

## Steel Industry



By Zacks Equity Research  
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### Steel Output Mounting

The Steel industry, which consists of companies engaged in the extraction of iron ore and coke coal for the processing of iron and steel, has the major chunk of sales concentrated with a few producers. The industry includes metal ore exploration and mining services, iron and steel foundries for smelting, rolling, forging, spinning, recycling, stamping, polishing and plating of iron and steel products such as pipes, tubes, wire, spring, rolls and bars.

The largest drivers of steel consumption have historically been the automotive and construction markets, which make up more than 50% of total steel consumption. Other steel consuming industries include appliances, converters, containers, tin, energy, electrical equipment, agricultural, domestic and commercial equipment and industrial machinery. Large automakers such as General Motors, **Ford Motor Company** (NYSE: [F - News](#)), **Toyota Motor Corporation** (NYSE: [TM - News](#)) and **Honda Motor Company** (NYSE: [HMC - News](#)) depend upon the steel industry.

**ArcelorMittal** (NYSE: [MT - News](#)) is the world's largest steel company with steel production of 103.3 million tons in 2008. Other major players in the industry are **POSCO** (NYSE: [PKX - News](#)), **Steel Dynamics Inc.** (NasdaqGS: [STLD - News](#)), **AK Steel Holding Corporation** (NYSE: [AKS - News](#)), **United States Steel Corporation** (NYSE: [X - News](#)) and **Nucor Corporation** (NYSE: [NUE - News](#)).

The Asia-Pacific region, especially China and India, is witnessing higher production and consumption of steel. This is due to the per capita consumption reaching up to U.S./European levels, which could, theoretically at least, double steel demand in the longer-term. China has set up the largest steel industries in the world, driven by increasing demand for rapid urbanization and large infrastructure projects. The country accounted for nearly 50% of monthly total world production in August 2009.

China's share is larger than the combined production of the U.S., the European Union (EU), Russia and Japan, which have historically been the largest producers of steel. In 2001, China's annual share of world production stood at 17%, while the EU accounted for the largest share at 18%. In eight years, China's share of world production has almost tripled, while other producers have seen their shares decrease. Ranked behind China are Japan and the U.S.

According to the World Steel Association (WSA), global steel output had increased to 107 million tons in the month of September 2009, down marginally (0.6%) from the same month of the previous year. Month-on-month, steel output improved slightly from 106.5 million tons. World crude steel production has continued to show a steady increase since April 2009. Steel production had reached its highest level in July this year on the back of a moderate rise in demand and the resumption of idled facilities by producers. The total output of 103.9 million tons was an improvement of 4% from 99.8 million tons produced in October, but down 11.1% year over year.

All major steel producing countries -- China, Japan, Germany, the U.S., Brazil, Turkey, Russia and the Ukraine -- have shown peak monthly figures so far this year. Production in the Middle East, where demand was buoyant last year due to booming infrastructure spending, edged up by 2.0% in September, while monthly steel output in Asia increased 15% to over 60 million tons. Of this, production in China climbed 28.7% to 39.4 million tons. However, global steel production was down 32.3% in North America while production in Europe saw a drop of 23.7%.

According to the data released by the International Trade Administration, steel prices increased across almost all product groups in September 2009 from August 2009. Hot-rolled sheet prices increased 12.6% to \$535 per ton from \$475 per ton. Cold-rolled sheet increased 10.04% to \$625 per ton from \$568 per ton. Stainless sheet prices increased 2.7% to \$2,334 per ton.

Steel prices across all product groups have fallen significantly from the previous year despite recent price increases, with the price of hot-rolled sheet showing a 54.6% decrease and cold-rolled sheet a 41.3% decrease from September 2008.

In 2007, China's steel industry revealed signs of consolidation in a market that was previously rather fragmented and in need of mergers and acquisitions (M&A). Despite the current slowdown in consolidation within the global steel industry, M&A activity remains a critically important business strategy for companies. While the economic downturn is a significant factor in short-term decisions regarding M&A activity, steel companies expect to make acquisitions over the next three years.

### OPPORTUNITIES

We expect global steel demand to improve in the long term with the recovery of the user industries. China is expected to remain the largest consumer of steel going forward. The WSA is forecasting an 8.6% year over year decline in steel production, better than the previous forecast of a 14.1% decline, driven by a strong growth in Chinese steel demand. With signs of a recovery across the world since the beginning of the second half of 2009, the association is anticipating global steel demand in 2010 to grow by 9.2% to 1,206 million tons, which is similar to the level in 2008.

With steel demand picking up in the last couple of months, steel producers are restarting facilities. U.S. Steel Corp. is restarting its blast furnace at its Hamilton, Ontario plant after a nine-month shutdown. The company had closed its Hamilton blast furnace in November 2008. It had suspended the remaining operations at Hamilton and the Nanticoke operation in March 2009 due to a drop in demand. Both the facilities were running at less than half their capacity.

Net losses for Nucor Corporation, the largest recycler of steel scrap in the U.S., narrowed to \$29.5 million, or 10 cents per share, for the third quarter of 2009. The result was more positive than the Zacks Consensus Estimate of a loss of 14 cents. Long-term contracts, cost reduction efforts and a dominant acquisition strategy inspire optimism about the company's performance in the coming quarters.

The third largest steel maker in the U.S., Steel Dynamics Inc. reported net income of \$69 million -- 30 cents per share -- for the third quarter of 2009, after reporting losses for three consecutive quarters. The earnings, which were driven by cost reduction through higher production and shipping volumes at the Flat Roll Division and better-than-expected performance in the Metals Recycling segment, were higher than the Zacks Consensus Estimate of 23 cents. However, on a year-over-year basis, earnings were down 69%.

### WEAKNESSES

The global steel industry is cyclical, highly competitive and has historically been characterized by overcapacity. Production cuts of up to 35% are occurring to keep

operating rates in the low-80s and keep the market balanced. The U.S. domestic production capacity utilization has fallen dramatically since August 2008. Capacity utilization peaked in February 2008 at a level of 91.6%. In May 2009, estimated capacity utilization was 44.3%, less than half of its level six months ago. Capacity utilization reached its lowest point, 40.9%, in December 2008, though it has increased again since May 2009.

Overcapacity in the global steel industry could increase the level of steel imports and result in downward pressure on steel prices. Overcapacity in China has the potential to result in a further increase in imports of low-priced, unfairly traded steel and steel products to the U.S. In recent years, capacity growth in China has significantly exceeded the growth in Chinese market demand. A continuation of this unbalanced growth trend or a significant decrease in China's rate of economic expansion could result in China increasing steel exports.

Key steel consuming industries such as auto, shipbuilding and construction had been experiencing weak demand in the last quarters, forcing global steel makers to slacken production levels. U.S. Steel, the eighth largest steel producer in the world, the largest integrated steel producer headquartered in North America, and one of the largest integrated flat-rolled producers in Central Europe, slashed production by almost 62% during the second quarter of 2009, while Korean steel maker POSCO cut production by about 15% in December last year. This was the first time in its history that POSCO was forced to take such a measure, proof of the very bad operating environment.

The current low demand from the automotive and residential sectors and rising labor costs are affecting producers in the steel industry. Weak demand and significantly lower operating rates have forced producers to shut down facilities. The slowdown in the U.S./Europe/Japanese economies remains a negative issue facing steel producers. The automotive market has yet to recover fully. Steel shipments are off at a double-digit rate.

As a whole, the steel industry posted weak results in the third quarter of 2009. U.S. Steel Corporation recorded its third sequential loss -- \$3.03 billion, or \$2.11 per share -- in the third quarter of 2009, in contrast to a net income of \$9.19 billion or \$7.79 per share in the third quarter of 2008. Commercial metals company AK Steel posted a negligible income of \$6.2 million compared to \$188.3 million in the same quarter of 2008.

Despite a sharp rise in steel prices in September 2009, the future pricing remains uncertain, and we believe continued demand weakness, production resumption by some mills and lower iron ore and coking coal prices in the second half of 2009 would drive monthly prices down again. The recent significant reduction in global steel production in late 2008 and into 2009 has resulted in decreases in many raw material prices.

We expect that such prices will rebound when global steel production returns to more customary levels. In contrast, prices for steelmaking commodities such as steel scrap, coal, coke, iron ore, zinc, tin and other metallic additions have escalated significantly over the last several years due primarily to growth in worldwide steel production, especially in China.

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