Prolonged steel cycle- Healthy EBIDTA of above Rs20,000/t in FY22 to support deleveraging

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Global steel industry has demonstrated strong momentum during calendar year 2021 continuing a very strong upcycle which started from mid of calendar year 2020 as reflected by recovery in consumption and a very sharp uptick in prices. There has been some moderation in global steel prices in the recent months attributable to a slowdown in Chinese steel production and consumption and resultantly sharp correction in seaborne iron ore prices. However, the domestic HRC steel prices continue to remain elevated above Rs.60,000 per tonne on the back of healthier domestic demand and surge in coking coal prices thereby evading the discount vis-à-vis global steel prices. Elsewhere, China has reported sharpest decline in consumption and correction in prices due to slowdown in the real estate market, fading of impact of last year's stimulus package and country's ongoing quest to decarbonize and deleverage the economy. United States has recently announced one trillion-dollar infrastructure spending which is likely to substantially boost country's steel consumption thereby keeping steel prices firm in the US market at nearly USD 1950 per tonne after nearly four-fold jump from mid-2020 levels.

Notwithstanding recent jump in coking coal prices, continually high domestic steel prices and better competitive advantage gained through comparatively lower indigenous iron ore prices, major listed domestic steel players have been earning healthy spreads leading to combined EBIDTA per tonne of nearly Rs.25000 on rising volumes amidst recovery in steel consumption over the last few quarters. As a result, there has been a very sharp and sizable deleveraging reported by the industry, especially the large-integrated steel producers (ISPs) with total debt to EBIDTA falling below 1.5 times by September 2021 from peak of nearly 6 times in March 2020. CARE Ratings believes that there are no immediate signs of abatement of steel upcycle and therefore industry players shall continue to earn healthy spreads and report further deleveraging notwithstanding ongoing capex and fresh expansion plans announced over the last one year.

Why steel upcycle is sustaining?

The start of one of the sharpest and strongest upcycle in the steel industry can be attributed to supply bottlenecks and logistical constraints, tight export markets due to lower Chinese exports, resurgent consumption stimulated by pent up and restocking demand and monetary and fiscal stimulus packages and buoyancy in raw material prices besides a scenario of surplus liquidity conditions globally. The global steel industry is not showing any signs of abatement barring some moderation in prices in various geographies the degree of which varies. Chinese steel prices have corrected relatively more than the other markets due to debt crisis in Chinese property giant Evergrande and general weakness in housing and real estate market which contributes nearly 30% to Chinese steel consumption. However, continued production curbs in China to curtail carbon emissions have not resulted into any major supply glut to increase Chinese exports, thereby keeping global world export prices at elevated levels with only some moderation from peak of USD 1100 per tonne in May 2021 to USD 820 per tonne in December 2021.

Beyond China, buoyancy in demand and tight supply conditions have kept the steel prices elevated, with USA steel prices remaining firm at nearly USD 1950 per tonne in December after rallying from USD 550 per tonne in June 2020 to USD 2150 per tonne in October 2021. Similarly, European steel prices despite correction after sharp rally from USD 450 per tonne in June 2020 to USD 1400 per tonne in June 2021, continued to trade firm at above USD 1000 per tonne amidst resurgent steel consumption. India has reported strongest resilience with domestic HRC prices making fresh highs at nearly Rs.70,000 per tonne in October 2021 surpassing earlier peaks of Rs.67,000 per tonne witnessed in June 2021. With expectations of improved demand conditions in seasonally better second half of ongoing fiscal and limited scope for increase in supplies, it is unlikely that there will be any significant fall in domestic steel prices in near term beyond any possible impact of cooling down of coking coal prices.

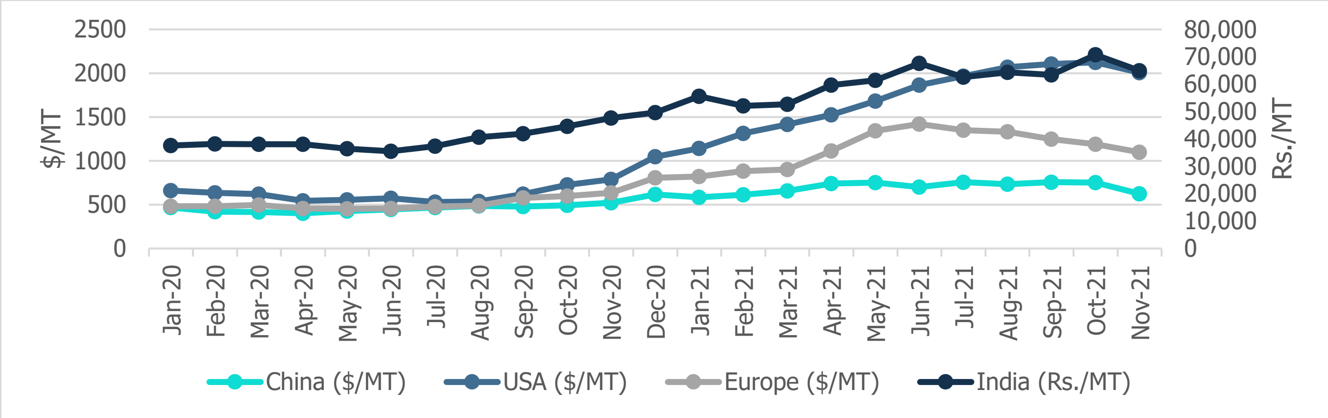

Exhibit 1: Steel Prices (Source: Steel Benchmarker and Steel Insights)

Steel upcycle impact- sizable deleveraging and fresh capex announcements

Domestic steel industry players especially the large-integrated steel producers (ISPs) have used the current upcycle to significantly deleverage their books with sizable reduction in debt levels which coupled with significant jump in EBIDTA has helped them to register unprecedented improvement in leverage, debt metrics and liquidity profile. The combined EBIDTA per tonne of top four listed players which meets more than 55% of country's steel demand has more than doubled from nearly Rs.9,300 per tonne in FY20 to about Rs.25,000 per tonne in H1FY22 due to a regime of high realizations and relatively low raw material prices especially coking coal. As a result, the gross consolidated debt to EBIDTA improved remarkably from nearly 6 times in March 2020 to less than 1.5 times by September 2021. Although these ISPs have announced fresh brownfield expansions to the tune of nearly 15 million tonnes besides their ongoing expansions, the leverage levels are expected to remain healthy on the back of continually higher steel prices and resultantly robust cash accruals. Moreover, unlike the earlier capex cycle in steel industry, the current expansions are brownfield projects which not only entail lower project costs but also comes with much lower project implementation risks vis-à-vis greenfield projects which requires land acquisitions, resettlement and rehabilitation and setting of several common infrastructure utilities.

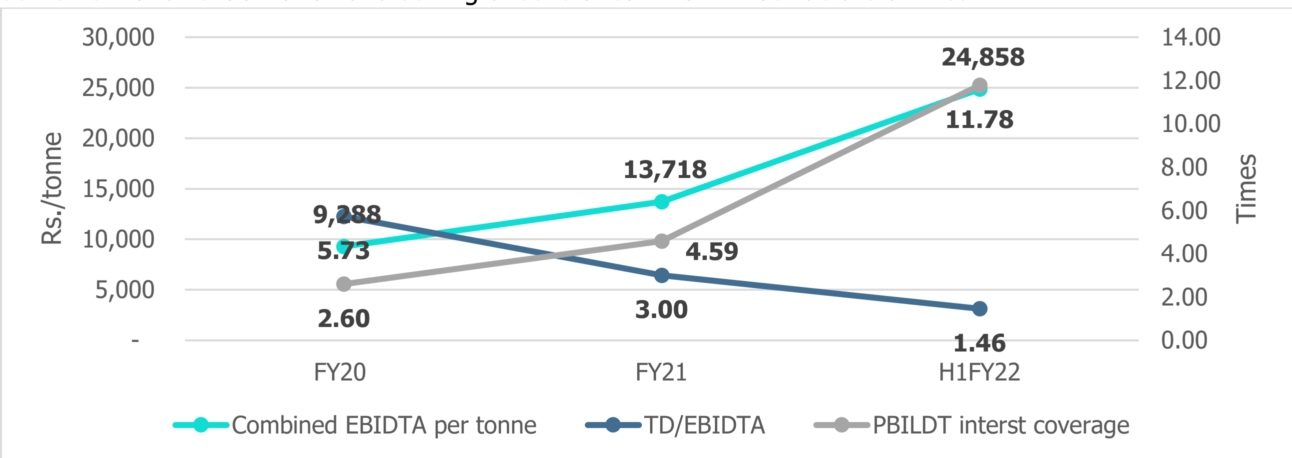

Exhibit 2: Profitability and leverage of top 4 listed ISPs (Source: CARE Rating Ltd)

Future demand supply scenario and credit outlook

As per world steel association, after a buoyant H1CY2021, Chinese steel consumption is expected to decline sharply in H2CY2021, and hence overall Chinese steel consumption is likely to dip by 1% in CY2021 and remain stagnant in CY2022, which coupled with production curbs in China is expected to result in sustained moderation in raw material prices as supply conditions also improve. However, all other major steel consuming nations such as India, USA, Japan, Korea, etc, are expected to report healthy demand growth in CY2021 and CY2022. India's domestic steel manufacturing capacity has grown at a very slow pace in the recent years from 138 million as of March 2017 to 144 million as of March 2021. During FY22 to FY25, a total crude steel capacity of about 25 million is likely to get added out of which only 7-8 million tonnes is coming onstream during FY22, while remaining capacity will take another 2-3 years to get commissioned. On the other hand, after a severely impacted year CY2020 which saw steel consumption falling to 89.3 million tonnes, India's steel consumption is expected to jump by nearly 17% to about 104 million tonnes in CY2021 and 111 million tonnes in CY2022 on the back government push on infrastructure and better demand from construction, engineering & industrials, and automotive sector.

Domestic steel consumption has already grown to 66 million tonnes in April-November 2021 from 55 million tonnes in April-November 2020. It is imperative that domestic steel demand supply conditions will remain favourable for domestic players, which coupled with likely scenario of continued low exportable surplus from China will keep the steel prices firm and spreads healthy. Going forward, the domestic prices and spreads shall, inter alia, depend on movement in raw material prices especially the coking coal, CareEdge expects domestic HRC steel prices to remain in the range of Rs.55,000 to Rs.65,000 per tonne in the near term. Furthermore, operating margins despite the likely moderation from peak levels are expected to remain in healthy range of Rs.15,000 to Rs.20,000 per tonne over next few quarters with a bias towards the upper end of the range. The leverage and liquidity for majority of the industry players is likely to remain in improving trajectory and healthy for FY22 supported by healthy cash accruals generation. Resultantly, improving trend in overall credit quality of iron and steel companies is expected to sustain in short to medium term.

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