

October 26, 2016

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## Survey Structure

- ▶ The total amount of steel traded by the survey group is 2.5 mln tons or 0.3% of domestic steel consumption. Each survey participant is one of the top five steel traders in its respective province. The 10 provinces covered in this survey consume approximately 63% of all domestically consumed steel in China.
- ▶ Our past surveys have proven good predictors for industry trends on a quarterly aggregate basis but the respondents demonstrate high volatility and significant regional differences.
- ▶ Repeat sources: All
- ▶ Interviews conducted October 17-21, 2016

## Objectives

- ▶ To understand the current demand and outlook for steel from construction and manufacturing endusers of steel. We survey sales, inventory, financing, and the industry environment to build a picture of demand and outlook.

## Steel Survey Q3 2016

# Property Boom Finally Drags Up Steel Demand

- ▶ Steel demand grew by around 5% in Q3 and expectations are for continued growth in Q4.
- ▶ Auto, infrastructure and property construction drove growth.
- ▶ We can expect growth in new infrastructure projects to maintain strong infrastructure growth into 2017. Auto and property demand expected to peak in Q4.
- ▶ New transport restrictions have increased steel costs by RMB 100 – 300/ton and could be the key price driver for steel in October – not demand.
- ▶ Steel traders are destocking in Q4.
- ▶ Steel mills are starting to overproduce, iron ore and coal price have risen faster than steel and most steel mills are now making losses. We expect steel production to fall in November.

**W**e estimate domestic steel demand grew around 5% in Q3. Every region, with the exception of the perennial underperformer Northeast China, showed good growth in Q2. Auto, infrastructure, and property construction were the key drivers of growth. We estimate that growth will continue into Q4 with most regions expecting growth in the range of 0-15%.

## Construction: Driving Demand

Property construction was a key driver of steel sales in the key markets of South and East China and was flat to down in North and Northeast China. Construction from new starts was up dramatically in Guangzhou and was strong in Suzhou and Changsha. Steel traders stated that construction demand would remain strong in Q4, as property under construction has been sold, and some regions that have lagged in price increases, like Chengdu and Chongqing, are experiencing a sales boom in Q4. Most traders believe new restrictions will curtail new construction, and they expect steel sales related to property

Increased funding of infrastructure has boosted sales to projects under construction and accelerated preparations for new projects.

**Table 1. New Property Construction Projects (% of Sales)**

	Harbin	Shenyang	Qingdao	Chongqing	Suzhou	Guangzhou	Changsha
<b>Q3 2016</b>	15%	5%	4%	15%	40%	70%	32%
<b>Q3 2015</b>	0%	20%	5%	15%	30%	20%	25%

Source: J Capital

construction to trend down in 2017.

Construction steel traders all cited strong infrastructure sales as a growth driver even though their sales to new infrastructure projects are lower than last year. We see this as a positive. Increased funding of infrastructure has boosted sales to projects under construction and accelerated preparations for new projects. We expect improved growth in new infrastructure projects to be a key driver of growth in Q4 and Q1 in 2017. Steel traders indicated they have tenders in hand for a lot of new projects.

**Table 2. New Infrastructure Projects (% of Sales)**

	Shenyang	Qingdao	Chongqing	Chengdu	Guangzhou	Changsha
<b>Q3 2016</b>	5%	6%	10%	0%	30%	0%
<b>Q3 2015</b>	20%	4%	15%	0%	80%	9%

Source: J Capital

### Strong Auto Sales

All steel traders selling to manufacturers reported very strong sales to the auto sector. Most felt this demand was peaking, as buyers had purchased cars ahead of the expected expiry of tax concessions on smaller cars.

### Increased Transport Costs Driving Steel Prices in October

New rules implemented on September 18 limiting truck weight have driven up the cost of steel transport by 30–50%, or RMB 100–300 per ton depending on the proximity of the market to steel mills.

### Steel Traders Destocking

Nearly all traders told the same story. They had restocked too heavily when prices rose and are still in the process of selling down inventory.

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**Table 3. Steel Trader Sales (Q3, Q4 2016 estimated)**

City	2016 Q3 Sales (Distributor)	Demand in Q3	2016 Q2 Sales YoY	2016 Q3 Sales YoY (Region)	2016 Q4 Sales YoY	Demand in Q4
<b>Harbin North</b>	-15%	From August, sales collapsed, particularly those sales related to construction demand. This year there are no private projects, only SOEs.	0%	-20%	0%	We have had no orders since August and we will get no orders in winter.
<b>Shenyang North</b>	20%	Infrastructure demand is driving all growth. Underground utilities tunnels are the main source of demand.	30%	20%	0%	No sales in winter
<b>Qingdao North</b>	7%	Low season. Price volatility is very high. Steel mills are restricting output. Rising prices led to some customers restocking, generating modest growth.	7%	10%	15%	Demand from autos, white goods, exports, and property sector all better than last year.
<b>Wuhan Central</b>	0%	August was a very low month, July and September stronger. Excessive heat caused work to stop at construction sites for 20 days in August	5%	-3%	2%	Sales and prices should improve in Q4.
<b>Chongqing West</b>	15%	Strong demand from the auto sector. Infrastructure, particularly rail, has improved significantly. Lower production at steel mills has restricted supply.	-15%	5%	15%	Property construction is expected to pick up in Chongqing. Chongqing has not experienced the price rises of other Tier 2 cities. In anticipation of coastal buyers descending on the city over the October holiday, some properties saw price rises of 30%.
<b>Chengdu West</b>	-13%	Very dismal market, end of August beginning of September was slightly better.	-38%	-25%	-20%	At best, demand will be flat on last year, but it is most likely to continue to trend down.
<b>Hangzhou East</b>	27%	Strong and improving demand from the auto sector. The new transport rules are increasing costs to steel mill and traders so are pushing up price.	13%	15%	3%	Q3 was negatively impacted by the G20, so a lot of manufacturers stockpiled steel. Sales in October have been very slow.

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City	2016 Q3 Sales (Distributor)	Demand in Q3	2016 Q2 Sales YoY	2016 Q3 Sales YoY (Region)	2016 Q4 Sales YoY	Demand in Q4
<b>Suzhou East</b>	9%	Stronger property construction demand.	-40%	30%	0%	Expecting construction to slow following real estate restrictions in October.
<b>Guangzhou South</b>	33%	Strongest demand is from wholesalers speculating. New property construction demand is also strong. Supply restrictions leading to stock out.	120%	10%	12.5%	Q4 is a good period for construction. The weather is good for construction, and we expect stronger demand.
<b>Changsha South</b>	5%	Good demand from the property and auto sectors. Prices rising for most of Q3.	-3%	7%	0%	Expect the market to flatten. Real estate now has reintroduced restrictions and there is uncertainty about extending the tax exemptions to cars with engines of 1.6 liters or less.

**Table 4. Steel Trader Inventory Q3 2016**

City	QoQ	YoY	Q4 Estimate	Notes
<b>Harbin North</b>	-20%	-10%	-50%	We always reduce inventory in winter. This year we started one month earlier.
<b>Shenyang North</b>	-30%	100%	-70%	Last year was terrible and we had no stock. This year we have a small amount of stock.
<b>Qingdao North</b>	-65%	40%	0%	We restocked a lot as prices rose. We have been destocking since July but we overstocked so still have a lot more stock than last year.
<b>Wuhan Central</b>	0%	0%	5%	No big change, slightly up in Q4 as we held very low stocks in Q4 last year.
<b>Chongqing West</b>	-30%	-25%	15%	Our stocks are low as prices rose too fast in Q2 and we could not order from Chongqing Iron and Steel.
<b>Chengdu West</b>	300%	100%	-50%	Our stocks are a little high so we will run them down.
<b>Hangzhou East</b>	8%	-17%	-5%	We ordered a lot of stock in advance of the G20 in September. A lot of the stock did not arrive until October, when demand fell. Our stocks are at the highest for this year. We will destock in Q4.
<b>Suzhou East</b>	50%	90%	0%	We stocked up in Q3 due to increased property construction. We will destock in Q4.
<b>Guangzhou South</b>	-16%	-36%	-15%	Sales increased and we sold more direct from the steel mill. Inventory will fall as we destock as sales improve.
<b>Changsha South</b>	-30%	10%	20%	Our inventory was very low last year. Our levels now are a little low for demand and supply is a little constrained. We will restock in Q4.

**Table 5. Steel Mill Inventory Q3 2016**

City	Increase YoY	Reasons
<b>Harbin North</b>	-5%	Maintaining operations-level inventory. Production reduced from September.
<b>Shenyang North</b>	30%	Steel mills in the north are building stocks to sell in South China.
<b>Qingdao North</b>	Private 20% SOE – 30%	Private steel mills have overproduced as they borrowed money to produce as much as possible in H1. SOE steel mills reduced production and have low levels of inventory.
<b>Wuhan Central</b>	-3%	Since Wuhan Iron and Steel merged with Baosteel, the company has stopped adding to inventories of low-value steel to align with Baosteel strategy of focusing on high value steel
<b>Chongqing West</b>	-30%	Chongqing Iron and Steel has reduced production and so has reduced inventory.
<b>Chengdu West</b>	-20%	The Sichuan government is controlling the output of the smaller steel mills.
<b>Hangzhou East</b>	-10%	As auto steel sales have been good, steel mills have been able to keep inventory at lower levels.
<b>Suzhou East</b>	0%	Normal inventory levels.
<b>Guangzhou South</b>	-25%	There have been a lot of environment-related inspections as well as production control and maintenance shutdowns, so this has influenced inventory levels.
<b>Changsha South</b>	-15%	Steel mills have been requested to reduce production.

Source: J Capital

**Data Matters**

# Steel Heading into Overproduction in October

Steel production, since falling dramatically in January, grew modestly around 2% YoY in subsequent months and is now flat YTD September. Improved steel demand with lower production and inventory pushed up prices and helped steel mills to achieve one of the best periods of profitability in recent years. Improved profits led to improved cash flow at steel mills that have been starved of credit since early 2015. This has enabled steel mills

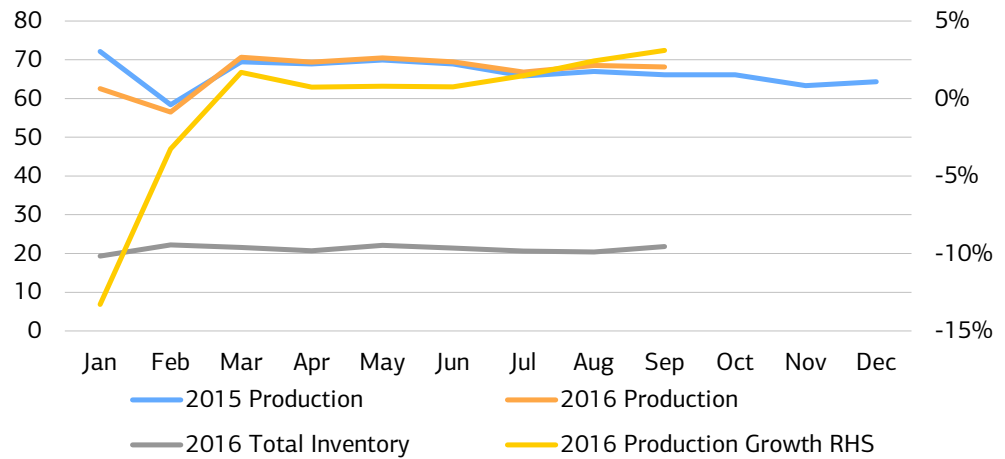
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to increase production.

Steel production grew 3% in September and appears to be following that trend in October. Cost of inputs have risen at a faster pace than steel prices and steel margins have now turned negative again. Average losses per ton are now around RMB 100. Over 80% of steel mills reported being profitable at the beginning of September and by mid-October that has fallen below 50%.

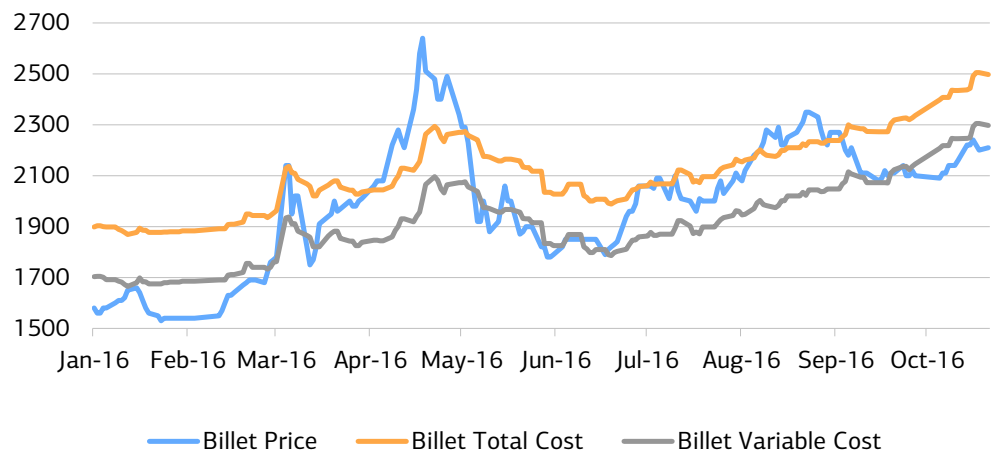
Despite a positive outlook for steel demand and improved cash flows steel mills cannot tolerate losses, and we expect that production will start to decline from November.

### Chart 1. Steel Production and Inventory



Source: Mysteel

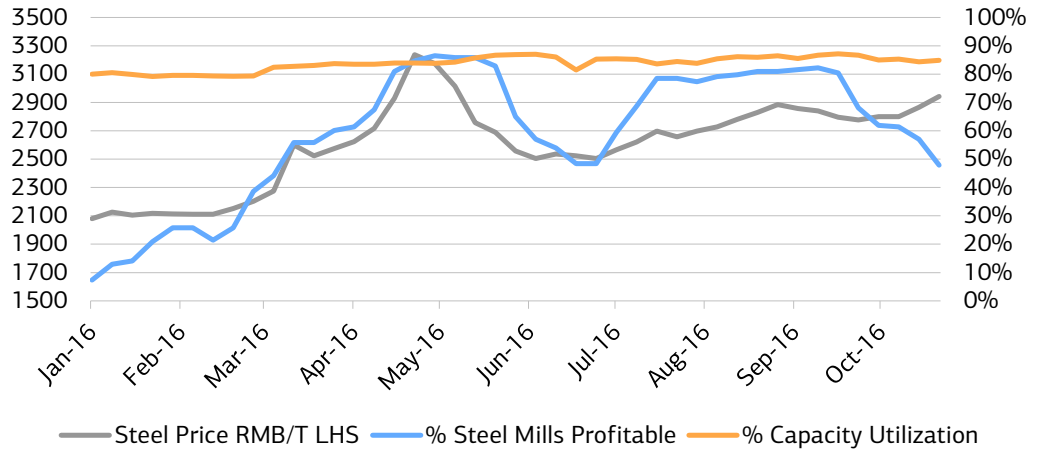
### Chart 2. Billet Price and Cost RMB/Ton



Source: Mysteel

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**Chart 3. Profit, Price, and Capacity Utilization**



Source: Mysteel

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