JCAP

Survey China

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Survey Structure

- Survey of 10 steel traders supplying: 5 Construction industry only; 2 Manufacturing industry only; 3 Construction and manufacturing.
- Regional: 2 East China; 1 South China; 2 Central China; 3 North China; 2 West China.
- Ownership type: 4 SOE; 6 private.
- 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 Dec. 7-12, 2016

Objectives

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

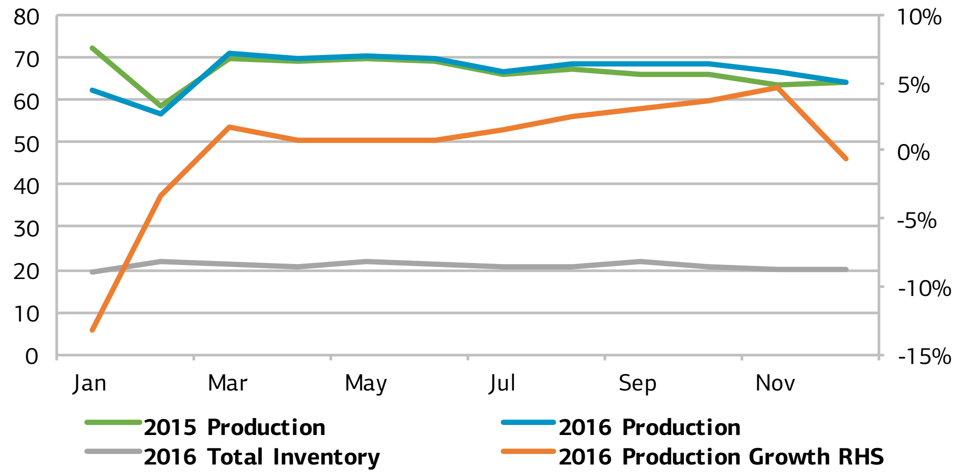
Steel Survey Q4 2016

Production Slows, Profits Surge

- Lower production, not higher demand, is holding up steel prices.
- Demand flat for full-year 2016. After a dramatic year of rapid price increases in steel and housing plus increased infrastructure spending, we finish the year with domestic steel demand the same as last year. Steel production will be 800 MMT in 2016; and steel exports YTD November are 101 MMT, both the same as 2015.
- Steel mill profitability is sharply up in December: Higher prices have been sustained by production cuts.
- Capacity reductions are starting to be felt in the market: Many survey participants stated that small steel mills are being closed around the country for environmental reasons.
- Q4 steel sales are down YoY in most regions: Where sales are up, it is due to restocking and not improved demand.
- 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.
- New infrastructure starts disappoint: We had expected more new infrastructure projects to start in Q4, they are down YoY in every region we surveyed.
- We expect iron prices to fall significantly in Q1: Falling steel production and high levels of port and steel mill inventory of iron ore will see iron ore prices slide even if steel prices remain high.

We expect steel production in December to be 62 MMT or less, down 3-4% MoM and flat to down 1% YoY. Every survey participant said steel mills were slowing production and running down inventories. Data from the market research firm Mysteel is indicating that blast furnace operating rates fell from 79% in October to 77% in November and 75% in December. Slowing production is propping up steel prices.

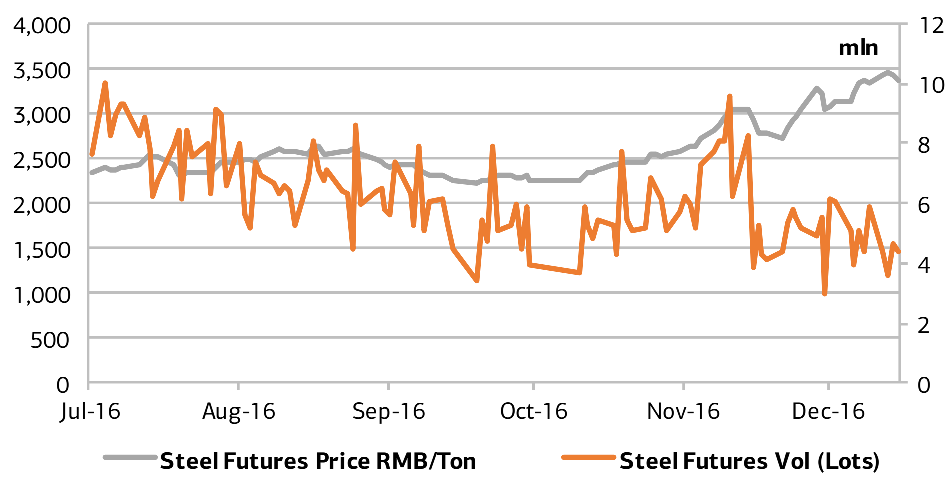
Chart 1. Steel Production and Inventory MMT



Source: Mysteel

Steel prices shot up 15% or more in November, but most of the increase was driven by the high volume of speculative trading on futures markets. December futures trading fell sharply, but steel prices rose another 15% as steel mills slowed production.

Chart 2. Steel Futures



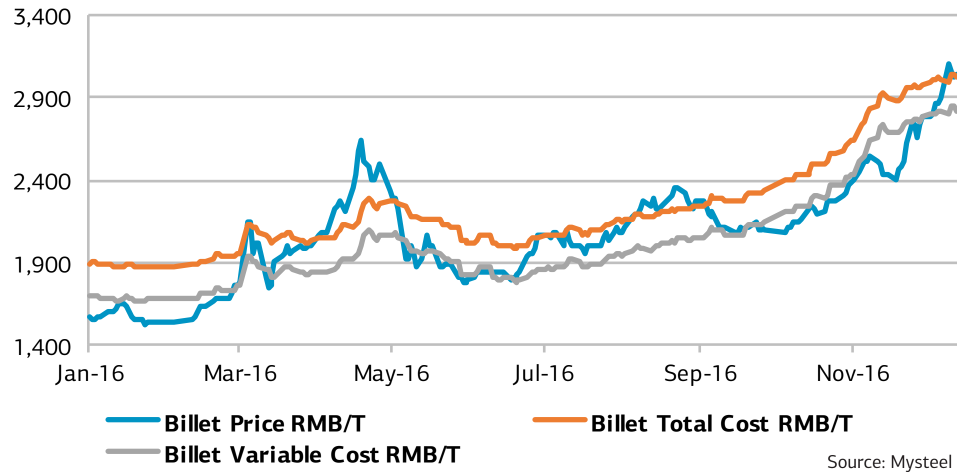
Source: Wind

In early December, steel mills have been making good profits on steel sales. Billet steel margins went positive in the second week of the month, and the Mysteel blast furnace survey saw steel mills reporting profitability increase from 44% at the end of November to 70% in mid-December.

Steel Demand Flat

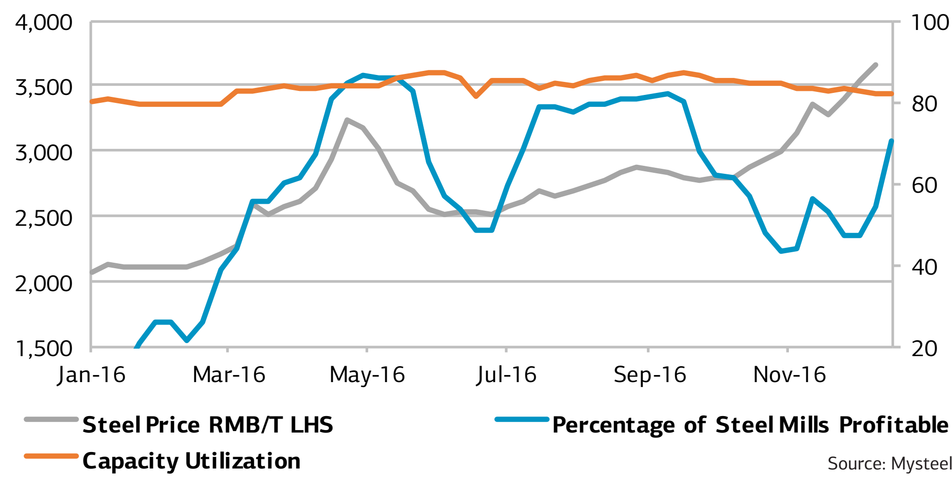
We had expected Q4 to be the last quarter of growth for construction. It turns out that construction demand was flat. New property construction

Chart 3. Billet Price and Cost RMB/Ton



Source: Mysteel

Chart 4. Profit, Price, and Capacity Utilization



Source: Mysteel

was up in South China and down in the rest of China, with total property construction demand flat. The greater disappointment was infrastructure demand. We had expected a surge in new project starts but they were down in every region in the survey.

The only positive area for demand was improved sales to truck manufacturers. The recent tightening of restrictions on truck payloads has led trucking companies to upgrade their fleets to trucks that can legally carry heavier loads.

Sales have relied on restocking by steel wholesalers, who see rising prices and want to stock up.

Table 1. New Property Construction Projects Q4 (% of Sales)

	Harbin	Shenyang	Qingdao	Chongqing	Suzhou	Guangzhou	Changsha
Q4 2016	0%	0%	0%	10%	20%	60%	30%
Q4 2015	10%	0%	5%	15%	30%	20%	26%

Source: J Capital

Table 2. New Infrastructure Projects Q4 (% of Sales)

	Shenyang	Qingdao	Chongqing	Chengdu	Guangzhou	Changsha
Q4 2016	0%	0%	15%	0%	40%	0%
Q4 2015	10%	0%	25%	0%	80%	8%

Source: J Capital

Table 3. Steel Sales Growth Q4 2016

City	2016 Q4 Sales (Distributor)	Demand in Q4	2016 Q3 Sales YoY	2016 Q4 Sales YoY (Region)	2017 Q1 Sales Est. YoY	Demand in Q1 2017
Harbin North	-20%	This is the slow period, but this year is unusually slow. Prices are too high. When prices rise, sales fall. Demand has fallen all year but at a faster rate in Q4.	-15%	-20%	-10%	Developers are not positive, so we expect sales to continue to fall.
Shenyang North	100%	The second half has been much better than last year and we have purchased stock low and sold high.	20%	80%	50%	Property about the same as last year but we are selling a lot to exporters.
Qingdao North	12%	End of year restocking, particularly from white goods. Demand is not up. Increasing prices are leading to restocking	7%	0%	20%	There was not much restocking in Q1 this year but we expect more in Q1 2017
Wuhan Central	0%	Demand from construction is good. Rising prices has led to restocking and good profits for steel traders	0%	40%	10%	Expecting prices to rise through December. There will be little price risk through to April.
Chongqing West	-20%	Prices have skyrocketed and end demand has fallen as clients buy less. Steel mills have slowed production, and orders are being filled slowly. Steel traders are just buying as they need steel.	15%	-20%	-15%	Industrial demand for steel will fall from the End of December until April as production slows. We are expecting property and infrastructure demand to be lower next year.

City	2016 Q4 Sales (Distributor)	Demand in Q4	2016 Q3 Sales YoY	2016 Q4 Sales YoY (Region)	2017 Q1 Sales Est. YoY	Demand in Q1 2017
Chengdu West	-50%	End demand is not great, prices are up and so that is good but sales down a lot and steel is hard to buy.	-13%	-10%	0%	Should be about the same as last year, prices may be better.
Hangzhou East	12%	Trucks sales are up, as the new transport restrictions are forcing truckers to upgrade trucks. Sales to truck and engine manufacturers up significantly. Rising prices are causing end customers to hoard inventory – end consumption is not rising.	27%	10%	10%	We are expecting good sales as customers restock ahead of Spring Festival. Steel mills are slowing production and orders are exceeding production.
Suzhou East	-16%	Prices are rising, the environmental agencies have been inspecting and closing some electric arc furnaces and demolishing some blast furnaces. Traders are restocking and pushing prices up.	9%	-5%	0%	Flat on last year. No construction demand. Mainly just traders restocking.
Guangzhou South	80%	Rising prices have led to speculation and restocking. Spring Festival is early this year and so restocking is earlier. There is a lot of trading activity but end demand is no better.	33%	20%	-100%	Going into new year sales will be very low
Changsha South	10%	Demand is greater than supply. Property construction demand is good.	5%	7%	5%	Expecting a small increase. Q1 will definitely be better than last year.

Source: J Capital

Table 4. Steel Trader Inventory Q4 2016

City	QoQ	YoY	Q1 Estimate	Notes
Harbin North	No inventory	-20%	0%	The steel mills have not given us the winter restocking price and terms. At current prices, we will not restock. We expect next year to be down on this year, so we will not restock much.
Shenyang North	30%	100%	0%	We previously had a zero-inventory strategy. With rising prices, we are holding stock now.
Qingdao North	-18%	40%	30%	With rising prices if you hold stock you are making money. When we can get stock from the mill, we will.

City	QoQ	YoY	Q1 Estimate	Notes
Wuhan Central	30%	30%	10%	We are slowly rebuilding stock to support sales.
Chongqing West	-40%	-60%	-15%	Prices are too high so we are not holding inventory
Chengdu West	-60%	-35%	0%	We sold a lot of stock in November, and with these high prices we are not restocking.
Hangzhou East	-21%	-31%	10%	Confidence has returned and everyone wants to restock. There is a shortage of specialty steel. We cannot buy enough stock.
Suzhou East	-23%	33%	-95%	We still have a few construction projects we are supplying. In Q1 we will destock.
Guangzhou South	-50%	-40%	100%	This year there is a lot less steel from the north being sold in the south is a lot less.
Changsha South	10%	30%	0%	We would like to buy more stock. Steel mills are slowing production and delivering stock slowly.

Source: J Capital

Table 5. Steel Mill Inventory Q4 2016

City	Increase YoY	Reasons
Harbin North	No Inventory	Steel mills are all watching the market and operating at the lowest capacity possible. They are only operating half of their blast furnaces. The price of steel has been very erratic.
Shenyang North	-60%	Steel mills cannot keep up with orders. They do not have enough coking coal. They have plenty of iron ore.
Qingdao North	-20%	With high prices, steel mills are selling steel fast and stocks are low.
Wuhan Central	-35%	Wuhan Iron and Steel capacity has been reduced by around 40%. They have demolished 4 MMT of capacity.
Chongqing West	-15%	With prices rising, there is a shortage of stock. Distributors are short of stock so you have to be quick to order.
Chengdu West	-20%	Sales are good and inventory is low at mills. Some categories of steel are stock out.
Hangzhou East	-15%	Supply cannot keep up with demand. Special steel is very short on stock. Everybody is fighting to get special steel.
Suzhou East	-30%	Steel mills are all reducing capacity. Inputs are all at high prices, so they are reducing capacity.
Guangzhou South	-30%	Input prices have risen steeply and environmental regulations have impacted production. So steel mills are producing less.
Changsha South	-30%	Inventory is low, as steel mills are reducing production. There have been a lot of environmental inspections closing smaller mills. A lot of the other steel mills have been shutting down blast furnaces. Production in December is down 10% on last year.

Source: J Capital

Notable Quotes

"Some steel plants in the North-East owe money to distributors. This has influenced steel traders to not restock in the winter. Steel traders have lost confidence in steel mills." North East China

"With rising prices, traders that can get stock have made money" North East China

"The government has been firm in closing down inefficient and polluting steel mills. We expect more blast furnaces to be eliminated next year. This will put further downward pressure on production and will push prices up. We are stocking up on rebar as we expect a good construction market next year. There are a lot of new projects starting next year in Hebei and Shandong." North China

"Prices have risen a lot this year. It has not been from improved demand but rather from less supply. Most steel mills have reduced production by around 30%. Steel mills are producing less steel for industrial use. There are shortages of some types of steel and so prices are rising." Central China

"Since the government put restrictions on real estate, there has been more money flowing to futures. There have been a lot of speculative increases in prices pushing up the input costs of steel." Central China

"Profits have increased this year. We have good orders all the way through to April. So we expect the positive profit direction to continue." Central China

"Lately around 80% of steel mills have been reducing production. A lot of reduced production is due to environmental reasons." Central China

"This price increase has been induced by government policy to drive up GDP and PPI. Demand has not improved anywhere near how prices have increased. Production is not up this year and everyone is keenly aware that speculation has been a key price driver. "This year a lot of auto part manufactures that are heavily exposed to steel prices have all made losses and several have gone out of business." West China

"We made more money this year than last year even though we were more conservative about risk this year" West China

"The central government has sent several inspections teams to the province this year. A lot of steel mills have been required to stop production. A lot of electric arc furnaces (EAF) have been shut down. This has reduced supply and pushed up prices. " East China

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"In November, the Central government environment inspection teams had a big impact on the province as several small steel mills were forced to close. These inspections are continuing. We are always expecting an announcement every few days that another steel mill will be closed. Thus, some steel types are in shortage." East China
"There is a lot of speculation in the market based on announcements of government policy. We do not believe prices will to continue to rise as there is not very strong demand. Now steel traders are relying on steel wholesalers restocking. With these high prices, there is much lower enthusiasm for restocking by wholesalers." – East China
"A lot of small steel mills are being pushed out of the market by government regulations. Large steel mills are increasingly selling directly to end customers. There is now reduced opportunity for steel traders and this is a strategic threat." South China
"The reduction in production capacity has fed speculation in commodities markets. This has caused an explosion in price" South China

Source: J Capital

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