



Fitch Interview: China Steel Production Capacity to Peak in 2016

Fitch Ratings-Hong Kong-19 November 2015: Fitch Ratings today says that China's steel production capacity is likely to peak in 2016, with capacity elimination over the next five years likely to outpace additions.

In the Q&A below, Hong Kong-based Laura Zhai and Shanghai-based Charles Li of Fitch's Industrial Team, discuss the factors driving their forecasts for China's steel production, exports and consumption.

Q. Chinese steel production capacity continues to increase despite weak demand; when will capacity peak?

Fitch expects Chinese steel production capacity to increase to about 1.17 billion tonnes in 2015 from 1.15 billion in 2014. The increase in 2015 includes about 30 million tonnes of new capacity, which is partly offset by estimated capacity shutdown of 10 million tonnes. Fitch expects annual new capacity of around 16 million tonnes to be added in 2016 and 2017, although this will be offset by shutdowns of plants with total capacity of 75 million-85 million tonnes over the next five years. This will result in capacity peaking in 2016.

Fitch believes that future capacity elimination in China will mainly be driven by market forces rather regulations. Most of the regulatory measures implemented have already forced out smaller players and the plants that remain in operation are larger in comparison and comply with existing policies. Stricter environment standards could also cause financially weak steel producers to shut down because they will not be able to afford the required investments.

Q. China's apparent steel consumption declined in 2014 for the first time in 20 years, and the decrease has extended into 2015. What is Fitch's expectation for steel consumption for 2016 and after?

The decline in China's apparent steel consumption (sum of production and imports, less exports) was mostly due to slower fixed-asset investment (FAI) growth and de-stocking in the steel industry.

China's FAI rose by 10.2% in 10M15, slower than the 15.9% in 10M14, due to deceleration in activity in the manufacturing and property sectors, which accounted for 33% and 23%, respectively of FAI in China in 10M15. The slowdown in construction activity led to a collapse in steel prices. At the same time, steelmakers stepped up sales of their stocks. De-stocking is not captured in apparent consumption, contributing to an understatement of the apparent consumption figure.

Fitch expects FAI growth to pick up slightly in 2Q-3Q16, driven by real-estate construction activities, before reverting to a lower level of normalised growth 12-18 months later. Fitch believes that Chinese apparent consumption of steel will remain flat in the next few years now that de-stocking has ended, at about 760 million tonnes a year. Any substantial negative or positive surprises in growth rates are likely to be driven by swings in real-estate construction activities.

Q. What is Fitch's expectation for Chinese steel exports in the long term?

Exports of steel reached 93.8 million tonnes in 2014, but are likely to return to around 70 million-80 million tonnes a year in the long term. China's exports comprise product sales overseas and the transfer of production capacity overseas, which is known as capacity export in China, to alleviate overcapacity in China.

In the short term, Fitch expects Chinese steel producers to continue to enjoy cost advantages stemming from further depreciation in the Chinese yuan and lower material prices, which will help drive exports.

Over the long term, exports will be mainly driven by China's One Belt One Road plan, where Chinese funding for the construction of a network of transport, energy, and telecommunications infrastructure extending across Asia to Europe and East Africa will create demand for either Chinese steel products or Chinese-constructed production capacities abroad, as a means to alleviate current overcapacity issues in China. The implementation of this policy, though, will depend on domestic government funding and more concrete policy guidelines.

Q. What are the key challenges for Chinese steel producers amid oversupply and slack demand in the market?

Fitch believes that Chinese producers will need to invest in R&D to facilitate manufacturing of higher-value-added products. They will also be faced with more stringent environmental regulations, such as lower limits on sulphur dioxide emission (a major by-product of steel making). Meeting these new standards would require substantial investment with no significant benefit to EBITDA, which may reduce profitability for some steel manufacturers.

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