JCAP

Survey China

July 6, 2017

Tim Murray
tim@jcapitalresearch.com

Ada Wang
ada@jcapitalresearch.com

+852 2534 7405

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 June 19-23, 2017

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

Past the Peak

- We expect demand to slow in Q3 and decline in Q4.
- Inventory of steel at steel mills is low, and inventory in the market is slightly elevated. Steel traders are telling us they will destock next month.
- Steel mills have not slowed production and steel traders now believe they are overproducing.
- We expect iron ore prices to fall back to USD 50/ton as production slows in Q3.
- Demand from the auto sector is unusually weak.

Following the best quarter for the steel industry in the most recent five years we now expect steel demand growth to fall in Q3 and potentially decline. We estimate steel mills are now overproducing and that steel and iron ore prices will decline in Q3. We now expect iron ore prices to fall to around USD 50/ton in Q3.

Steel demand was strong in Q2, driven by property and infrastructure construction. Our survey indicated that 60% of steel traders had strong growth YoY, 30% had flat sales, and only 10% reported negative sales. New property projects were strong but less so than last year, as sales derived more from existing projects. New infrastructure projects and existing projects were both strong.

Demand from manufacturing, and autos in particular, was weak. All steel traders supplying the auto sector said sales in all regions had declined.

The Q3 demand outlook is poor. Some 50% of traders expect growth YoY, but lower growth than in Q2. Another 30% expect sales to fall, and 10% that sales will be flat.

Most traders—80%—plan to destock inventory. There is a general belief that steel mills are now over-producing.

The Q3 demand outlook is poor. Some 50% of traders expect lower growth than in Q2. Another 30% expect sales to fall, and 10% that sales will be flat.

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

	Harbin	Shenyang	Qingdao	Chongqing	Suzhou	Guangzhou	Changsha
Q2 2017	0%	0%	15%	30%	30%	20%	28%
Q2 2016	15%	0%	0%	20%	40%	33%	30%

Source: J Capital

Table 2. New Infrastructure Projects (% of Sales)

	Shenyang	Qingdao	Chongqing	Chengdu	Guangzhou	Changsha
Q2 2017	10%	0%	10%	80%	10%	0%
Q2 2016	30%	0%	5%	67%	8%	9%

Source: J Capital

We think the steel and iron ore markets have peaked for 2017. Available data is indicating demand for steel is strong. Steel mill production utilization rates and profitability remain at recent highs. Iron ore prices have rebounded to USD 65/ton and port stocks are high but declining. Domestic iron ore production remains at recent high levels of utilization. Steel mill steel inventory is down 9% YoY, steel inventory in the market is up 7% and trending down. This is what we should expect as the market peaks.

Survey Demographics

10 steel traders supplying
- 5 construction industry only
- 2 manufacturing industry only
- 3 construction and manufacturing

Ownership type:
- 4 SOE
- 6 Private

Regions represented:
- 2 East China
- 1 South China
- 2 Central China
- 3 North China
- 2 West China

Table 3. Steel Trader Sales (Q2, Q3 2017 estimated)

City	2017 Q2 Sales (Distributor)	Demand in Q2	2017 Q1 Sales YoY	2017 Q2 Sales YoY (Region)	2017 Q3 Sales Outlook YoY	Outlook for Demand in Q3 2017
Harbin North	18%	Our old clients are building more. This is not typical of the whole market in Harbin. The market in general is not good. The real estate market is doing well but developers are reluctant to start new projects. High-speed rail projects are positive for demand.	10%	-10%	10%	Our clients are doing well, they have good cash flow.
Shenyang North	50%	End demand is good and there has been some restocking.	10%	20%	20%	We expect more projects to start up in the second half. We have bids on many Infrastructure and utilities tunnels.
Qingdao North	10%	We are now helping steel mills do direct sales. The market is not that great compared to the surge we had last year in Q2.	12%	-30%	-30%	The second half last year was crazy. We will not match those sales this year. This year we are not expecting customers to build inventory.
Wuhan Central	0%	Demand same as last year. Construction steel demand is up and industrial demand from auto and white goods is flat	-5%	5%	4%	Expect Q2 trends to continue
Chongqing West	15%	Many new projects, we are supplying two new factory construction projects. Construction is up and industrial demand is down. Steel prices are falling.	15%	10%	10%	We have added a Hyundai supplier as a client. Hyundai and Changan demand are both falling. Our current construction projects will keep our sales up in Q3. We need to get new manufacturing clients to maintain growth.
Chengdu West	115%	Old customers have more construction projects this year. Both property and infrastructure demand is strong. Our wholesale customer demand is also strong.	400%	10%	0%	We can see sales slowing in June. Q3 is normally a slow period. We expect end demand to weaken.

Tim Murray tim@jcapitalresearch.com **Ada Wang** ada@jcapitalresearch.com +852 2534 7405
See final page for disclaimers.

City	2017 Q2 Sales (Distributor)	Demand in Q2	2017 Q1 Sales YoY	2017 Q2 Sales YoY (Region)	2017 Q3 Sales Outlook YoY	Outlook for Demand in Q3 2017
Hangzhou East	-9.8%	Decline was larger than expected: 1) Korean auto sales were impacted by the THAAD issue. Korean brands stopped production. 2) Orders for auto parts slowed. 3) Auto manufactures had high inventory levels. Auto and auto parts sales have declined YoY. Policy brought forward consumption in 2016.	11%	-8%	-10%	We are expecting the trends of Q2 to continue in Q3. Sales should improve in Q4 as subsidies roll off in 2018 and it is a peak sales period for autos.
Suzhou East	0%	Construction level is about the same as last year	-21%	0%	0%	Will be flat YoY and down on Q2 10%. We don't have any new projects starting and we expect a drop off in August.
Guangzhou South	230%	Steel prices are higher in the South so Northern steel mills are sending more steel. We are building a bigger warehouse. The overall market is down from June.	15%	-30%	-25%	Demand is weakening. We can see the tremors in the futures markets.
Changsha South	0%	When prices fell at the end of March, sales improved for a period. Property construction and infrastructure have been ok. Auto sector demand is poor.	-3%	2%	5%	Prices seem stable, property construction is stable. Manufacturing demand is better than it has been in the last few years.

Tim Murray tim@jcapitalresearch.com **Ada Wang** ada@jcapitalresearch.com +852 2534 7405

See final page for disclaimers.

Table 4. Steel Trader Inventory Q2 2017

City	QoQ	YoY	Q3 Outlook	Notes	Could steel mills meet demand in Q2?
Harbin North	-50%	-10%	-5%	Inventory is lower because sales have been strong. We are controlling inventory as some customers have not paid us and we need to be careful with cash.	A few items hard to source
Shenyang North	-30%	100%	-20%	Last year we did not hold inventory. This year we did. Demand and sentiment strong. We need to sell down inventory before we restock.	Supply is slightly tight
Qingdao North	5%	-35%	-20%	Last year with rapidly increasing prices we bought whatever we could buy. This year we are only buying when we have orders. We will sell down in Q3 as steel mills will produce less.	Some rebar types are stock out.
Wuhan Central	-15%	0%	-5%	Demand from construction, whitegoods, auto, shipbuilding, and electrical is only okay. Prices are about to fall, orders from wholesalers are flat. So inventory has not changed much.	There are shortages in some hot selling product types.
Chongqing West	-20%	-25%	10%	Prices were high at the end of the month so we did not restock.	No problem steel mills are producing at high rates.
Chengdu West	-50%	0%	-15%	We are concerned that we are overstocked and have cash flow pressure so we will reduce inventory.	No problem – steel mills are making RMB600 – 700/ton and producing as much as they can.
Hangzhou East	-15%	5%	-5%	Demand is softening seasonally and so we will reduce inventory. Some steel types have been short so we have stocked up on those types.	As rebar has been selling so well, steel mills have shifted production to focus on rebar. As a result some steel types are in shortage.
Suzhou East	42%	21%	0%	Inventory is high. We are restocking at normal rates but sales are not great. Last year we had trouble with supply at this time.	No problem
Guangzhou South	-10%	45%	-20%	Prices in North China have been lower so we have stocked up. Wholesalers are being cautious with inventory. Steel mills in the north are selling more direct. So we will destock next quarter	No problem
Changsha South	-15%	-30%	10%	Falling prices made us dump stock. Wholesaler demand was down and steel mill stocks are high. Now prices are increasing and we will restock.	No problem

Tim Murray tim@jcapitalresearch.com **Ada Wang** ada@jcapitalresearch.com +852 2534 7405

See final page for disclaimers.

Table 5. Steel Mill Inventory Q2 2017

City	Increase YoY	Reasons
Harbin North	-10%	Steel mills are having their best year ever. The only reason they have any inventory is because their logistics cannot keep up with sales.
Shenyang North	0%	Normal levels of inventory
Qingdao North	0%	Inventory is normal now. Steel mill inventory went up in April when prices rose and then down when prices fell in May June
Wuhan Central	-10%	Construction steel is sold as soon as it is produced. Industrial steel is only made to order.
Chongqing West	15%	Construction steel is priced high so traders don't want to buy. Industrial steel price is low but so is demand. So inventory is rising. We are in a speculative period
Chengdu West	0%	It looks installed capacity is increasing
Hangzhou East	-15%	Stocks are low as demand is high and there has been capacity elimination in the province.
Suzhou East	10%	The rate inventory is moving has slowed. Wholesalers are not keen to increase inventory.
Guangzhou South	30%	Steel mills are overproducing construction steel and direct selling more so inventory is up.
Changsha South	10%	A lot of capacity that went offline last year is back. So there is now overproduction.

Source: J Capital

Notable Quotes

Supply-Side Reform

"Small steel mills have closed, but this has just shifted production to larger steel mills. There is no real reduction in capacity. There has been some tightness in supply of rebar. Medium frequency furnaces are meant to have been shut down but they are still operating in Liaoning as the local government is not chasing them to close."

—Harbin

Steel mills are having a great year; they have plenty of orders. After the clean-out of the industry last year everything is in order. Outdated capacity has been eliminated medium frequency furnaces have been shut down."

—Qingdao

"There is still steel being produced in medium-frequency furnaces in rural areas."

—Wuhan

"Many of the medium-frequency furnace steel producers are upgrading equipment, so we should expect an increase in installed capacity."

—Hangzhou

"Chongqing Iron and Steel is still in trouble despite the strong market this year. Many suppliers are still owed money and wait at the gates to the factory to get paid."

—Chongqing

Price

"Price fluctuations have been really great this year. We fear another price rise, as the fall may be huge. High prices are purely government policy of restricting supply and stimulating demand."

—Harbin

Finance

"The government has banned SOE steel traders from providing steel to developers on credit terms. We can only supply if we are paid. So smaller developers have turned to gray-market financing to pay for steel."

—Qingdao

"Business is good but margins are lower. The tax bureau has new systems to better track who should be paying VAT. That has had a big impact on private companies."

—Wuhan

"SOE steel traders are expanding their lending to developers—arbitraging SOE access to credit."

—Chongqing

Market

"Infrastructure investment seems to be slowing and rebar inventory has been growing since the end of May. I think the market has peaked."

—Hangzhou

Disclaimer

Tim Murray tim@jcapitalresearch.com **Ada Wang** ada@jcapitalresearch.com +852 2534 7405