few months
- Reiterating our Positive rating on the sector; we prefer Maanshan to Angang

China Steel Sector

- **Positive** (unchanged)
- Neutral
- Negative

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What's new

We have just returned from visiting several steel producers, traders, and steel-industry participants in Hebei Province, Liaoning Province, and Shanghai to gauge their latest views on the China steel market. Overall, we found them to be generally cautious about steel demand, although they thought short-term restocking could lead to steel prices rebounding.

What's the impact

The majority of the participants we met were, like us, very cautious about China's steel demand and prices in the mid-to-long term, with overcapacity being a critical problem. In general, they were also cautious on the outlook for market liquidity despite the stimulus policies implemented by the central government this year. That said, views differed about the steel market over the near term.

After experiencing weakening demand growth and steel prices YTD, steel mills and steel traders have already turned prudent about their production and inventory levels since 1H12. They see limited downside to steel prices and demand from the current levels.

We expect demand to improve slightly in 2H12 due to seasonal factors and on the back of a slow pick-up in infrastructure construction, which would translate into a rebound in steel prices in the coming months. In addition, the low inventory level for steel traders is likely to be positive for steel prices.

The steel traders and mills we visited said they are seeing a shortage of different steel products as buying interest has picked up during the past two weeks, driven by a recovery in steel prices. More traders have started restocking, in anticipation of higher steel prices ahead. They also indicated that they are likely to stock up on some products ahead of spring and Lunar New Year in 2013.

With traders currently accounting for about 65-70% of domestic sales volume, we believe their sentiment and behaviour will determine steel prices in the short term. Given traders' current restocking from low inventory and our anticipation of some demand recovery, we continue to expect steel prices to rise in the coming months.

What we recommend

We reaffirm our Positive view on the China Steel Sector for the next 3-6 months. We expect low inventory and better demand to lift steel prices during this period, resulting in profit-margin expansion. On a longer-term horizon, we remain concerned about a potential rebound in raw-material prices, limited consolidation likely among steel mills and steel demand potentially peaking.

We prefer Maanshan Iron & Steel (323 HK, HK$1.82, Buy [1]) to Angang Steel (347 HK, HK$4.08, Outperform [2]) as its earnings are more sensitive to building and construction, which we forecast to account for about 30-40% of its 2012-13 sales volume.

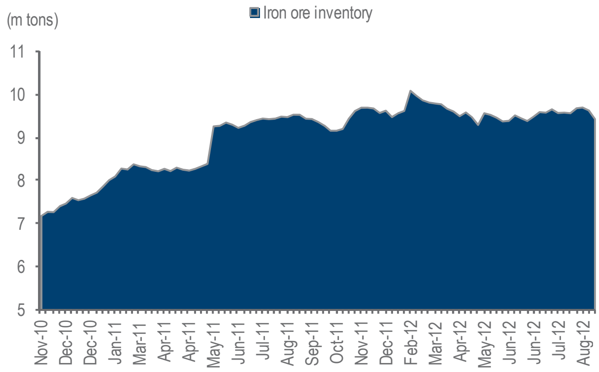
The main downside risk to our sector view would be a worse-than-expected demand recovery.

How we differ

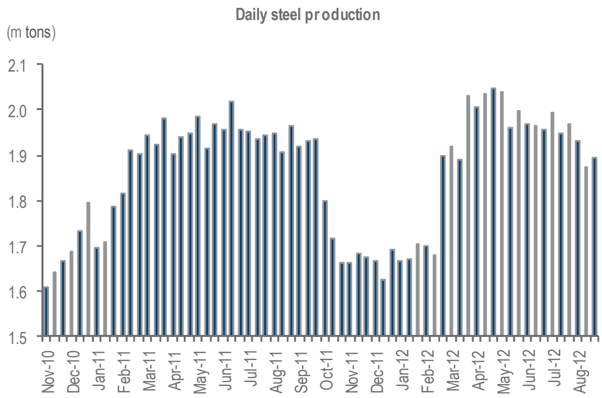
We are one of the very few houses with a Positive view on the China Steel Sector and the steel mills. Notably, our Daiwa China Momentum Gauge also indicates clearer signs of a recovery for China's economy (see Daiwa's report, *The uptrend continues*, published on 21 September).

■ Trip overview

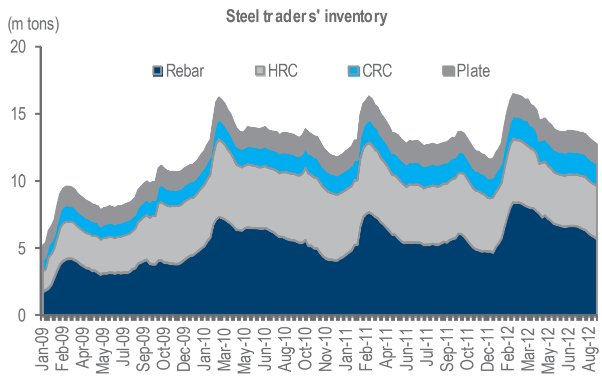
Iron-ore company
Hanking Group (3788 HK)



Steel producers
Tanggang mid-thick plates
Guofeng Steel
Angang steel (347 HK)



Steel traders
Tangshan Quansheng
Shanghai Lining Enterprise
Shanghai Jushen



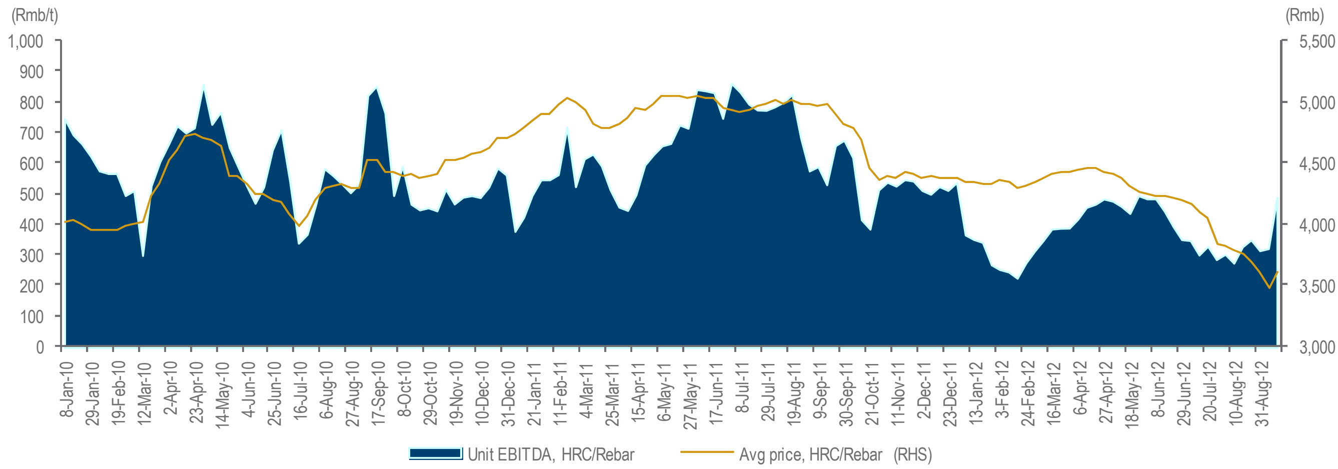
Source: China Iron & Steel Association (CISA) , CUSteel, Bloomberg, pictures by Daiwa

▪ Steel mills, traders, and others in Hebei, Liaoning and Shanghai: summary of their expectations for the China steel market for the next 3-6 months

	Steel prices	Raw-material prices	Demand	Supply	Inventory	Strategy/comments on current demand weakness
Steel traders						
Shanghai Lining Development	↗	↗	↗	n.a.	↗	✓ Inventory has been very low ✓ Currently more active in terms of trading volume ✓ Hesitating over whether to restock before the next Lunar New Year
Shanghai Jushen Metal	↗	↗	→	→	→	✓ Has started restocking after cutting inventory from May-August 2012 in the expectation of higher prices ✓ About 70% of its working capital is reserve and retained cash, 30% is in the form of bank borrowing
Tangshan Quansheng Metal	↘	↘	→	↗	→	✓ Maintaining low inventory levels since the beginning of the year ✓ Cautious about further increase in steel prices ✓ Almost no bank borrowing
Steel producers						
Tanggang Mid-thick Plate	→	→	→	↗	→	✓ Maintaining a low inventory of raw materials (equivalent to two days of production and steel products – 15,000 tonnes or two days of sales) ✓ Building more direct sales channels
Tangshan Guofeng Steel	n.a.	n.a.	→	→	→	✓ Strict inventory management ✓ Favours imported Indian low grade iron ore ✓ Looking to acquire upstream assets
Angang Steel	→	→	↘	↘	→	✓ Utilisation rate to remain at 80% ✓ Raw-material inventory equivalent to about one month of production ✓ Giving more trade credits to steel traders
Others						
Hanking Holdings (3788 HK)	→	→	→	→	→	✓ Expanding capacity, including acquisition of smaller miners, especially in Fushun city, a move that is supported by the government ✓ Cost of sales is much lower than for other small mines
Steelhome	→	→	→	→	↗	✓ No significant changes in overall demand ✓ Believes many small-to-mid sized steel traders will go bankrupt by the end of 2012 as banks reduce or cut off their credit lines
Xiben Express	↘	↘	→	↗	↗	✓ Expects steel mills to struggle with profitability as steel prices should remain at about cost for a long time ✓ Believes steel mills should not expand their proportion of direct sales significantly due to the high costs incurred ✓ Believes consolidation should be easier now that the industry is struggling to make a profit

Source: Companies, compiled by Daiwa

▪ China Steel Sector: EBITDA/tonne



Source: Daiwa

Trip summary

We see limited downside to demand for the next 3-6 months

Almost all of the market participants (steel mills, steel traders and industry consultants) we met said they are not seeing any improvements in end-user demand at present. They believe this is due mainly to insufficient liquidity in the China economy. The steel traders are more cautious about the China steel market now than they were earlier in the year. Overall, they expect the 2H12 sales volume to be lower than it was for 1H12.

While we are concerned about China steel demand over the mid-to-long term, we expect some recovery in steel demand in 4Q12 for seasonal reasons and on a slow-but-sure pick-up in infrastructure construction. Our trip underpins our view, as do the key macro indicators (ie, adjusted year-on-year FAI growth for property investment, planned investment for new projects, and floor space started), which showed an uptrend between July and August.

While local government financing remains tight, the governments are finding different ways to finance infrastructure projects, and we expect them to obtain private capital and/or state-owned companies to participate in these projects.

Low inventory to support the bottoming-out of steel prices

All of the traders and most of the steel mills we met have reduced their inventory levels significantly compared with last year or the start of this year, due to the uncertain economic outlook and difficulties in obtaining bank financing. One mid-size (annual trading volume of 300,000 tonnes) steel trader in Tangshan, Hebei Province, the largest steel-producing province in China, currently keeps its inventory at only 10% of what it was at the beginning of this year. Two Shanghai traders we met have cut their inventory to less than one-third of their normal levels during the same period.

Should demand improve in the coming months, we believe steel traders will restock rapidly given their low inventory levels currently, thus leading to a rise in steel prices.

China steel prices highly affected by sentiment of steel traders

CUSteel, an iron and steel data provider and consultant backed by the China Iron and Steel Association, and SteelHome, a well-known independent steel consultant, both indicate that 65-70% of the domestic steel producers' sales volume is sold by the steel traders. This compares to about 30-40% in Japan.

Notably, the steel traders are very sensitive to short-term movements in steel prices and their trading decisions are driven by sentiment, like speculators in the stock market. The traders informed us that when they see or expect prices to rise, they buy more and sell less (ie, build up inventory). The bandwagon effect in the steel-trading market could result in a steel-price rally between now and the end of this year. As steel traders account for a large share of sales, they play an important role in setting near-term steel prices. This helps explain why China's steel prices are more volatile than in developed countries.

Potential consolidation among steel traders

The steel producers informed us about their plans to expand their proportion of direct sales, especially for higher-quality flat products. The steel traders and domestic steel consultants told us that many steel traders in Shanghai and nearby areas are likely to bankrupt or close their businesses before the end of this year, as they were finding it hard to obtain bank financing.

We believe this trend will expand nationwide in the near future, with strong steel mills and traders likely to take over market share. When the steel market becomes more consolidated, steel prices should become less volatile. The pace of consolidation generally speeds up if both prices and demand remain weak.

Our take on the steel-market players we met

We visited three steel traders, three steel companies and two industry consultants in Hebei Province, Liaoning Province and Shanghai.

Shanghai Lining Enterprise Development (steel trader)

Background: Shanghai Lining Enterprise Development (Shanghai Lining) started business in 1995, focusing on construction steel. It sells steel from Shanghai Hubao Rolled Steel, Jiangyin Xicheng Steel, Lengshuijiang Iron and Steel, and Jiangsu Shagang Group, etc, to Shanghai and nearby provinces, such as Suzhou and Zhejiang.

Annual sales volume: 1m tonnes per year, of which 30% goes directly to the construction companies and 70% to the second-tier traders.

Latest strategy: the company has been destocking since May this year. It reduced its inventory from 80,000 tonnes to the current level of 15,000 tonnes , as the market rebar price fell from around Rmb4,200/tonne in May to Rmb3,500/tonne at the beginning of September, a new low for this year.

Management is cautious about the current market and is thus not aggressively building up inventory at the moment.

View on steel prices: *immediate future*: steel prices should remain strong until the beginning of October and should then fall, reflecting the real demand. *Medium term*: steel prices should rise during 1H13 thanks to the PRC Government's stimulus projects. However, the company has no clear view on the trend of steel prices in 2H13, as there are still too many uncertainties.

View on the steel market: management thinks the steel traders are likely to hoard inventory just before next year's Lunar New Year. As that period is traditionally the high season, traders usually build inventory to meet the demand in the spring, when more construction projects start on the back of warmer weather.

Management also commented that in the past two years, the steel traders did not build up stock before the Lunar New Year. On the run-up to the 2013 Lunar New Year, however, as Daiwa expects the macro economy to turn positive after the likely new president of China, Xi Jinpin, takes up his post, and in view of the reduced cash cost of holding inventory (from Rmb50-60/tonne last year to Rmb35-40/tonne currently), we believe many steel traders will resume stock building before the next Lunar New Year.

Shanghai Jushen Metal (steel trader)

Background: Shanghai Jushen started business in 2003 in the Shanghai area and is a first-tier agent for Rizhao Steel, Hebei Jingye Steel, Beiying Steel and Tianjin Tiantie Metallurgy Group. Its main products are rebar, wire rods, hot-rolled coil (HRC), cold-rolled coil (CRC), and billets.

Annual sales volume: it expects to sell 150,000 tonnes of construction steel and 300,000 tonnes of flat steel in 2012. The company said that it expects its sales volume this year to be double the levels of the past several years.

Latest strategy: the company has been buying more steel since early September and keeping it in a warehouse until prices rise in the short term.

View on prices: management expects current prices to remain stable for the rest of this year, with the market rebar price likely to stay at around Rmb3,700/tonne. Management believes market sentiment should turn positive before the Communist Party's 18th National Congress in October 2012.

Management believes that the company's steel, at a rebar price of Rmb3,100/tonne, has been over-shorted (ie, that this price is too low, as it is below its production costs). Management thinks it unreasonable that the price of steel has been pushed to its lowest level since 2008, as the economic fundamentals are better now than they were then.

View on the steel market: management believes that half of the steel traders in the Shanghai area will find it hard to refinance their loans at the end of this year. Management thinks this will be positive for the industry as it should squeeze out many speculators, thereby reducing steel-price volatility.

Financial status: 50-70% of the company's working capital comes from its retained cash and 30% from bank loans. Its interest rate on its bank loans this year is 7-8%, lower than 11% last year.

Tangshan Quansheng Metal (steel trader)

Background: Tangshan Quansheng Metal is a first-tier trader for Hebei Wenfeng Iron and Steel Co, Shijiazhuang Jingye, and Tangshan Iron and Steel Group. It also sells plates from Shougang, Hangang Steel, etc.

Annual sales volume: 300,000 tonnes of general carbon mid-thick plates, ie, low-end plates used to make heavy equipment/machinery and metal sections.

Latest strategy: has maintained a low inventory level since the start of the year. Its current inventory is around 3,000 tonnes, representing only 10% of its inventory levels of recent years. On our visit, we saw that part of the company's steel-inventory yard was being used to raise geese (see photo).

View on steel prices: steel prices are likely to fall again after the market's reaction to the current positive news flow (the government's concentrated approvals of infrastructure projects and QE3) subsides. The company has not seen any improvement in end-user demand recently.

View on the steel market: the company is very cautious about the demand outlook for the steel market. Though steel prices have rebounded over the past two weeks, the company has not bought plates aggressively.

Financial status: 100% of its working capital comes from retained cash. It has no bank loans currently.

■ Tangshan Quansheng Metal: part of inventory yard is used to raise geese

Source: Daiwa

Tanggang Mid-thick Plates

Background: the company is a subsidiary of Tangshan Steel Group. It had an annual capacity of 2.5m mid-thick plates, and added 0.8m tonnes of capacity to this earlier this year. The new production line has not started operating yet due to low demand.

Annual production volume: 2.5m tonnes of mid-thick plate.

Latest strategy:
1) The company aims to keep its raw-material (mainly iron ore and coking coal) inventory at equivalent to two days and its finished steel inventory at less than 15,000 tonnes.

2) The company only manufactures in sufficient volume to meet orders that have already been placed by steel traders, so as to avoid the risk of having too much inventory. Its utilisation rate has been about 100% recently. We did not see any idle production lines during our visit to the plant, but the plant's working pace seemed a little slow.

3) It is targeting to increase its direct sales as these have higher ASPs than sales through steel traders. Currently, 70% of its products are sold to traders and 30% to end-users directly.

View on steel prices: at about Rmb3,400/tonne for HRC, the company believes the market HRC price of Rmb3,400/tonne at the end of August will be the low for this year, because at the end of August the billet price (Rmb2,900/tonne) was lower than the cost of production.

The company thinks the HRC price will remain stable at the current level of Rmb3,600-3,700/tonne on the back of the government's positive stimulus measures.

View on the steel market: steel traders have been moving fast to rebuild their inventory recently on the back of the rebound in steel prices. Most of them have cut inventory to very low levels this year.

■ Tanggang Mid-thick Plates: billet production line

Source: Daiwa

■ Tanggang Mid-thick Plates: raw material is equivalent to 2 days of production

Source: Daiwa

Tangshan Guofeng Steel (steel producer)

Background: the company's main shareholders are: China Travel International Investment Hongkong (308 HK) and Kin Ho Development Co, with respective shareholdings of 51% and 49% currently. Its main business is the production and sale of strip steel, HRC, CRC, rebar, and billets. As at 31 December 2011, the company's production capacity was 9m tonnes of crude steel and 8.5m tonnes of finished steel.

Annual production volume: 9m tonnes of crude steel and 8.5m tonnes of finished steel.

Latest strategy:
1) Vertical integration: the company is looking to acquire potential upstream resources, specifically iron-ore mines, both overseas and domestically.

2) It is targeting to reduce its cost of production by mixing in more low-grade Indian iron ore, while maintaining the high quality of its steel products.

3) It aims to ensure that it has no inventory of finished steel and is maintaining its raw materials at the equivalent of one month of production.

Cost advantage: the company has low financing costs. It was able to raise money in Hong Kong in 2010 at an interest rate of 2.5%. This is lower than the average interest rate payable on new financing of 8% for other local private steel producers.

View on the steel market: the company thinks the current overcapacity issue can only be solved by market activity, which is in turn driven by price changes. Over the long term, it expects steel prices to be weak and profit margins to be low.

Angang Steel (347 HK) (steel producer)

Background. Angang Steel (Angang) is based in north-east China, in the city of Anshan in Liaoning Province. The company's principal activities include the production and sale of hot-rolled sheets, cold-rolled sheets, galvanised steel sheets, colour-coated plates, silicon steel, medium plates, wire rods, large steel products, and seamless steel pipes. These products are widely used in the automobile, construction, ship-building, home electrical appliances, and railway construction industries, and in the manufacture of pipelines.

Annual production volume. For 2011, Angang Steel produced 19.8m tonnes (up 8.7% YoY) of steel and 19.2m tonnes (up 8.2% YoY) of steel products. For 1H12, the company produced 9.6m tonnes (up 3.8% YoY) of steel and 9.4m tonnes (up 3.0% YoY) of steel products.

Latest strategy:
1) The company has no plans to cut production at this time. It said that it only produced enough volume to cover the monthly orders that it received. Although its production volume is not decreasing, Angang Steel said that it had started to receive more acceptance bills from customers as forms of payment, due to the sluggish market.

2) The company said it was trying to develop more direct sales channels. Currently, 50% of its products are sold to traders and 50% directly to customers such as shipbuilders, household-appliance makers, and automakers.

Plant visit. On our visit, the company's production lines appeared to be well managed. Its operations are highly automated; we did not see many workers standing by the machinery (compared with other plants we visited). The company commented that its production lines are currently running at a utilisation rate of 80%.

Hanking Holdings (3788 HK) (iron-ore producer)

Background. Hanking Holdings is the biggest producer of iron-ore concentrate in Liaoning Province. The company has four iron-ore mines with reserves of 163m tonnes and resources of 196m tonnes.

Production volume. For 1H12, the company's output was 0.68m tonnes (up 8.7% YoY) of iron-ore concentrate; for 2011, production was 1.31m tonnes (up 3.4% YoY).

Latest strategy.
1) The company plans to double its current iron-ore capacity to 10m tonnes by 2015. It aims to acquire more iron-ore assets, while the local government is encouraging Hanking Holdings to take over small iron-ore producers in and near Fushun City.

2) Due to its proximity to many steel companies, Hanking Holdings has a stable order flow from customers such as Benxi Steel and Fushunshin Steel, so it has noted that its sales volume has not been affected by the current sluggish demand. In addition, during our visit to the company's Aoniu iron-ore mine near Fushun City, the company informed us that it is currently operating the mine 24 hours a day (a 100% operating rate).

3) As a result of its production of high-grade raw ore and the short transportation distances to its customers, the company's cost of sales per tonne was Rmb321 for 1H12, less than half the average cost of about Rmb800/tonne in the domestic market over recent years, according the company

View on iron-ore prices. The company expects the iron-ore price to continue to be about Rmb800/tonne (excluding tax) in about three years' time, which it also believes is the average production cost in China currently. It believes that the iron-ore price has been over-shorted recently, and notes that many local small-scale iron-ore producers have ceased production.

■ Hanking group: Aoniu iron-ore mine under operation

Source: Daiwa

Shanghai SteelHome Information and Technology
(steel industry data provider and consultancy)

Background. Shanghai SteelHome Information and Technology, which began operating on 1 November 2004, provides information and consultancy services on the China steel industry. We spoke to its chief analyst.

View on steel prices. The company expects steel prices to remain lower than the average cost of sales for the whole industry over the long term. It believes steel prices would rise in the following two situations: 1) a rise in China's exports, led by a recovery in the global economy, and 2) continuing rises in inflation against the backdrop of a long-term monetary loosening policy.

View on steel market.
1) Insufficient liquidity is the key issue limiting infrastructure and property construction, which is being reflected in low steel-demand growth.

2) It believes more steel-trading companies will encounter financial difficulties before the end of this year. Over the next 3-5 years it expects consolidation within the steel-trading industry, with large-scale state-owned trading companies likely to acquire small ones.

Xibenxinganxian
(steel industry data provider and steel e-trading platform)

Background. Xibenxinganxian is a steel-trading and logistics-industry conglomerate based in Shanghai. In addition to a physical steel-trading business, the company has an e-trading platform that provides steel-market information and related services. We spoke to its steel analyst.

View on steel prices. The company expects steel prices to fall again after the October National Day holiday, mainly because it expects a slow recovery in real demand. Over the long term, Xibenxinganxian expects the iron-ore price to be slightly above US$80/tonne, and the general rebar price to be Rmb3,400/tonne.

View on steel industry. The company expects steel companies' profits to remain very low over the long term. In addition to the steel companies' weak negotiating power on raw materials and slow demand growth as a result of China's sluggish economy, rises in operating costs are also likely to put pressure on the steel companies' profits. As the banks generally consider the steel industry to be one of China's riskiest segments to which to provide loans, even riskier than property, Xibenxinganxian expects interest rates to rise at some point going forward. Furthermore, as more steel companies are expanding their direct sales channels, it believes their SG&A expenses are likely to see large increases over the coming years.

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