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INDIAN FERROUS SECTOR

The Long Story: Small long-steel product manufacturers to benefit from revival in demand and lower input costs

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Long steel demand to pick up with rebound in infrastructure investments. Capacity utilization and margin gap between large and small steel producers to narrow as demand swells

The long steel product industry will be a direct beneficiary of the Indian Government's heightened immediate- and medium- term (under the National Infrastructure Pipeline) focus on infrastructure investments to "build India" out of the Covid induced economic slowdown. Following years of anaemic long steel product demand, ICRA expects this construction activity to revive demand strongly, lifting the fortunes of large and small manufacturers alike. So far, available demand has been largely absorbed by the larger long steel manufacturers leading to sharply divergent capacity utilisation trends between large and small long-steel manufacturers.

The strong steel price rally and benign coking coal prices have lead to windfall gains for large integrated steel manufacturers while smaller manufacturers have struggled with high input costs (non-coking coal, scrap and sponge iron) and an iron ore shortage during FY2021. ICRA expects the recent easing of iron ore prices in the country and sharp increase in coking coal prices, besides an improvement in capacity utilisation of smaller players, to narrow the margin gap between large and small steel manufactures going forward.

- **Inflection point for a multi-year demand growth story:** Following around five years of anaemic long-steel demand, ICRA expects a strong uptick for long products, stemming from increased infrastructure and construction activity as the country attempts to "build" itself out of a Covid-induced slowdown.
- **Journey out of Covid and beyond:** Following the massive construction disruption in Q1 FY2021, infrastructure activity picked up in Q3 FY2021 with pace of execution crossing pre-Covid levels in H2 FY2021. The state government capex, which accounts for 60% of the total capex by the Governments, also picked up sharply from December 2020, adding to the Central Government expenditure. Further, wave-2 was relatively less disruptive with continued construction activity. ICRA expects the GoI's announced expenditure plans and the post Covid pent-up demand pick-up in rural and urban construction activity to lead to increased offtake for long products.
- **Swelling demand to lift capacity utilisation for small steel manufacturers :** The weak demand for long steel in the Indian markets over the past five years (pre- and post- Covid) had impacted smaller steel manufacturers (players using the Electric Arc Furnace (EAF)/Induction Furnace (IF)) more severely than the larger manufacturers (players using the Blast Furnace-Basic Oxygen Furnace (BF-BoF) route). During the Covid period (past 14-18 months), apart from capturing the available demand in the domestic markets, larger players also succeeded in exporting semis, leading to sharply divergent capacity utilisation trends between the larger and smaller players. ICRA expects the demand uptick stemming from the Government's thrust on infrastructure, apart from the pickup in smaller construction activity to lead to increased offtake from smaller manufacturers in the coming quarters.

- **Margin gap between large and small manufacturers to narrow in H2 FY2022:** A steep steel price rally, coupled with benign coking coal prices (until May 21) led to a sharp increase in contribution margins of large players to all-time highs in FY2021 and Q1 FY2022, improving their credit profiles significantly. On the other hand, with prices of sponge iron, scrap and non-coking coal, raw material used by small and medium players increasing significantly over the same period, smaller player margins were impacted. Moreover, in FY2021, smaller players were also impacted by a shortage of iron ore in the market, which larger integrated players were insulated from to an extent, because of their captive sources.

During the past few weeks, ore prices have been correcting amid better availability in the domestic market and a decline in international prices. Further, since June 2021, international coking coal prices have almost doubled. While large integrated steel manufacturers' margins will continue to remain insulated from iron ore price movement, to the extent of their captive iron ore availability, the impact of higher coking coal prices will show up in the margins in H2 FY2022, with a lag of about two months for imported coking coal. On the other hand, smaller players would stand to benefit from lower iron ore prices at a time when demand conditions are likely to improve after the ongoing monsoon season. This will lead to narrowing of the margin gap between larger and smaller players.
- **Infrastructure projects under NIP to drive medium-long term demand:** The National Infrastructure Pipeline (NIP), programme which underpins India's infrastructure roadmap and is aimed at improving infrastructure in the country, will lead to significant demand for long steel products. However, on-ground delivery of these projects would be critical.

INFLEXION POINT FOR A MULTI-YEAR GROWTH STORY

The global pandemic opened fault lines across the world, with developed nations surviving the disruption much better than emerging markets. Governments the world over have tackled the Covid induced slowdown with policy and liquidity easing. While many nations focussed on driving consumption, others like India and China have taken a more longer-term view, investing in infrastructure. This opens growth avenues for several industries linked directly and indirectly to infrastructure growth in the country. **ICRA expects the long steel product segment to be a direct beneficiary of this “building out of the pandemic” growth path.**

54% of all the steel consumed in the country is in the form of long products. Longs go primarily into construction and infrastructure activities.

Exhibit 1 : Share of steel demand from Infrastructure and Construction vs. Auto for key countries

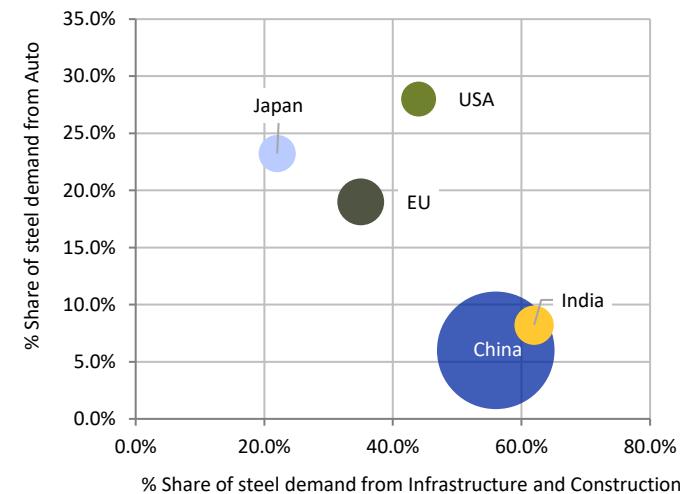
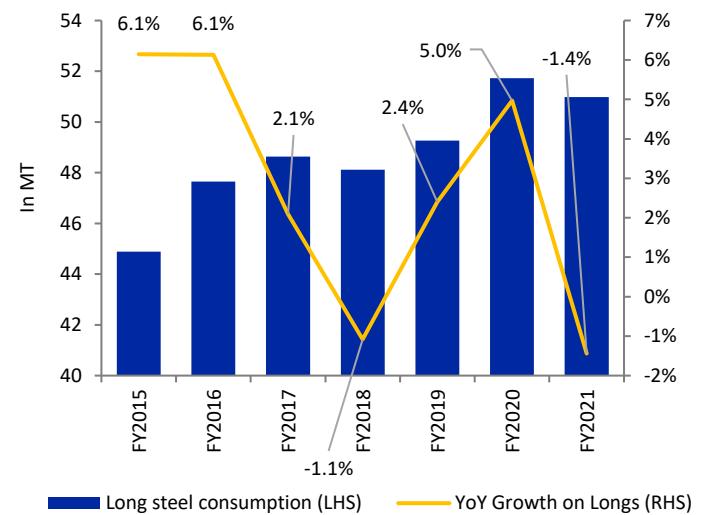


Exhibit 2: Trend in domestic long steel demand



Source: ICRA Research; JPC; Steelmint

As with emerging nations still engaged in infrastructure investments, demand for long steel used in construction activity in India accounts for over 60% (Exhibit 1) of the total steel consumed. Over the past six years, given the multitude of policy and social/health disruptions, infrastructure activity both from the Government and the private sector has taken a back seat. Long steel demand grew at an anaemic 6-year CAGR (FY2016-2021) of 1.4% (Exhibit 2) while the demand for flat steel grew at 5% CAGR during this period.

While headwinds from poor state finances, a weakened economy crimping private sector participation in infrastructure and significant reduction in real estate activity persist, the trends post wave-1 and the Government's continued thrust on infrastructure investments are reassuring.

THE JOURNEY OUT OF COVID AND BEYOND

The pandemic has been massively disruptive to life and business over the past 15 months. While the first wave caught the world unaware and unprepared, leading to one of the more stringent lockdowns in India, with massive labour migration and supply chain disruptions, the second wave was more forgiving on construction activity around the country. Despite the higher Covid incidences and the inadequate healthcare system, reverse migration of labour was minimal and construction activity was permitted.

Infrastructure activity picked up in Q3 FY2021, following the sharp contraction in Q1; pace of execution crossed pre-Covid levels in H2 FY2021 (Exhibit 3) and has largely held up since, barring a marginal dip in May 21 (second wave). Road construction activity, which slowed down in May 21 temporarily, has also picked up in June 21 (Exhibit 4). Project awarding also picked up in H2 FY2021 with roads (Rs. 1.28 lakh crore) and railways (Rs. 0.77 lakh crore) dominating the project awards in FY2021.

The state government capex, which accounts for 60% of the total capex by the Governments, again picked up sharply from December 2020, adding to the Central Government expenditure. Gujarat, Odisha, and Uttar Pradesh had the highest share of project awards in FY2021. The Public Works Department (PWD) Tamil Nadu, and PWD Uttar Pradesh awarded the highest projects, among state departments.

Exhibit 3: Index of Infra/construction goods & YoY growth

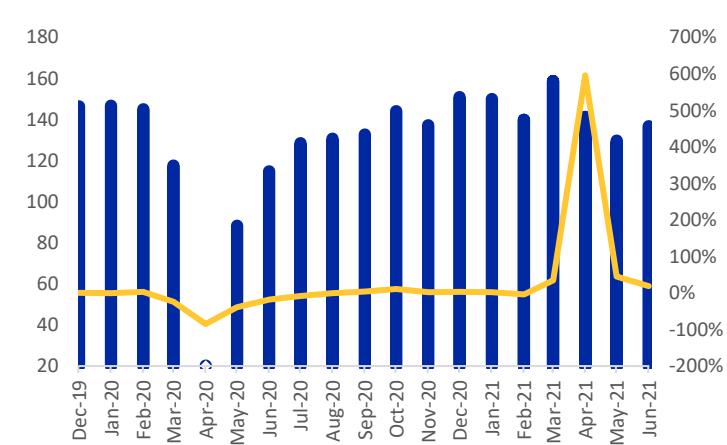
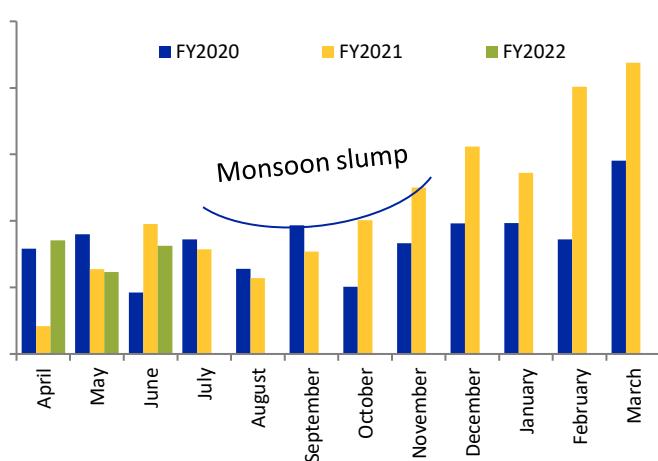


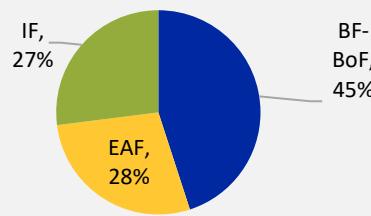
Exhibit 4: Road construction in Kilometers



Source: ICRA Research; MoSPI; The infrastructure and construction goods index, which has a weightage of 12% in the Industrial Production (IIP) has 29 items, including paints, cement, cables, bricks and tiles, rail materials, etc which is a good representative of the construction/infrastructure raw-materials.

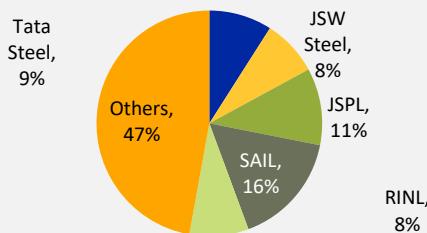
45% of the total production of steel in India is under the Blast Furnace-Basic Oxygen Furnace (BF-BoF) route with large steel manufacturers.

Exhibit 5: Indian steel production by production route in FY2020



Long steel is a highly fragmented industry with only 53% of the industry catered to by the five industry majors, as compared to 82% for flat steel products. This fragmentation, across hundreds of small to medium sized companies high competitive intensity in this segment.

Exhibit 6: Company-wise production mix of long products in FY2021



SWELLING DEMAND TO LIFT CAPACITY UTILISATION FOR SMALL STEEL MANUFACTURERS

While steel demand has picked up rapidly post the April 2020 lockdown, pace of recovery was smoother for the top five producers of bars and rods (Exhibit 7) as opposed to the smaller producers. During wave-2 in April-21, the difference was even starker with the larger producers not witnessing any slowdown. Despite the muted domestic offtake during the Covid peaks, larger manufacturers with a presence in long products were relatively unaffected as they increased export of semis to Europe, the Middle East, China and Vietnam. This disparate trend in capacity utilisation (Exhibit 8) which was visible even prior to the pandemic, during the past five years (FY 2016-21) of anaemic long steel demand (Exhibit 2) widening in the last 18 months. However, with infrastructure-lead demand for long steel expected to ramp up sharply, post the Q2 FY2022 monsoon, ICRA expects this disparity to reduce as swelling demand is likely to increase capacity utilisation for smaller secondary steel manufacturers also.

Exhibit 7: Production of Bars and Rods (in '000 MT)

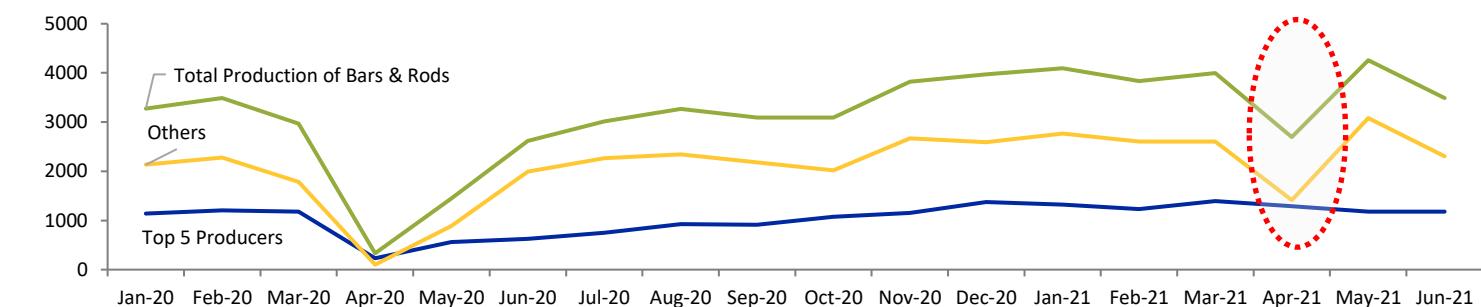
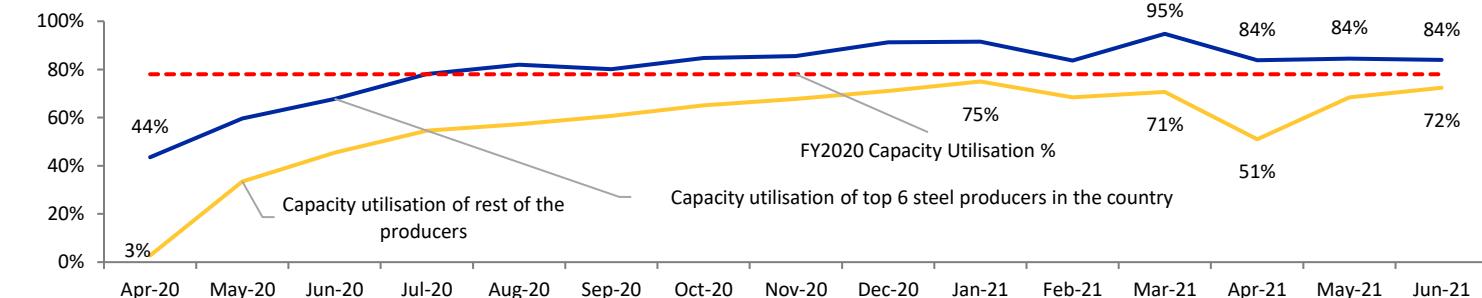


Exhibit 8: Capacity utilisation trends for Indian Steel Producers



Source: Steelmint, ICRA Research

Integrated primary steel producers benefitted the most, while local iron ore shortages impacted non-integrated smaller mills.

MARGIN GAP BETWEEN LARGE AND SMALL PLAYERS TO REDUCE

Global supply-demand imbalances and the pivotal role China plays in global commodities tipped prices in late CY2020, with global steel prices climbing sharply (Exhibit 7) and continuing the trend in CY2021. On the other hand, geopolitical trade tensions, partly stemming from the Australia-China tiff, led to the temporary de-coupling of the strong linkage between steel and coking coal prices in FY2021 (Exhibit 7 & 8). A strong steel price rally, coupled with muted coking coal prices led to windfall profitability gains for large BF steel manufacturers (Exhibit 9). On the other hand, prices of sponge iron, non-coking coal (used by sponge iron players) and scrap (Exhibit 10) used by smaller EAF/IF manufacturers started increasing in mid-FY2021. Coupled with supply shortages of iron ore in India during FY2021, domestic prices of iron ore too increased sharply. While larger steel manufacturers were fully or partially insulated from the iron ore price hike, given their backward integration into iron ore mines, the smaller manufacturers faced the brunt of high ore prices to a greater extent.

Exhibit 7: Trend in Domestic Steel Rebar price (ex-works, Mumbai)

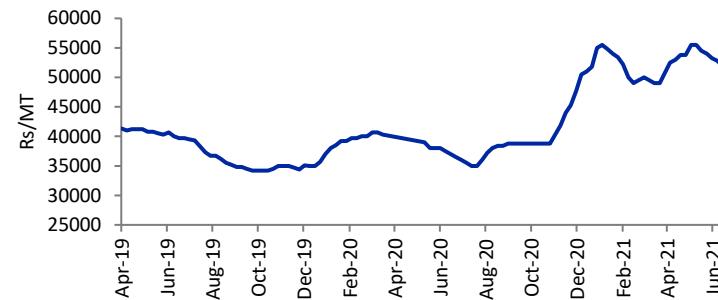
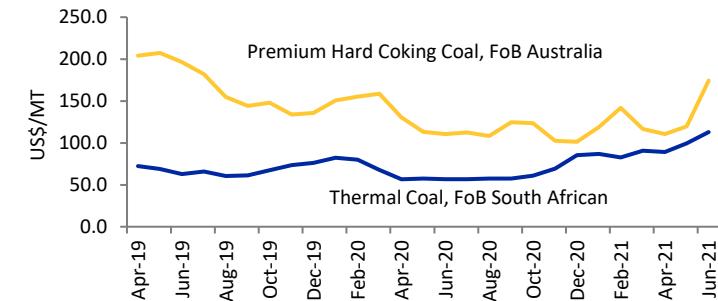


Exhibit 8: Trend in seaborne thermal & coking coal spot prices



Source: Steelmint, ICRA Research

Exhibit 9: Trend in domestic steel spreads for a primary long producer

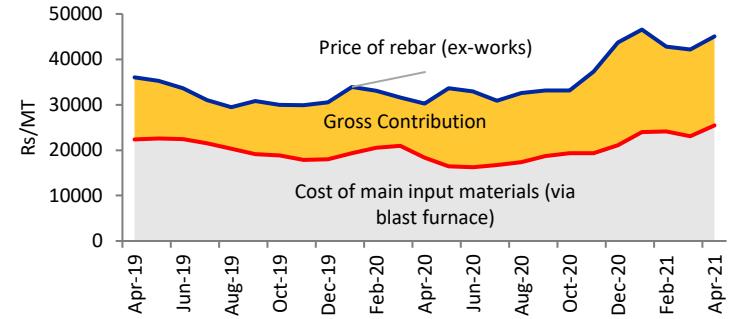
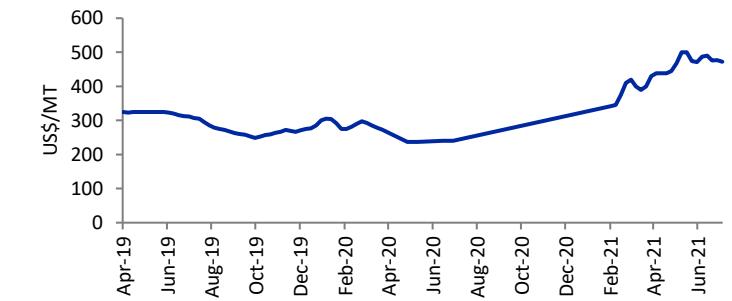


Exhibit 10: Trend in HMS 1&2 (80:20) imported scrap price (Dubai org.)



ICRA expects the margin gap between primary Blast furnace (BF) and secondary (EAF) producers to narrow going forward.

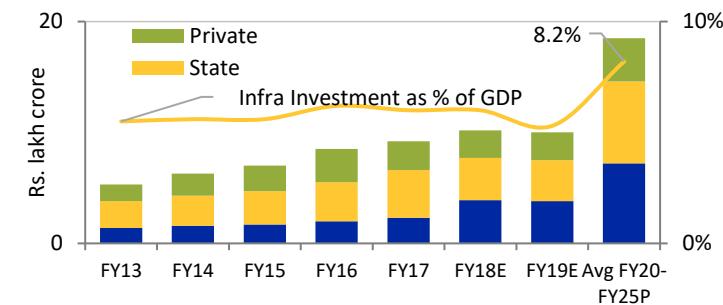
This double whammy of lower capacity utilisation and the sharp hike in input cost (scrap, thermal coal and iron ore) impacted margins of smaller EAF/IF manufactures while larger integrated BF manufacturers witnessed all-time high margins on the strong steel price rally and the low coking coal prices. Consequently, the margin difference between the large and smaller players widened significantly in FY2021.

Since the beginning of Q2 FY2022, Chinese policy measures to clamp down on steel production in the current year started cooling the global iron ore markets. Further, with increasing domestic production and prospects of lower exports to China, the iron ore shortage has corrected, leading to a fall in domestic iron ore prices since July 2021. The smaller manufacturers will benefit from this while the larger backward-integrated manufacturers will stay largely insulated. Further, international coking coal prices have almost doubled since June 2021 as global demand for coking coal started increasing ex-China as well. This will start reflecting in the cost of production for larger manufacturers in H2 FY2022, narrowing the margin gap between the larger and smaller manufacturers.

INFRASTRUCTURE PROJECTS UNDER THE NIP TO DRIVE MEDIUM TO LONG TERM DEMAND

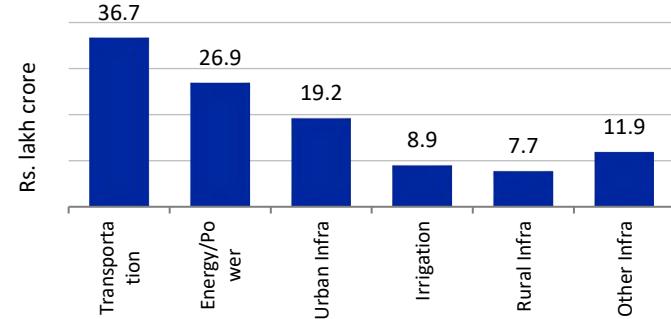
The Government has identified a pipeline of infrastructure projects to be developed under the National Infrastructure Pipeline (NIP), earmarking a total expenditure of Rs. 111 lakh crore to be spent during FY2020-FY2025 (Exhibit 11). This programme underpins India's infrastructure roadmap and is aimed at improving road, railway, power, irrigation and rural infrastructure in the country. The Central Government and the state governments would have an equal share of 39% each in the NIP, with the private sector share accounting for the balance. There is enormous potential for long steel products from the NIP. Further, state capex budgets have increased significantly in FY2022. The total capital outlay of states in their budget estimates of FY2022 (FY2022 BE) is around Rs. 5,85,567 crore, ~36% higher than FY2021 RE (revised estimates). Optimistically, considering the impact of the second wave on state revenue receipts and higher demand for social sector spending, but given the last two years of muted capex, high capex growth is achievable.

Exhibit 11: Infra Investment (past and planned under NIP)



Source: ICRA Research; NIP Documents

Exhibit 12: Segment-wise break-up of Infra investment (und. NIP)





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