Flat Steel Products

SEPTEMBER 2017

INDUSTRY STRUCTURE

The flat steel industry in Pakistan comprises two local producers International Steels Limited (ISL) and Aisha Steel Mills Limited (ASL). Flat steel producers import Hot Rolled Coil (HRC) and convert it into Cold Rolled Coil (CRC), Galvanized and Color Coated sheets. Currently, ASL only produces CRC while ISL also produces Galvanized and Color Coated Sheets in addition to CRC. At end-FY17, ISL had a 70% market share in terms of installed capacity in Pakistan. During FY17, ISL produced 464,023 MT of CRC of which 312,886 MT was further processed into galvanized steel.

Table 1: Industry Capacity Utilization

CRC strip (tons)	Pre-expansion Capacity	Production (FY17)	Capacity Utilization	Post-expansion Capacity
Aisha Steel	220,000	209,525	95%	700,000
International Steel	550,000	464,023	84%	1,000,000
Total CRC Industry	770,000	661,152	87%	1,700,000

EXPANSION

Given the healthy demand outlook, both ISL and ASL have announced expansions which are expected to come online in FY19. Capacity announced by ISL and ASL is similar at around 450,000 MT; resultantly, ASL's market share in terms of installed capacity will increase to around 40% (Pre-expansion: 30%). Expansion announced by ASL also includes a galvanizing line which will represent around 36% of ASL's total installed capacity and facilitate in diversifying revenue streams. ISL's expansion plan comprises a line for CRC only and not for galvanized coils.

DEMAND AND SUPPLY

Total demand for flat steel products (Cold Rolled and galvanized sheet) in the country is estimated at around 1.1m tons. Demand for flat steel products is supported by widespread usage and healthy demand outlook for industries catered to by ISL and ASL including autos (motor cycles), consumer durables and construction. As per industry estimates, demand is projected to grow at around 10%, going forward.

Around two-third of the demand is currently being catered by the two local producers with remaining demand being met through imports. Imports of CRC have primarily been from China, Ukraine and Russia. Both local players recorded healthy growth in sales during FY17. Total industry sales in FY16 were higher vis-à-vis FY17 due to influx of cheaper CRC from Russia at end-FY16 which has been sold in the market during FY17.

Table 2: Use of CRC products

Automotive	Motor cycle frame, fender, muffler, chain cover, fuel tank, rim, seat pan, shock cover, precision tubes, auto door panels, various members/pillars/brackets etc.
Consumer Durables	Refrigerators, deep freezers, split a/c, washing machine, ceiling lights, tube lights, ceiling fans, bracket fans, exhaust fans.
Others	Roof and wall systems (industrial, commercial, and agricultural buildings) steel racks, structural members, corrugated sheets or profiles for roofing, telecom towers, shelters, filters and tubes etc.

Table 3: Industry sales data

CRC Sales (In MT)	FY16	FY17
ASL	181,259	214,313
ISL	124,010	190,629
Imports	359,000	183,000
Total CRC industry sales	**664,269**	**587,942**
Galvanized products Sales (In MT)	**FY16**	**FY17**
ASL	-	-
ISL	240,528	300,375
Imports	270,000	212,000
Total GI industry sales	**510,528**	**512,375**

REGULATORY DUTY

Local players importing HRC under SRO 565 enjoy a 5% duty advantage compared to CRC imports from countries where a Free Trade Agreement (FTA) is in place with Pakistan. The advantage increases to 11% if imports are made from countries without a FTA with Pakistan.

Table 4: Regulatory Duty Structure

For Importers	With FTA duty		Without FTA duty	
Item	**Duty %**	**RD%/ADC%**	**Duty%**	**RD%/ADC%**
Hot Rolled Coils (Alloy Steel)	5%	12.50%	11%	12.50%
Cold Rolled Coils (Non Alloy Steel)	5%	5.00%	11%	5.00%
For Aisha Steel	**With FTA duty**		**Without FTA duty**	
Item	**Duty %**	**RD%/ADC%**	**Duty%**	**RD%/ADC%**
Hot Rolled Coils (Alloy Steel)	5%	12.50%	11%	12.50%
Hot Rolled Coils (Non Alloy Steel) under SRO 565	5%	0.00%	5%	0.00%

ANTI-DUMPING DUTY

Domestic companies had filed cases with the National Tariff Commission (NTC) for the imposition of anti-dumping duties (ADD) on cheaper influx of imports. To shield the domestic industry from dumping, NTC has imposed a definitive ADD in the range of 13-19% on CRC and in the range of 9-40% on imports of Galvanized Coil from China and Ukraine for a span of five years.

Table 5: ADD on Chinese and Ukrainian players

Country/Exporter/Foreign Producer	Definitive Antidumping Duty Rate (%)
China	
Shougang Casey Steel Company Limited	19.04
Sougang Jingtang United Iron & Steel Co. Limited	19.04
Beijing Shougang Cold Rolling Company Limited	16.27
Handan Iron & Steel Group Han-Bao Co. Limited	13.17
Maanshan Iron & Steel Company Limited	19.04
All Others	19.04
Ukrine	
Zaporishtal Integrated Iron-and-Steel Works	18.92
Ilyich Iron and Steel Works of Mariupol	19.36
All others	18.92

BUSINESS RISK FACTORS

WIDESPREAD USAGE AND HEALTHY DEMAND OUTLOOK OF INDUSTRIES CATERED TO BY ISL AND ASL TO SUPPORT GROWTH

Auto (motor cycles) and consumer durables segment has recorded double digit growth over the last two years while construction activities have also picked pace with initiation of infrastructure projects under CPEC and introduction of affordable mega-housing schemes initiated. However, JCR-VIS believes that use of domestic flat steels products in local car assembling is not expected to materialize in the short to medium term.

VOLATILITY IN HRC AND CRC PRICES IS THE SINGLE LARGEST BUSINESS RISK FACTOR

JCR-VIS considers steel sector in general and flat steels sector in particular to comprise high business risk given the significant volatility in HRC and CRC margins and threat of dumping. This is also evident from significant volatility in gross margins of both players over the last 8 quarters. HRC prices represent around 80%-85% of total cost of goods sold. With raw materials representing the major cost component and significant volatility in prices, efficient procurement and inventory management are critical to gross margins and profitability levels.

QUANTUM OF IMPORTS HAS DECLINED BUT WILL CONTINUE DESPITE IMPOSITION OF ANTI-DUMPING

Despite regulatory duty protection, dumping from China continued to pose a significant pressure on profitability of local players. During FY16, difference between HRC and CRC prices offered in Pakistani market was as low as $30/MT. However, post imposition of ADD, month on month import trend of CRC during 2HFY17 suggests that quantum of imports have declined. However, industry players anticipate that imports would continue at lower levels from countries on which ADD has not been levied. Largest imports are currently from Russia and NTC has been approached to impose ADD on the Russian suppliers. There is a possibility that imports from Russia increase in the short term before the antidumping is in place.

PRICING POWER HAS IMPROVED AS EVIDENT FROM RECENT PRICE HIKES

Post imposition of anti-dumping duty, pricing power of both players has improved as evident from recent price increase to pass on the impact of higher HRC prices. Both ASL and ISL have increased prices multiple times in order to pass on increasing HRC prices subsequent to February'2017.

COMPETITION AMONGST EXISTING PLAYERS TO INTENSIFY POST EXPANSION

Currently, ASL only caters to CRC customers while galvanized coils are major contributors to ISL's sales. Resultantly, limited competition exists currently. With ISL significantly increasing CRC capacity and ASL entering into the galvanized steel segment, competition amongst existing players will intensify post capacity expansion by both players. Price under cutting in an excess supply scenario will create pressure on profitability.

EXCESS CAPACITIES COMING ONLINE MAY NECESSITATE TAPPING EXPORT MARKETS

Assuming imports decline to 250,000tons (FY17: 395,000) due to full year impact of imposition of ADD and annual demand growth of 10%, capacity utilization levels will decline to 71% (FY21: 80%) in FY20 from 92% currently. Utilization levels may fall further in case of imports exceeding assumed level. Both industry players will look to tap export markets in order to improve utilization levels. With imposition of anti-dumping duties on Chinese Steel exports by most countries, both ASL and ISL are hopeful of making inroads in select markets including USA, Spain, Brazil and Sri-Lanka.

Table 6: Demand Supply Dynamics

	FY17	FY18	FY19	FY20	FY21	FY22
Demand	1,100,317	1,210,349	1,331,384	1,464,522	1,610,974	1,772,072
Demand – Ex Imports	705,317	815,349	1,081,384	1,214,522	1,360,974	1,522,072
Supply	770,000	770,000	1,700,000	1,700,000	1,700,000	1,700,000
Capacity utilization	**92%**	**106%**	**64%**	**71%**	**80%**	**90%**

RUPEE DEPRECIATION TO HAVE LIMITED IMPACT, IF ANY

Contrary to common perception rupee depreciation will have a limited impact, if any, on profitability of flat steels products.

FINANCIAL PROFILE

Improvement in financial profile of both flat steel producers is a function of improved capacity utilization and sales and higher gross margins. Both the aforementioned factors along with lower finance cost (decline in debt levels and lower borrowing rates) have translated in improved profitability levels during FY16 and FY17. Going forward, quantum of profits for FY18 will primarily depend on HRC-CRC margins given that both players are operating at high capacity utilization levels.

With an increase in profitability and cash flows (cash flows tend to be better than profitability due to sizeable depreciation charge), liquidity profile has showcased sizeable improvement. ISL has healthy cash flows in relation to outstanding obligations while ASL's cash flows are now adequate for debt servicing given the extended repayment period that the company enjoys.

Given that profits have largely been retained by both players along with reduction in debt levels, gearing ratio for both players have halved over the last two years. While gearing is expected to increase on account of debt planned to be raised for expansion, however, the same is expected to remain within manageable levels.

Table 7: Financial Profile

Amounts in Rs.m	FY14	FY15	FY16	FY17
ASL				
Sales	9,259	9,492	9,634	10,774
Gross Margin	1%	0%	10%	19%
Operating Margin	10%	-1%	9%	14%
Net Margin	-4%	-13%	-2%	9%
RAO	-2%	-8%	-1%	6%
ROE	-18%	-50%	-7%	23%
ISL				
Sales	21,291	17,938	20,499	24,783
Gross Margin	11%	8%	14%	18%
Operating Margin	9%	7%	12%	17%
Net Margin	3%	1%	6%	8%
RAO	4%	1%	6%	8%
ROE	13%	4%	19%	23%

Table 7: Financial Profile

Amounts in Rs.m	FY14	FY15	FY16	FY17
ASL				
FFO	(1,358)	(988)	205	1,294
FFO/Total Debt	-15%	-10%	2%	19%
FFO/LTD	-25%	-18%	4%	35%
ISL				
FFO	1,007	559	1,916	4,026
FFO/Total Debt	12%	5%	23%	84%
FFO/LTD	34%	10%	47%	136%

Table 7: Financial Profile

Amounts in Rs.m	FY14	FY15	FY16	FY17
ASL				
Total Equity	1,905	2,420	2,274	4,320
Total Debt	8,873	9,494	9,698	8,929
Gearing Ratio	4.66	3.26	4.26	2.07
ISL				
Total Equity	5,206	4,978	6,168	7,657
Total Debt	8,627	10,660	8,268	6,394
Gearing Ratio	1.66	2.14	1.34	0.84

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