Global steel 2013

A new world, a new strategy

Ernst & Young

Quality In Everything We Do

Executive

"Controlling raw material costs is a benefit of vertical integration; however, steelmakers should critically assess the value of vertical integration and consider possible alternatives to help mitigate the cost of raw materials."

Mike Elliott
Global Mining & Metals Leader, Ernst & Young

Global steel — will 2013 be the bottom of the trough?

Despite a slight increase in demand for steel and the removal of some older steelmaking capacity in 2012, the global percentage level of excess capacity is greater now than it was 12 months ago due to the continued growth in new steelmaking facilities particularly in developing economies.

Capacity utilization rates in the sector remain below 80%, and in 2013 excess capacity will remain the most significant issue in the steel sector.

Growth in global steel demand is unlikely to improve significantly in 2013. Sluggish demand combined with excess steelmaking capacity and ongoing volatility in raw materials costs will challenge the sustainability of high-cost producers.

The continued closure of older, higher-cost steelmaking capacity and increased demand growth should lead to improved profitability for the sector in 2014 and 2015, driven by better utilization rates. The closure of inefficient capacity will require the sector to avoid political interference with commercially rational decisions.

Restoring sustainable value

Ernst & Young's 2012 steel report detailed the importance of customer reach, operational agility, cost competitiveness and stakeholder confidence for producers to remain profitable. These remain priorities for 2013.

The big challenge for steelmakers in 2013 is how to be cost competitive while maintaining enterprise value. To achieve this, producers need to assess and address whether they are best set up for the new operating environment:

- **Is there value in vertical integration?**
- Strategic cost reduction for survival and future growth
- The optimal capital structure for the future business model

Is there value in vertical integration?

In recent years, many steelmakers have integrated raw material (coal, iron ore) mines into their supply chains. However, new analysis by Ernst & Young suggests that despite the benefits in controlling raw material costs, it may not always have a positive benefit on enterprise value.

Steelmakers should critically assess the value of vertical integration to their business and consider alternatives to managing raw material costs and supply, such as long-term contracts with suppliers and relocating production sites closer to upstream suppliers.

Strategic cost reduction

With continuing weak market conditions, cost reduction activities are essential for steelmakers' sustainability and future growth. While these activities are necessary, it is crucial that steelmakers do not move away from their overall company strategy, thus potentially causing further value erosion.

In this report we discuss the different approaches that are currently being used to reduce cash operating costs, including:

- Reducing production volumes from loss making plants to stabilize steel prices and address oversupply in the market

summary

- Restructuring labor
- Canceling or reducing supply contracts

Optimizing capital

Today's economic environment is forcing steelmakers to assess whether their capital structure is optimized for the new operating environment. Companies must objectively review the alignment of their asset portfolios to their business strategies. The goal for companies is the optimal allocation of capital to maximize shareholder returns and achieve the most efficient capital structure. As a result, an increasing number of corporate boards are putting greater focus on the key drivers of efficient capital allocation.

This focus is extremely relevant to steelmakers because falling demand and oversupply in regional markets have led to short-term liquidity challenges that may threaten credit ratings and debt covenants. Capital management today includes:

- Building in options
- Capital raising
- Divesting non-core assets

China restructuring

China remains the largest market in the steel sector, even though it experienced lower steel demand, overcapacity, a fragmented industry and weak profit margins in 2012. The Chinese government aims to address these challenges through its 12th Five-Year Plan (FYP), which represents China's goal to rebalance its economy and shift the focus from investment toward consumption and move development from urban areas to rural areas.[1] In terms of the steel sector, the 12th FYP focuses on promoting the use of modern technology, energy efficiency and improved product quality.

Successful execution of the 12th FYP policies will not only help contribute to the domestic and global steel demand, but also promote the production of value-added steel.

Is India on track to becoming the next steel powerhouse?

Although China is the dominant market in the steel sector, India is increasing its presence in the global steel market as a result of domestic steel consumption. The rising middle class population coupled with increased urbanization will grow steel intensity in the economy. India has seen a rapid rise in production over the past few years, which has resulted in India becoming the fourth largest producer of crude steel and the largest producer of sponge iron in the world.

There are many opportunities that are helping grow the Indian steel market. These opportunities include:

- Rural demand picking up
- Investment planned in road sector
- Indian railway expansion
- Automobile and power sectors offer opportunity for specialized steel
- Refocus on manufacturing

However, there are also some challenges that India must overcome in order to continue on the path of becoming the next steel powerhouse. These challenges include:

- Land acquisition and environment regulations
- Shortage of coking coal
- Availability and pricing of domestic iron ore
- Downstream value addition
- Insufficient infrastructure and logistics
- Overburdened port facilities
- Adoption of modern technology

1 "China's rebalancing push needs tailor-made policy," *Shanghai Daily*, 20 December 2012, Factiva, http://global.factiva.com/ha/default.aspx.

Ernst & Young's Global Mining & Metals Center

With a strong but volatile outlook for the sector, the global mining and metals sector is focused on future growth through expanded production, without losing sight of operational efficiency and cost optimization. The sector is also faced with the increased challenges of changing expectations in the maintenance of its social license to operate, skills shortages, effectively executing capital projects and meeting government revenue expectations.

Ernst & Young's Global Mining & Metals Center brings together a worldwide team of professionals to help you achieve your potential — a team with deep technical experience in providing assurance, tax, transactions and advisory services to the mining and metals sector.

The Center is where people and ideas come together to help mining and metals companies meet the issues of today and anticipate those of tomorrow. Ultimately it enables us to help you meet your goals and compete more effectively. It's how Ernst & Young makes a difference.

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