China's Steel Industry Slows Down

Following Years of Rapid Growth, Production Retreats as Global Demand Dwindles

By ANDREW BATSON

China's steel industry, which in the boom of the past few years has become the biggest in the world, is now facing a long, cold winter.

Demand is declining both in the home market and abroad. China's steel exports, which had been expanding at an extraordinary pace of 60% a year, are now falling. Weakening Chinese exports of home appliances and machinery have cut demand for steel, as has a collapse in the Chinese housing market that triggered sharp declines in construction.

Reuters

The current downturn is the sharpest and deepest for China's steel industry in at least a decade, with its output plunging 17% in October. Some executives don't think the boom times will ever return.

"We think that the era of high profits for steel companies has already come to an end," said Yang Siming, chairman of Nanjing Iron & Steel Group, a midsize producer based in eastern China.

Because China's steel industry grew so rapidly in recent years -- it is now five times bigger than it was during the last contraction, producing more than a third of the world's steel -- the downturn is being felt throughout China and across the world.

Big miners like BHP Billiton
and
Rio Tinto
have been hammered by the collapse in Chinese demand for iron ore and other minerals used in steel, as have producers of coal, which steelmakers consume rapidly. With prices and shipments for key products declining, BHP is now focusing on preserving its finances, and on Tuesday the company abandoned its bid
to take over
Rio Tinto.

Waning demand has also pushed steelmakers in other Asian nations to cut back production as well as prices, as they welcome BHP's latest decision regarding Rio Tinto.

Japan's Nippon Steel

Corp., the world's second-biggest steelmaker by output after ArcelorMittal, said it will extend production cutbacks to more than two million metric tons in its fiscal second half through March from one million tons, and didn't rule out more cuts in the future.

President Shoji Muneoka said the Japan Iron and Steel Federation "has strongly insisted that a takeover of Rio Tinto by BHP would hinder healthy competition in the market for steel materials. So, we welcome that BHP has practically dropped the takeover plan after the EU commission sent them a letter to oppose it."

Taiwan's China Steel
Corp., which sells as much as 75% of its production in the domestic market, said it will cut domestic steel prices in the first quarter of 2009. The price cuts, to be announced Wednesday, will be the first in nearly three years following 11 consecutive quarters of price increases.

China Steel Chairman Chang Chia-Juch said BHP Billiton's decision to drop its takeover bid for Rio Tinto is "very good for the steel industry," as it will ensure more competitive pricing of raw materials such as iron ore.

China Steel also said it expects 2008 production to be as much as 10% below last year's production of 10.19 million tons, and plans to push forward a maintenance shutdown at one of its blast furnaces to the first quarter, essentially cutting output by another 25% during the quarter.

In India, steel prices have come down by about one-third since July and have halved since the beginning of the year.

Indian steel companies including state-run Steel Authority of India <http://online.wsj.com/public/quotes/main.html?type=djn&symbol=500113.by
> cut prices between 15% and 20% earlier this month and analysts feel another cut is likely soon.

Steel imports, meanwhile, slowed in October, down to one-third from the previous month, Indian government data showed. Analysts said imports are still cheaper than local steel by about 5% to 10% as China's steel prices have slumped in the past couple of months.

The current downturn also means reduced business for the ports, railways and shipping lines that carry such commodities like coal and iron ore. The Baltic Dry Index, a global measure of costs for transporting bulk

The Baltic Dry Index, a global measure of costs for transporting bulk goods, is already down more than 90% from its levels in June this year, in large part because of lower expectations for Chinese demand.

A retrenchment in the steel industry could help shift the profile of China's economy, which has been focused on energy-guzzling heavy industry in recent years. The expansion of steel production has underpinned China's transformation into an industrial giant, but it also has been a big contributor to the surge in the nation's use of coal and oil and its emissions of pollutants and greenhouse gases. A smaller steel industry could mean a cleaner, more efficient China that is less of a strain on the world's resources.

"If steel production growth slows from recent trends to below 10% and the sector sees some healthy consolidation, by 2012 China will have saved more than one billion tons of coal and cut a France-sized hole in its annual carbon-dioxide emissions bill," said Trevor Houser, an energy analyst with Rhodium Group.

When the current crunch ends largely will depend on how quickly housing and infrastructure construction recover, something the government is trying to speed up with a huge stimulus package announced earlier this month. But the crunch is already causing strain: Almost all producers are cutting production and scaling back their once-ambitious plans.

Mr. Yang's company, based in the outskirts of the eastern city of Nanjing, started seeing demand for steel weaken in July, and began cutting some output in August. Although Nanjing Steel has been reducing inventory and trimming raw-material purchases, monthly profit has collapsed to about 50 million yuan ($7.3 million) in October from more than 400 million yuan in June, Mr. Yang said.

China's steel industry today is highly fragmented, rife with weaker players that have survived only because of soaring growth. Mr. Yang and other steel executives think that a shakeout is coming that will weed those companies out, and ultimately strengthen the industry. "Some small companies will not survive," said Mr. Yang. "I think that this adjustment is necessary. Otherwise companies will just continue expanding without limit, and things would be even worse later on."

Last month, FerroChina <http://online.wsj.com/public/quotes/main.html?type=djn&symbol=F33.SG> Ltd., a China-based steelmaker whose stock trades in Singapore, said a downturn in its business had left it unable to repay some of its loans. The company and its units now face 206 lawsuits from creditors seeking repayment of some 4.82 billion yuan, and is trying to come up with a restructuring plan.

The China Iron & Steel Association says that 23 of the steel companies it tracks lost money in September, and the industry's average profit margin fell to 1.4% from 7.6% in the first half of this year.

U.S. industry and government officials have long argued that China's steel industry has expanded too much, too fast, thanks to lax government policies that allowed both efficient and inefficient producers to get bigger. The current downturn might simply cause temporary closures by small mills that will come back when times are good. But Chinese officials privately agree with the need for real consolidation, and could take this opportunity to force mergers of steel companies, many of which are at least partially state-owned.

"The government has wanted to consolidate the industry, but while all the companies were making profits they haven't been able to do it," says Michael Komesaroff of Urandaline Investments, an Australian commodities consultancy. He notes that in Japan, the top five companies together account for 80% of the nation's steel output, while in China, you have to add together the top 66 companies to get to 80% of the market.

"Now that margins for the small players are so thin, or even negative, everyone will want to consolidate," he says. "This downturn gives China a chance of producing a genuine global champion in the metals industry."

Nanjing Steel's Mr. Yang wants to make sure his company is among those left standing. Nanjing Steel is only a midsize company by China's current standards, but it ranks 53rd in the world in terms of annual output.

The Chinese company prides itself on producing higher-quality product than most in the industry -- its steel has gone into the iconic "Bird's Nest" Olympic stadium in Beijing, as well as a wind farm in Wisconsin -- and thinks it could benefit from consolidation. "There is still room for some companies -- those with good products and a higher level of management -- to make an appropriate profit," he says. Nanjing Steel doesn't rule out the possibility of buying up some financially distressed competitors next year, he said.

Some combinations have already started. The local government in Shandong province earlier this year arranged the merger of two firms, Jinan Iron & Steel and Laiwu Steel Group. Officially, the policy is to support consolidation in the steel industry, though in a way that avoids large-scale layoffs.

Beijing is concerned about widening unemployment, one factor that could weigh against rapid consolidation. But Assistant U.S. Trade Representative Tim Stratford, who visited Beijing in October for trade talks on steel, said Chinese officials were asking about U.S. retraining programs for laid-off steelworkers. "They recognize it's cheaper to assist displaced workers than to subsidize ongoing operations of steel plants," he said.

The total output of China's steel industry is likely to shrink

The total output of China's steel industry is likely to shrink marginally this year, perhaps by 1% to 2%, and be roughly flat in 2009, according to industry executives and analysts. But coming after seven straight years of growth more than 15%, that is a sharp correction.

"A decrease would be pretty radical," says Mr. Stratford. "They haven't planned for that."

-Yuzo Yamaguchi, Alex Pevzner, Arpan Mukherjee and Miho Inada contributed to this article.

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