Mounting losses in China – what is the result and will they help to balance the market?

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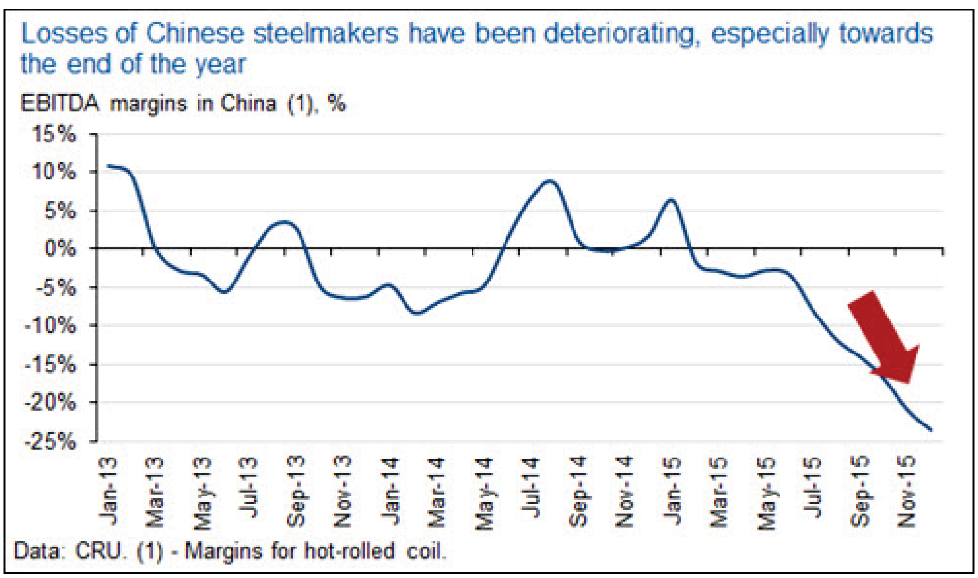
Dmitry Popov - 04 January 2016

Due to sharply falling steel prices across the world, an increasing number of steel producers have been unable to remain in the market amid mounting losses. Consequently, capacity idling and closures have been happening more frequently across the world, with China being no exception. However, this has not yet been enough to balance the market. Further reductions to supply, coupled with a cyclical improvement in Chinese domestic demand towards the end of 2016 Q1, are expected to see prices reverse the current downward trend. Still, this will not be enough to bring Chinese steel industry out of loss-making territory and we expect closures in China to keep mounting throughout 2016.

Growing closures across the world and China is no exception

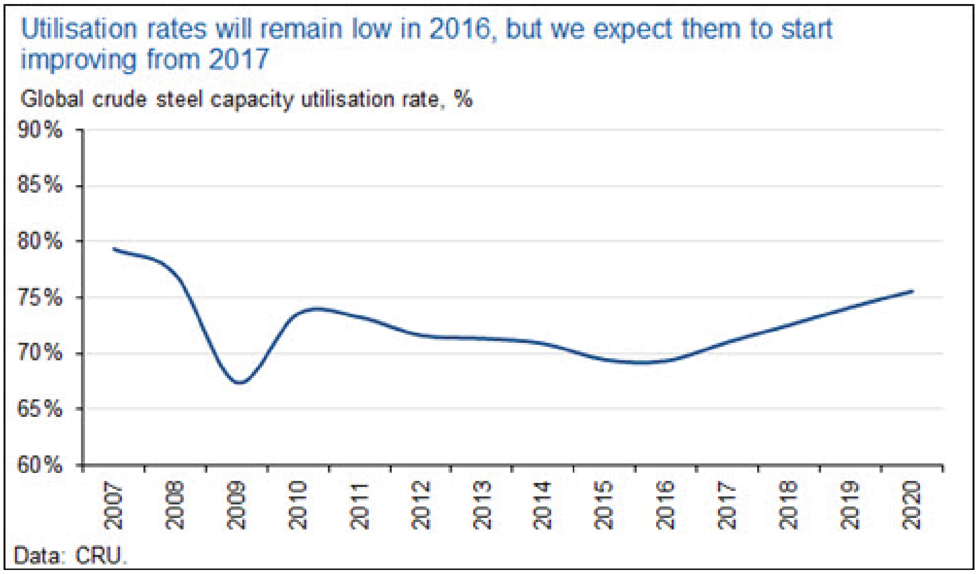
Global steel prices have continued their sharp downward trend and have been declining faster than costs, resulting in the worsening margins of steel producers across the world. Amid low prices and deteriorating profitability, a growing numbers of steelmakers have been struggling to remain in the market. This trend has led to numerous temporary idling of capacity, mothballing or even full shutdowns in various regions across the world.

However, the worst margins of steel producers have been recorded in China where oversupply has been particularly bad. According to CRU's analysis, notional EBITDA margins of Chinese steel producers (on benchmark product hot-rolled coil) have been negative through 2015 and have collapsed in recent months. Towards the end of the year margins in China were in the range of negative 20-25% (see chart).



If the margins are so bad, why is excessive supply in China not coming off the market for the balance to improve? In fact, the mounting losses in China have already resulted in almost 60 Mt of hot-end capacity closures so far this year, with the number of closures particularly accelerating since 2015 Q3. While this number is already quite significant, it has not helped to balance the market and more cuts are necessary. Closing a steel mill is a long process and steel companies have high exit costs, meaning it might be cheaper to operate at a loss for a period of time rather than shut production. All attempts will be made to reduce costs, reconfigure, close down parts of the operation and try to survive until the market improves. Only when resources run out and large losses accumulate will full closure happen and this may take months or years. With losses growing, as currently seen in China, more closures can be expected to come sooner, and China is by no means immune from closures. Consequently, growing number of closures in the coming months will help to reduce oversupply and in addition to the expected cyclical improvement in domestic demand in China due to the various recent support from the government will result in the better supply demand balance. Although this will help prices to reverse the downward trend, increases will be gradual and loss-making will persist, leading to further closures.

There are of course some factors that might prevent a more rapid growth in closures in China. The social considerations by the government from firing a large number of workers could become one of the main bottlenecks. Also, the decision of companies to shut down is restricted by a fear of losing market share. However, we believe that despite these difficulties a growing number of producers will be unable to remain in the market in the current price environment and will eventually be forced out of the market. Despite further capacity cuts in China, we expect global capacity utilisation to remain low in 2016 and to start improving only from 2017 as the global supply demand balance takes time to improve.



In CRU's latest *Crude Steel Market Outlook*, we present a detailed analysis of recent capacity closures across the world and particularly in China, and discuss how the developments in China will affect global steel prices. Although the bottom in prices is expected in the next couple of months, in the longer term we still expect only marginal growth as the market will remain oversupplied and low costs will also limit price increases.

The latest edition of the *Outlook* lowers our forecast given the weak state of the market and we now expect global crude steel production to grow by just 0.6% in 2016 instead of 1.5% previously anticipated - although such weakness is driven by China and production in the rest of the world will grow by 2.3%. Despite the recent weakness in China, we continue to believe peak steel consumption and production in the country has not been reached and we discuss this in one of the Special Focuses in the report that concentrates on the steel plate outlook for China.

CRU's *Crude Steel Market Outlook* gives a comprehensive overview of the global finished, crude and semi-finished steel market. It also provides deeper-dive analysis of current and topical market and industry developments. If you want to discuss any of the themes set out in this CRU Insight, please contact editor Dmitry Popov on dmitry.popov@crugroup.com. For information on how CRU can help you understand the raw materials market through our suite of products and tailored solutions, please contact: sales@crugroup.com.

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