Research

CRISIL
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Melting steel

The Covid-19 pandemic is set to wreck profitability

April 2020

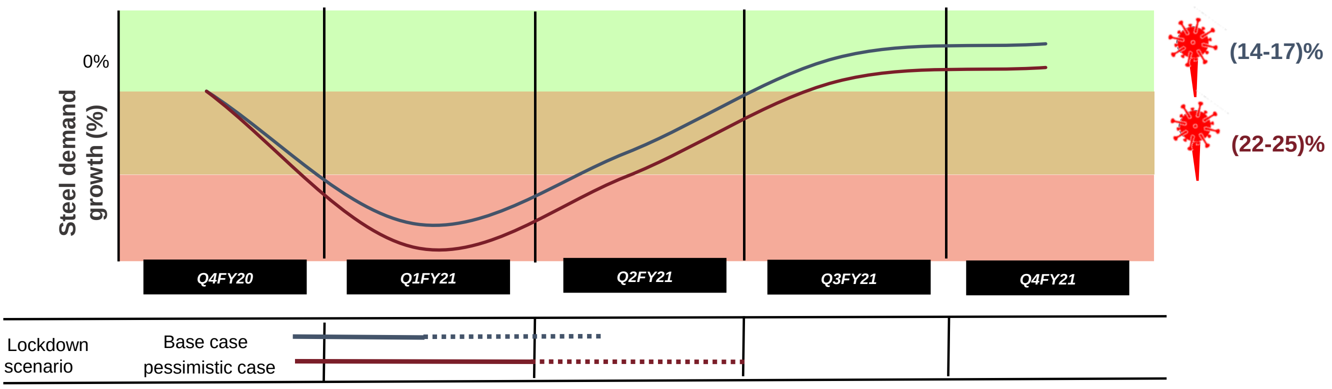
Steel demand to contract as pandemic culls end-use

With Covid-19 casting a long shadow over a much-anticipated mild recovery in fiscal 2021, the Indian economy needs to steel itself. Along with external factors such as weak global demand, supply disruptions, and worldwide financial shocks, the economy is grappling with lockdown, factory shutdowns, reduced discretionary spending, and delayed capex cycle. We expect this perfect storm to affect construction activities and automobile production, and thereby, steel demand.

So, how low will steel demand go? Given the uncertainty in the current environment, we have based our analysis on two possible scenarios (baseline and pessimistic) with regard to the spread and containment period of the pandemic.

Steel demand growth in this fiscal based on possible scenarios

In our baseline scenario, steel demand in India would contract 14-17% this fiscal. Extended vulnerability, on the other hand, will increase the demand contraction to 22-25%.



Base case

- National lockdown (complete/partial) likely to continue through Q1 with some after effects in Q2.
- Construction and production activities begins at the end of Q1

Pessimistic case

- Extended vulnerability to the virus with partial lockdown measures continuing through Q2
- Construction activities, automobile production begins from Q2FY21

Source: CRISIL Research, Industry

On a quarterly basis, steel demand would be a washout in the first quarter of this fiscal, given the pan-India lockdown that would hurt construction. All automobile plants have also been shut, which will further weaken demand prospects. There is also no respite from the capital goods industry in the current scenario. Demand will pick up only from the second half of this fiscal.

A full-fledged recovery will take longer because of the following reasons:

- Weak demand from infrastructure on account of lower capex by government, which will hurt steel demand. The lower infrastructure capex in on account of diversion of funds towards health and public welfare
- Building and construction (B&C) would contract this fiscal on account of weak demand from real estate and private individual home builders
- Supply constraints for the automobile sector as well as muted demand with estimated gradual recovery only in the second half would lead to sluggish wholesale offtake.
- Weakening capacity utilisation amid the virus outbreak would also weigh on industry capex, thereby dampening demand from the capital goods segment

End-use sector demand growth

Sector	**Share in demand** Last 2-3 years average	**On-year growth**	**Remarks**
Building and construction and infrastructure	65-70%	↓	• Nil demand till mid-May; momentum to build from June • Weak public spending by govt. (diversion of funds) • PMAY-G and PMGSY to pick up given higher potential to engage rural workforce
Auto	10-12%	↓	• Complete washout till mid-May, production to begin slowly • Weak demand sentiments post lockdown to dampen sales and hence production
Capital goods	8-10%	↓	• Lower discretionary spending, muted demand and slow recovery from Covid-19 would dampen investments in capital goods

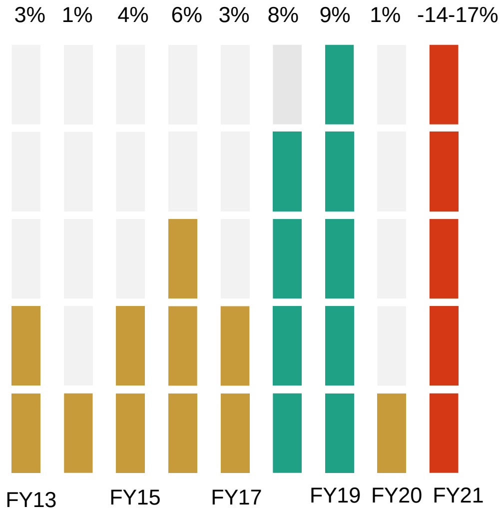
Note: Others (10-15%) includes consumer goods, engineering and packaging

Source: CRISIL Research, Industry

We expect weak steel demand in the first quarter, led by the Covid-related lockdown. While demand would contract in the second quarter as well, pent-up demand release, especially in construction and infrastructure, would aid growth in the second half. No capacity additions are expected during the year since steel players have postponed capex plans.

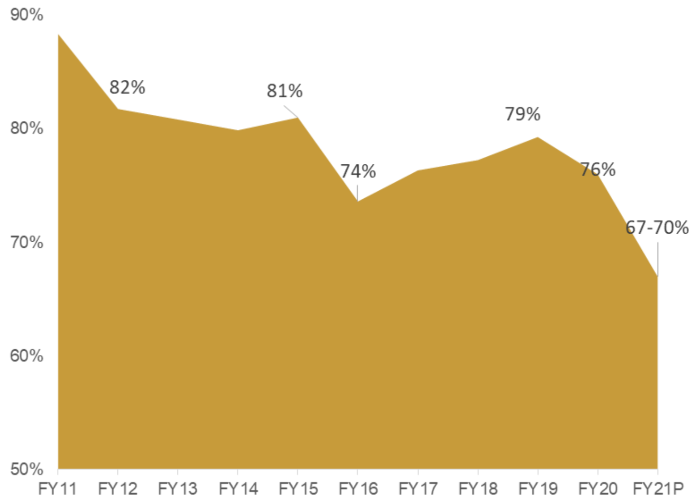
Steel demand growth sinking deeper

Domestic steel demand growth



Steel sector utilisation seen sliding lower

Domestic steel capacity utilisation



Source: CRISIL Research, Industry

Contracting demand growth will push the sector's utilisation level down further to 67-70% (to be lower for electric arc furnace/induction furnace players), adding to the pain from the weakening to 76% seen in fiscal 2020. Prior to the outbreak, 10 million tonne of steel capacity was expected to come on board in the second half of this fiscal. However, the current demand shock is expected to dent industry's capacity addition plans, and stall or delay projects in the medium term. At present, construction/modification activities at some of these plants are halted so we expect a delay in capital expenditure for these plants.

Global prices to continue to weaken amid slack demand

While China's activity picked up in March from its Covid-induced slump in February, steel demand in the first quarter of calendar year 2020 is estimated to have declined 30-40% on-year. This has led to high inventory levels of ~100 million tonne. While activities have begun to resume in the country, we believe the demand would remain muted in the first half. Property sales are also expected to drop significantly in 2020, thus crimping steel demand in China by 10-15% for the year.

China's activity slumps in February amid the Coronavirus outbreak, picks up in March

	Jan-19	Feb-19	Mar-19	Apr-19	May-19	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19	Jan-20	Feb-20	Mar-20
Manufacturing Purchasing Managers' Index (%)	49.5	49.2	50.5	50.1	49.4	49.4	49.7	49.5	49.8	49.3	50.2	50.2	50.0	35.7	52.0
New orders index(%)	49.6	50.6	51.6	51.4	49.8	49.6	49.8	49.7	50.5	49.6	51.3	51.2	51.4	29.3	52.0
New export orders index(%)	46.9	45.2	47.1	49.2	46.5	46.3	46.9	47.2	48.2	47.0	48.8	50.3	48.7	28.7	46.4
Finished goods inventory index(%)	47.1	46.4	47.0	46.5	48.1	48.1	47.0	47.8	47.1	46.7	46.4	45.6	46.0	46.1	49.1
Import index(%)	47.1	44.8	48.7	49.7	47.1	46.8	47.4	46.7	47.1	46.9	49.8	49.9	49.0	31.9	48.4
Raw materials inventory index(%)	48.1	46.3	48.4	47.2	47.4	48.2	48.0	47.5	47.6	47.4	47.8	47.2	47.1	33.9	49.0
Employment index(%)	47.8	47.5	47.6	47.2	47.0	46.9	47.1	46.9	47.0	47.3	47.3	47.3	47.5	31.8	50.9
Non-Manufacturing Business Index (%)	54.7	54.3	54.8	54.3	54.3	54.2	53.7	53.8	53.7	52.8	54.4	53.5	54.1	29.6	52.3
Crude steel production growth (%)	4.3	9.2	10.0	12.7	10.0	10.0	5.0	9.3	2.2	-0.6	4.0	11.6	7.2	5.0	

Jan-Mar 2020

Auto

Car sales is estimated to have declined by 42% on-year on account of restriction of travel owing to lockdown

Real estate

Investment in real estate declined by ~18% on-year in the first quarter, expected to remain weak in 2020

Steel

Demand for steel is estimated to have declined by 30-40% on-year in Q1

China's crude steel production continues to rise despite Covid-19 leading to high inventory

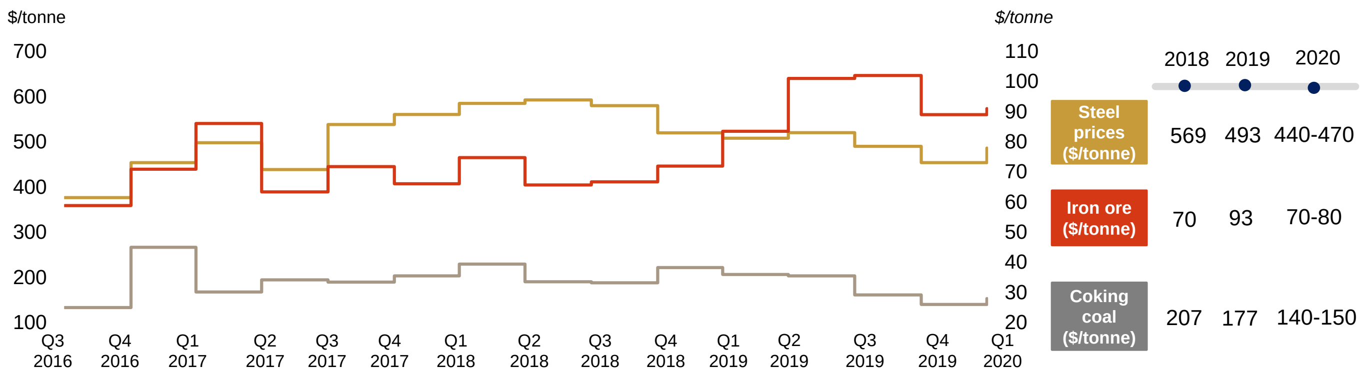
China steel demand is expected to decline 10-15% in 2020

Note: The above data refers to on-year growth

Source: National Bureau of Statistics (China), World Steel Association, CRISIL Research

Moreover, the export market for China steel is almost non-existent as other economies grapple with Covid, leading to a 4% on-year fall in prices to $486 per tonne for the first quarter of the year. China steel prices are expected to correct further owing to weak demand, with the resultant fall in prices taking steel to $440-470 per tonne for 2020. This comes on 13% decline in steel prices in China in 2019.

China steel free-on-board prices continue to fall as situation worsens in other economies



Source: CRISIL Research, Industry

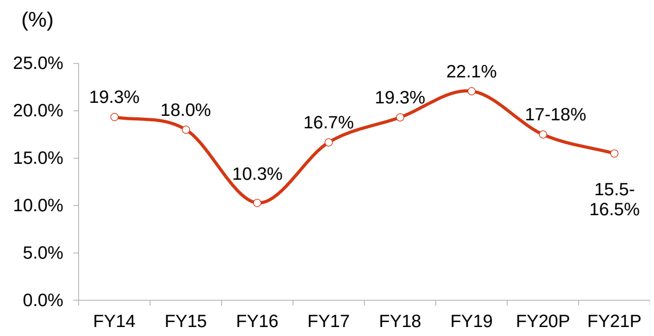
Revenues to erode as volumes and prices skid

We expect prices to moderate further this fiscal, with players struggling on the demand front. While global hot-rolled coil prices are expected to contract by 6-8%, rupee depreciation and anti-dumping duty levied on imports from China will thwart a free fall in domestic steel prices. The decline would be limited to 3-5% for flat steel since there was a massive slump in prices in fiscal 2020 in this segment. We forecast long steel prices to decline 6-8% this fiscal, with secondary players lowering their offers in lieu of weak demand prospects amid competition.

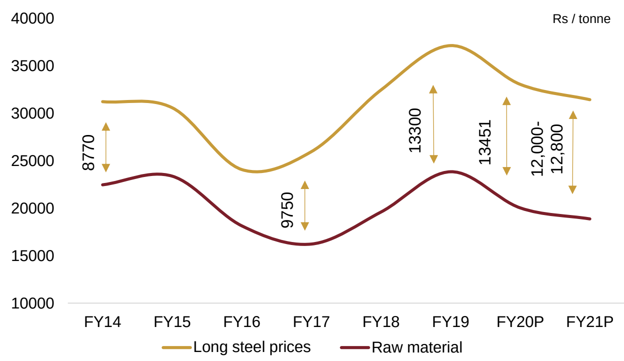
We expect the earnings before interest, tax, depreciation and amortisation (EBITDA) margin for the sector to contract by 100-150 basis points this fiscal. Lower coking coal prices should limit margin erosion since prices would likely ease to $140-150 per tonne in 2020 from $177 per tonne in 2019. We expect iron ore prices to remain range-bound with an upward bias since tepid demand will offset the price rise owing to high bid premiums in Odisha auctions.

Steel sector profitability

Profitability margin of large players



Gross spread for small long steel players



Note: Large players include Tata Steel (includes BSL from FY19, JSW Steel, SAIL and JSPL

Source: CRISIL Research, Industry, Annual Reports

Credit profile weakening ahead

A sample analysis of 43 listed firms and total debt of Rs 2.15 lakh crore as of September 2019, threw up some interesting takeaways.

- Eight firms, which constitute 2% of the set's debt, enjoy a healthy debt to EBITDA ratio of 0-1. However, 17 firms holding 65% of the set's debt have a relatively high debt to EBITDA ratio of >3
- As many as 22 firms holding 46% of sector's debt have a relatively comfortable interest service coverage ratio of >2 times. However, 21 firms holding 53% of the total debt of the sample set have an interest coverage of less than 2. Majority of these players are small players with weak cash balances
- Also, 70% of the sample's debt has a quick ratio / adjusted acid test ratio of <0.1

Dispersion analysis across key financial ratios

Interest service coverage ratio

ISCR	# Number of companies 43	# Debt Rs 2.2 lakh crore
<1	37%	41%
1-2	12%	12%
2-5	33%	44%
<5	19%	2%

Debt/ Ebitda ratio for sample

	#No of companies 43	# Debt Rs 2.2 lakh crore
<0	16%	11%
>3	40%	65%
1-3	35%	24%
0-1	19%	2%

Quick ratio

	# Number of companies 43	# Debt Rs 2.2 lakh crore
<0.1	74%	70%
0.1-0.5	21%	29%
0.5-1	5%	1%
>1	-	-

Source: CRISIL Research, Industry, Quantix

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