December Steel Survey

Zombies Must Die

- We expect steel production to fall 7% in 2016.
- Demand from the property sector will drop by more than 10%, with little or no prospect of improvement.
- The government is committed to eliminating steel "zombies," and we estimate 60 MTPA of capacity was permanently shut down in Q4 2015. At this rate, excess capacity could be significantly reduced in 2016.
- SOE steel traders are faking more than 20% of steel sales to meet political requirements, and many traders are going out of business.
- We estimate 2015 production down 3% and domestic consumption down 5%, higher than consensus estimates, which are 2% down in production and 4% in domestic demand.
- Policy support has resulted in an increase in sales of auto steel.

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We expect steel production to decline by 7% in 2016, as property construction continues to decline and neither exports nor infrastructure grow. Consolidation of the steel industry and elimination of excess capacity will be the major theme of the steel sector in 2016, and Q4 2015 saw a sharp increase in steel mill shutdowns. But the shutdowns in the near term will not provide relief to the economy: fewer steel traders are able to stay in business in this contracting market, and the banks are seeing increased bad debt. Employment, too, is suffering.

New Construction: No Improvement

Our survey confirmed that steel sales to new construction projects in December remained weak nationally. Chongqing and Changsha were the exceptions, explained by the low base effect in these cities. The Shenyang steel trader in our survey supplied one new metro line project, and the Qingdao trader supplied two new property construction projects. There were no reported sales to new construction projects in other regions.

While steel traders remain hopeful for infrastructure policy support, we remain skeptical that financing problems of the LGFVs—which lie at the root of the poor sales of steel—can be solved. In 2015, centrally funded rail projects were the most reliable infrastructure projects for generating steel demand, and yet China Rail is said to have RMB 250 billion in outstanding payables for projects and will achieve only RMB 600 bln in investments in 2015 rather than the planned RMB 800 bln. We expect infrastructure steel demand to remain flat in 2016 due to continued financing constraints.

Consolidation Picks Up Speed as Zombies Are Killed Off

We have identified an aggregate 54.5 MTPA of steel capacity that has been shut down, either under the

Table 1. Steel Mills Shut Down October–December 2015

Province	Name	Capacity MTPA
Liaoning	Siping Modern Steel	1
Liaoning	Fushun New steel	3.2
Shanxi	Shanxi Haixin Steel	5
Shanxi	Shougang Changzhi Steel	3.6
Hebei	Tangshan Songting Steel	2
Hebei	Jiaxin Steel	0.72
Hebei	Chenglian Steel	0.5
Hebei	Jianyuan Steel	0.3
Hebei	QingKuang Steel	1.5
Hebei	Fufeng Steel	0.6
Hebei	Aofeng Steel	1
Hebei	Antai Steel	2
Hebei	Xinglong Steel	2
Hebei	Jianbang Steel	1.35
Hebei	Xuanhua Iron and Steel Group	6
Sichuan	Sichuan Chuanwei Vanadium	6
Sichuan	Sichuan Dagang Group	4
Anhui	Hefei Iron and Steel (Subsidiary of Maanshan Iron and Steel, SHA 600808)	1.36
Jiangxi	Jiangxi Pinggang	0.8
Fujian	Fujian Sangang Minguang (SHE 002110)	4
Inner Mongolia	Baotou Iron and Steel	7.5
Total		54.5

Source: J Capital Research

guise of being "shut down for maintenance" or explicitly labeled a permanent shut down. Mills typically shut down production lines that have low or no utilization and only later give a reason unrelated to demand for the shut down. These shutdowns are almost exclusively permanent closures.

We expected a slower pace of permanent closures and are surprised at the acceleration of this consolidation process, which seems to have been spurred by increased political will to eliminate so-called zombie companies. These are SOE companies with loss-making track records. Both the State Council and the Central Economic Work Conference made commitments in December 2015 to support local governments in meeting welfare and reemployment costs for the laid-off workers.

Additionally, steel traders are expecting further environmental regulations to result in more closures of small steel mills, which are the least likely to meet these standards.

SOEs Faking Sales and Production

All SOE steel traders in our panel reported that SOEs are faking sales to achieve the unrealistic sales targets set by management or by SASAC, the State equity owner of record. SOE steel traders swap inventory with other traders to create sales even though the transaction incurs a cost per ton of around RMB 10-15. SOE steel traders, who trade more than half of all steel in China, reported faking 20-40% of their sales in 2015.

Steel mills are rumored to be using a similar process to fake steel production to meet targets. Crude steel production growth somehow managed to exceed pig iron production by one percentage point. Since crude steel is predominately manufactured using pig iron in a blast furnace (90% of total production), production from electric arc furnaces (EAF) using scrap rather than pig iron would have had to increase visibly. We know that this is not the case: in fact, scrap steel usage by the steel industry was down 15%

Table 2. 2015 Sales and 2016 Target

City	2015 Sales	2016 Target	Outlook
Harbin North	13%	9%	
Shenyang North	-30%	No Response	No plan for 2016 yet
Qingdao North	-45%	20%	Tighter environment controls will close more small steel mills, so they can grow market share
Wuhan Central	-50%	Flat	Dependent on macro economy and could go down further
Chongqing West	-15%	Flat	Infrastructure spending will be key to 2016 sales
Chengdu West	-3%	No Response	Plan for 2016 will be made in March
Hangzhou East	-9%	Flat	
Suzhou East	-47%	No Response	No plan for 2016 yet
Guangzhou South	8%	10%	Unrealistic target forced on them by SASAC. Faking sales to meet targets.
Changsha South	-8%	No volume target	Target is to increase profit with no volume target

Source: J Capital survey conducted by telephone 28-30 December 2015

YoY in 2015. The most likely explanation for this phenomenon is steel mills are swapping steel inventory with other SOE steel mills to inflate production statistics. Steel production is therefore more likely down 3% than the expected official number of 2%.

Steel Trader Inventory: No Restocking

All steel traders continue to hold very low levels of inventory. Apart from the Hangzhou trader who restocked auto steel, steel traders continued to destock. Most traders plan to hold inventory at current levels or further destock. Two, who both had the lowest inventory levels of around one week of stock, planned to marginally increase inventory.

Financial Risks Increasing at Steel Mills

In the boom years, steel traders would pre-purchase steel one year in advance and trucks would line up outside the steel mill to take steel away. Now steel mills have overproduced and undersold to such an extent that they cannot house all their inventory, and steel traders have limited financing options. As a result, steel mills are increasingly the owners of the stock held by traders. In the northeast, 60% of steel trader stock is owned by steel mills. Steel traders have been likened to removalists, just taking the risk and cost associated with transport. Steel mills have the dueling realities of attempting to increase working capital and while taking greater receivables risk in a declining market.

Traders: Last One Out

Traders are rapidly abandoning the market. Steel traders told us that 40% of steel traders will be out of business in the new year in Wuhan. In Shanghai, the annual steel trader convention saw a 25% decline in attendance last year. Jiangsu has experienced the steepest decline: more than two thirds of traders have exited the business in the last year.

Falling Gray Market Lending Rates for Steel

One SOE steel trader who finances steel sales to property developers is reducing its interest cost from an annual rate of 41% to 30%. The company prices loans per ton of steel rather than according to the value of the steel. With falling steel prices, the lending rates have become unattractive to customers. This will have little impact on demand for steel but illustrates how low steel prices are reshaping the way steel is traded.

Table 3. Steel Trader Sales December 2015

City	MoM Dec	YoY Dec	YoY Dec	Est YoY Next 3 Mon 2015	Est Regional Sales YoY Dec 2015	Trader Notes
Harbin North	0%	0%	0%	0%	0%	No construction in winter months
Shenyang North	-70%	0%	NA	0%	15%	A new high-speed rail project and two metro projects started. Other construction halted for winter.
Qingdao North	10%	7%	-18%	7%	40%	November steel price and sales very low. Steel price and sales improved in December. 2 new projects started.
Wuhan Central	-8%	-10%	NA	-5%	-20%	Very weak demand
Chongqing West	6%	-15%	NA	-20%	-15%	Medium plate (heavy industrial use) down 30%, auto steel up 20%. Chongqing Iron and Steel halted production for a period which pushed up prices of some steel types.
Chengdu West	-42%	-39%	4%	0%	-5%	Sharp drop in demand as property projects reached completion and focused on sales not new construction.
Hangzhou East	49%	1%	NA	7.5%	31%	Auto sector sales up sharply following positive sales from the lower tax policy on small vehicles. Some steel types are stock out. Expect sales to remain up through to March 2016. Expect further policy support for auto sector.
Suzhou East	-13%	-49%	-30%	0%	-70%	Very poor construction demand. Most construction sites shut down in January and February.
Guangzhou South	0%	-5%	-5%	-50%	0%	Final demand flat but SOE traders were all busy making fake sales to one another. Early CNY will see lower sales YoY in the Jan Feb.
Changsha South	12%	3%	NA	-13%	3%	Several steel mills stopped producing and which led to channel restocking ahead of those closures. Auto sector orders orders also improved.

Source: J Capital survey conducted by telephone 28-30 December 2015

Table 4. Steel Mill Inventory December 2015

City	YoY Dec	Notes
Harbin North	20%	Steel traders are not restocking, causing inventory to rise. Inventory of rebar was 700,000 tons in 2008/09, in 2014 it was 300,000 now it is back to 700,000 tons.
Shenyang North	-50%	Steel mills that are still operating are focused on selling steel in South China.
Qingdao North	NA	Production of rolled steel down 30%, construction steel down 5%.
Wuhan Central	-5%	Some steel mills have closed.
Chongqing West	-12%	Chongqing Iron and Steel halted production and this had a clear impact on inventory reduction at steel mills
Chengdu West	0%	Normal levels of inventory, there is one mill producing intermittently
Hangzhou East	-20%	Huai Steel Jiangyin Steel and Boasteel all have reduced production of wire rod. There was a surge in sales of wire rod in November and December that led to a rapid destocking of this category of steel.
Suzhou East	-40%	Production of steel has slowed considerably. Shagang Steel is selling rebar at RMB 1,700 ton.
Guangzhou South	-15%	Steel mills are running down inventory.
Changsha South	-15%	Steel mills are reducing production, some product types have low inventory levels. Steel prices have started to improve and this is encouraging some steel traders to restock.

Source: J Capital survey conducted by telephone 28-30 December 2015

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