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Industry Report

Italian steel at a crossroads

September 30, 2014

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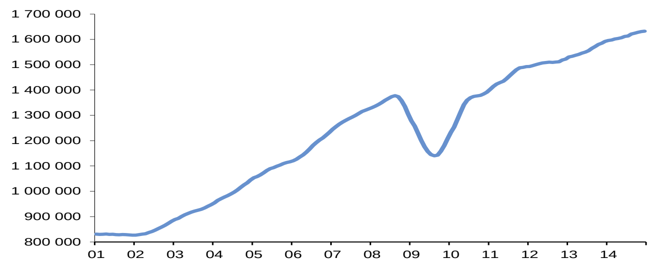
Executive summary

- World steel production increased by +2.3% in the first seven months of 2014 (to 960mn tons) causing more overcapacity, especially in China and Europe. As a result, the price of iron ore is declining, a trend which is expected to continue.
- In Italy, production increased in the first seven months of the year reaching 15mn tons but remains 24% below pre-crisis levels. The national value chain has somehow held up (and payment terms have improved, slightly) thanks to high value-added products, technologically advanced facilities, and exports.
- Yet, the steel crisis continues and stifles both SMEs and the giant ILVA. In the next two years, developing new target markets for Italian products, mergers and acquisitions in the common steel sector and a lull in production for special steels are to be expected.

The world steel market: Slowdown of global demand and decrease of prices

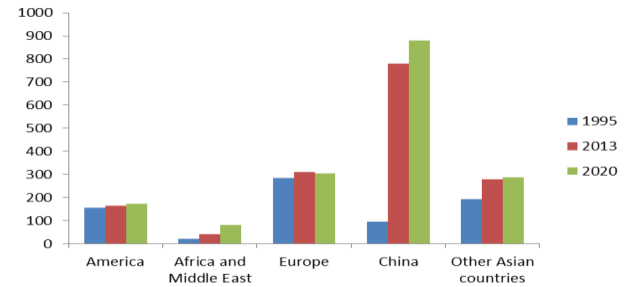
In 2013 world steel production (crude steel) grew by +3.5%, reaching a record level of 1.607 billion tons, driven by the performance of markets in Asia (almost 50% of the production is in China that will grow faster than the other areas until 2020) and the Middle East. A very partial restructuring (effective in the US, insufficient in Europe and not enacted in China: 200 million tons of overcapacity) and settling process is taking place which favors producers in developing countries. There, the demand for steel is growing, and steelmakers enjoy competitive advantages such as a lower cost of energy and raw materials, low labor costs and a much lower incidence of environmental constraints. The level of profitability in China is very low and the government is seeking to close small factories in order to reduce capacity, but local governments continue to invest. This situation becomes unsustainable as world steel consumption grew by +5% p.a. in 2012-2013, against +10-15% p.a. before the crisis.

Chart 1: World steel production (year average in KT)



Sources: World Steel Association, Euler Hermes

Chart 2: The changing geography of the world steel (mn tons)



Sources: Siderweb, Euler Hermes

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In Europe, consumption fell by 30% compared to 2007 while production capacity has been reduced by 20 million ton/year and is expected to drop by a further 10 million ton/year.

The data for 2014 shows +2.3% in global steel production in the first seven months of the year compared to the same period last year, while in Europe and in Italy production is increasing respectively by +3% and +2.1%.

Iron ore prices have fallen by 40% this year under 80$/ton because of an excess supply in the market. Due to economies of scale the development plans of BHP Billiton and Rio Tinto have also reduced production costs to the bone. Scrap prices are stable. Global steel prices will likely continue to decrease for all of 2014 because of overcapacity.

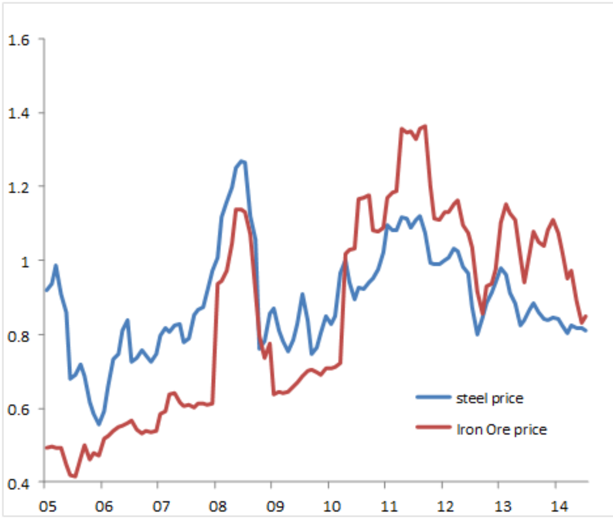
In Italy, some positive signs but a major overhaul is needed: revamp steel hubs, and solve excess in production capacity and lack of international competitiveness

In 2013, the Italian steel industry, ranking second in the EU after Germany, recorded sales of EUR34 bn, with a sector workforce of about 70 000 direct and indirect workers. Production fell by -12% in 2013 for both long and flat steel products, suffering from sluggish demand from automotive and construction industries, and the unresolved ILVA case. These difficulties are also reflected in the increase by +27% of bankruptcy proceedings and a credit crunch that has not spared the industry. Many small and medium-sized businesses had to downsize or stop production for months. However, the national production chain has somehow held up, thanks to high value-added products, technologically advanced facilities, and contributions from foreign markets. Exports have provided a buffer: for the sector, the trade surplus was EUR10 bn in 2013.

In 2014, numbers are improving slightly: production increased by +2.1% in the first seven months, and should reach +3% for the whole year, as a result of a renewed dynamism in machinery & equipment and electrical appliances. Domestic consumption remains weak weighted by the negative performance of construction sector, and a modest recovery is conceivable by 2015. As far as prices are concerned, Italian steel products will remain fairly cheap and it will be hard to offset the declines in recent years. On the payments front, steel companies continue to have too long payment terms: DSOs are expected to decrease slightly in 2014 to 108 days.

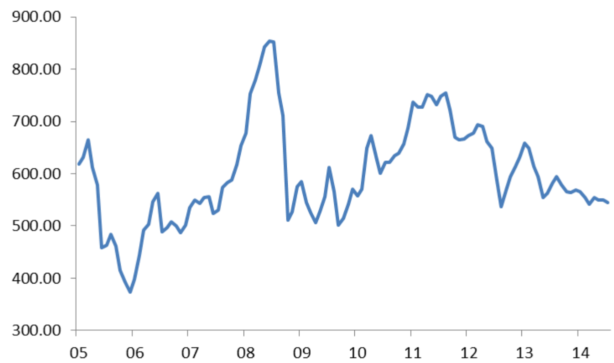
In spite of these limited but positive developments, the industry still has to absorb excess in production capacity, increase international competitiveness, and reposition in higher value-added segments. In addition, three major Italian steel hubs – ILVA in Taranto, Lucchini in Piombino-Trieste, and AST in Terni – still have to be dealt with. Looking ahead, there will be fewer and fewer blast furnaces, as electrometallurgy increases its shares and low energy costs will be the decisive factor for a competitive industry.

Chart 3: Evolution of iron ore and steel price (base 1$=April 2010)



Sources: Bloomberg, Euler Hermes

Chart 4: China spot market Steel price (USD/T)



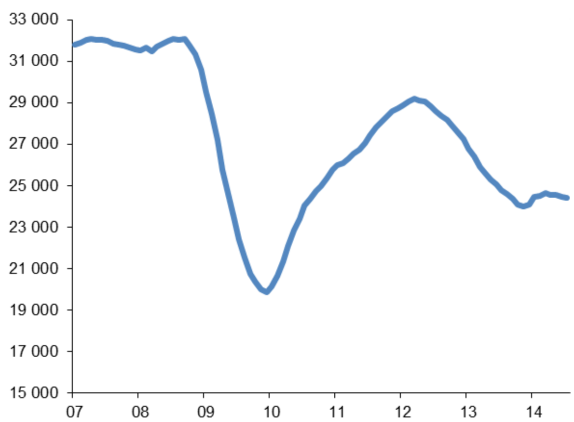
Sources: Bloomberg, Euler Hermes

Chart 5: Variation of steel price (USD/T) in July (year average)

	2010	211	2012	2013	2014
USD/T	622.2	747.8	586.8	593.8	545.2
Variation	2%	20%	-22%	1%	-8%

Sources: Bloomberg, Euler Hermes

Chart 7: Production of steel in Italy (year average in KT)



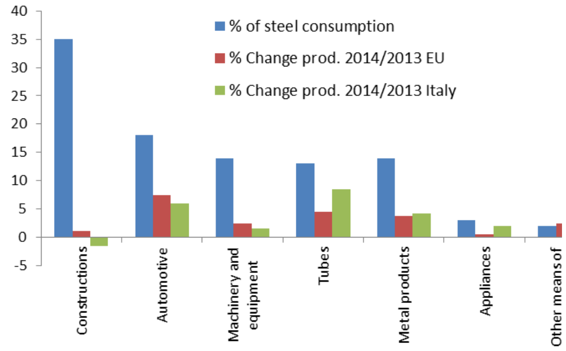
Sources: World steel association. Euler Hermes

The Maghreb, especially Algeria, appears as a new destination for Italian steel products

In 2013/2014, exports were the only solution to domestic market stagnation for producers of long steel. In addition to traditional destinations such as Germany and France, steel exports also looked eastward to East Europe and Turkey, and continued their foreign run towards the steel product giants in the Far East such as China (+15% in the first half of 2014 compare to 2013) and India (+17%). The interesting thing to note was the growth of commercial transactions in the Maghreb, primarily with Algeria (10% of total exports). The significant increase in exports of rebar, wire rod and welded mesh mainly benefited the small mills of Brescia that produce steel for construction.

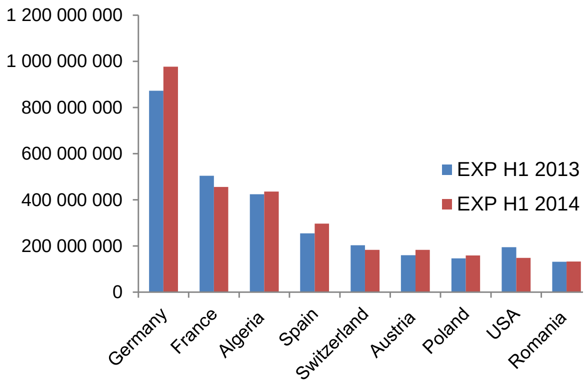
The prudent macroeconomic policies implemented in Algeria over the past decade, together with careful management of the huge revenues from the hydrocarbons industry, have brought about major economic growth, characterized by the accumulation of monetary reserves, along with good investment by the local government in infrastructure works and in projects aimed towards greater sectorial diversification. Along with being actively involved in ensuring adequate support for the stabilization of Algeria, Italy has also established a leading position among the main trading partners, becoming the third largest exporter after China and France. The industrial plan calling for investments of USD286 bn over the 2010-2014 period should somehow be reconfirmed during the 2015-2019 period, and thus the Italian long steel companies should be ready to guarantee the supplies requested and to use this new foreign opportunity as a driving force to jump-start the industry. Securing these trade routes will not be easy as risks remain (non-payment, political risks), including from international competition from Turkey.

Chart 8: Steel consumption by sector



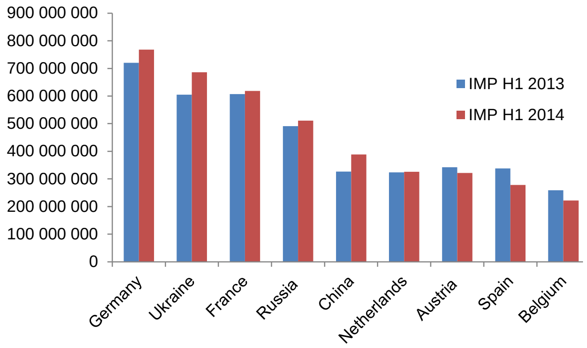
Sources: Siderweb, Euler Hermes

Chart 9: Italian exports of steel products in H1 2014 (euro)



Sources: Istat, Euler Hermes

Chart 10: Italian imports of steel products in H1 2014 (euro)



Sources: Istat, Euler Hermes

Focus on common and special steels: Who is winning and who is losing?

	Common steels	Special steels
What are they?	High carbon content, which makes them not very ductile and less resistant. Their main market is the domestic construction market.	Low carbon content and various alloys, are characterized by high ductility and high resistance, and their main markets are the machinery & equipment, automotive, oil & gas and alternative energy industries.
Who are they?	The common steel sector is mainly characterized by a large number of companies and a market with a production capacity that exceeds the demand, given the difficulties that the construction industry has been facing for several years.	Special steels, on the other hand, are strongly export oriented, and are characterized by a high added value, both in the case of direct exports - manufacturing and exporting of finished products - and indirect exports - processing of raw materials, forged and pressed in Italy and then sold on export markets such as the USA and UAE.
Where are they going?	Common steels: one product but many players.According to our forecasts, strong changes will be seen in the common steels sector over the next two years, with large players uniting through mergers and acquisitions. Repositioning, in terms of production capacity, is necessary in order to remedy sluggish domestic demand, to seek new export markets, and make up for the lack of infrastructural investments in Italy as much as possible.	Special steels: few players with great production and output diversification. For special steels, we can expect a lull in production, with margins down slightly for companies involved in oil & gas and renewable energy, and a stable trend for machinery & equipment and automotive companies.

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