

Turning the corner Global metals outlook

A three-part series on the future of the global metals industry



The past year has been a volatile one for the global metals industry—to say the least. Plummeting commodities prices, frozen credit markets, and diminishing demand has caused many metals manufacturers to take drastic measures in order to survive. What lies ahead for the sector? To find out, Deloitte Touche Tohmatsu’s (“Deloitte”) Global Manufacturing Industry Group turned to a panel of metals industry leaders, including Nick Sowar, Claude Martin, and Dick McLaughlin, for perspectives on the state of the global metals industry—and what to expect down the road.

Outlook at a glance

- Global metal demand has dried up, prompting lay-offs, oven and furnace off-lining, and broken contracts
- Positive signs include a drop in supply, industry consolidation, and opportunities to buy bargain assets
- Companies need to drive out fixed costs throughout their entire organization and consider restructuring

Q:How has the global financial crisis impacted the global metals industry?

Nick: It’s been quite dramatic. It is almost as if you can’t find customers anymore—they have become phantoms. Capacity and supply continues to be reduced. Take steel — world crude steel production was 86 million metric tons in January 2009, 24 percent lower than the same month last year¹. So it’s not surprising that so many companies are taking thousands of people out of their global workforce. Companies are also being forced to restructure and divest some non-core assets. But I think the real positive news could be consolidation. Consolidation is going to be beneficial for the global steel market—to take out some of the marginal performers. And with the Chinese

situation and their discussion of enhancing their infrastructure—Western China really hasn’t been touched—there’s a lot of great opportunities. And as China goes, so do a lot of others along with it.

Claude: In a number of sub-regions of the world, we will see a deliberate driving of infrastructure and at least long steel-type products will benefit from that. There is definitely a dip in construction demand. Some projects have been temporarily delayed and there is a lot of stock in the system. On the optimistic side, however, the financial crisis has brought down the cost of raw materials and inputs like energy. And in the long run, that will be helpful for the industry.

Dick: I think there is a fundamental disagreement or uncertainty over exactly what we're in here in terms of this crisis. As an example, I've been doing an analysis for a client—and the business plan they are putting forward suggests that they think this is a very short-term and modest dip in overall activity and that, come the second or third quarter of '09, things will start picking up again. And if you listen to what's being said at KeyBanc, who covers the metals industries in depth, there's a sense of optimism that things will come back in 2009². But there's another line of thought. Microsoft announced their first major layoff earlier this year and said they believe we are going through a structural deleveraging³ of the economy⁴. That this is not just a temporary downward spike, not just a normal recession. Their take is that there is leverage being wrung out of the economy on the part of consumers, commercial and industrial firms, and financial institutions. And if that's true, then we have a lower level of economic activity in front of us for as far as the eye can see—fewer new homes, autos, tractors, appliances. You may be looking at a permanent reduction in the production of metal-containing goods. Now is the time that everyone is shutting down furnaces and trying

Dick: This is a demand problem—no one is buying steel or other metals. That yields inventory destocking, which is good. If and when things do turnaround, there could be quite a pop on the upside.

Q: Are you of the view that cuts in production will be sustained?

Dick: One way of framing that question, is to ask if this a downturn measured in quarters or in years? And there is evidence that suggests that this is a downturn measured in years not quarters. What does everyone else think?

Claude: Well, we can look upstream as an indicator to what's going on. Companies upstream are also shutting down projects and operations and laying off tens of thousands of people—that's not something you can turn on again in a hurry. So, even as the optimism returns and the cash begins to flow again, I think it's quite a long time before the jobs return and the capacity is turned on again. I don't share the short-term view—there may be other things that improve dramatically in six month's time, but not the hard-core, industrial world we're talking about.

Q: In addition to production cuts and headcount reductions, what other things are companies doing to respond to the crisis?

Claude: Well, I think the view is that a lot of cost has built up in the supply chain and on the supply side. Clearly there's a focus on radical cost reduction and companies are renegotiating contracts and slashing whatever they can. And obviously there is a strong focus on improving processes and working capital.

Nick: Companies are "hunkering down." Some are even taking action to make pay cuts around 10 percent across the board for salaried workers. That hasn't been seen in a long time. Now, it's enabling them to keep their jobs, but it's a tough situation. I think we're going to keep seeing those types of approaches. Companies are realizing that

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— Claude Martin

to keep prices at a level that allow them to be profitable at low levels of utilization. But some of those furnaces may never come back if what Microsoft says is true.

Nick: I'm hearing, "Okay, things will be tough for a little bit, but 2009 is the bottom." And it's going to be early in 2009. And, in fact, in the fourth quarter of 2009, things are going to get better.

changes need to be made to reduce costs. The whole issue is really the one that Dick raised: is this a structural issue and that the demand curve itself has permanently changed? And, boy, that's disheartening if that is the case—and it sure might be.

Q: What impact has the crisis had on the supply base? Are contracts being renegotiated?

Claude: Yes, contracts are being renegotiated and cancelled left, right, and center. I don't think the long-term contract stands for much these days.

Dick: From the point of view of contracts that the steel industry has with its customers, these have historically been subject to renegotiation as market conditions change. The contracts that the raw materials companies have with the steel companies, however, they are much less likely to be renegotiated until the contract terms are up. I've heard of more than one mill that has iron ore piling up on the ground. The iron ore companies are not stopping deliveries. Their contracts are take or pay, and they hold the steel companies to their agreements. It may be some time before steel companies are able to work their way through relatively high-cost raw materials.

Nick: I've seen that phenomenon before. Where you're just bleeding iron ore.

Is China the answer?

The last few years was a boom period for most industrial metals, with China's demand one of the main factors behind rising metals prices through to the beginning of 2008⁶. As part of the panel discussion, the question arose if China and its stimulus plans hold the key to a return to demand and profitability in the global metals markets:

"How much of China's investment and therefore their demands for metals is driven by its own internal needs versus how much of that demand is driven by its export activity?" asks Dick McLaughlin. "If an infrastructure spending bill in China basically affects 60 percent of its economy, then that will have a huge positive impact in absorbing more raw materials and finished metals."

Can the stimulus packages planned by the Chinese government lead the way out of the current global downturn in metals? In November 2008, China's State Council announced its US\$586 billion (4 trillion Yuan) stimulus package aimed at boosting domestic demand and developing low-income housing, roads, railways, airports, and infrastructure in rural areas through the end of 2010. Its impact on metals can be assessed as such:

- About a half of the 4 trillion Yuan investment will go to infrastructure construction, which may create an estimated steel demand of about 100 million tons.
- The newly launched projects stimulated by the economic package will mostly start construction activity in the first quarter of 2009, and thereafter positive affect will be witnessed in the steel industry.
- The government package promises a 10 billion Yuan subsidy over the next three years for auto makers. Also, efforts to promote the mass production of electric cars in big and medium-sized cities will boost demand in the steel sector.

In 2008, nearly 45 percent of steel demand in China came from infrastructure and real estate combined⁷, with residential construction accounting for about one-fifth of Chinese steel demand⁸. As such, stimulus to these sectors should have a global benefit. The government also plans to use the financial crisis as a means to shut down small steel mills and encourage large steelmakers to consolidate⁹. This could help eliminate excess in the market and stimulate demand in the long-term.



Q: We referred to China and the impact that it has. Will the economic stimulus package in China and in other economies around the world help stir appetite again?

Dick: I would expect that the impact of China's stimulus package is going to benefit the domestic steel industry; that is, domestic consumption of domestically produced steel. This should reduce Chinese steel exports, which would improve industry conditions elsewhere. Net exports from China are already down around 2 million tonnes or close to 5 percent for 2008 compared with 2007⁵. There might also be a pick up of raw material demand and prices. (See sidebar, "Is China the answer?")

Nick: It's almost like a chicken and egg here—what's going to bring demand back? What's going to bring it back is consumer spending—that's where we're seeing the slow down. That's what I think is disconcerting—the drive to spend, and to spend with debt, if that structurally changes, then we really do have permanent change.

Q: What has been the impact of the global financial crisis on service centers?

Nick: The service center started out being the middle man, so to speak, for any steel user that didn't have enough leverage with the mill. The

of '08, they weren't sure if they should be buying. Everything was real dicey, everything was moving fairly fast. That said, service centers continue to reduce inventory, and once that's all reduced out—and assuming that there's going to be a pull from the users of steel—they'll be back. But right now, they're in just as much trouble, I think, as anybody else.

Dick: I think with the question of how they're handling the collapse in prices, I'm afraid, the answer is, "we're eating it." Yes, they bought steel at a thousand dollars a ton, now it's selling for five hundred a ton. So the next few quarters of results aren't going to be that attractive. Going forward, I think the other concern they have is underlying demand. Just like the steel companies, the service centers are finding that the customers have stopped buying steel.

Q: There's talk that in this crisis, there's opportunity. Do you think now is the time to buy some assets? What's the feeling right now out there?

Claude: For some companies, it is fairly clear to me that they are going to make some acquisitions. They need more critical mass. They've got cash. So clearly they'll be looking for bargains.

Nick: What I'm seeing is unbelievable opportunities to buy, but it all comes down to what's your time horizon. Today may be a great day to buy—but if things get worse, then tomorrow's even better. So the way I see it, people are going to conserve cash, they're not going to be rushing to do deals. From a global standpoint, there's still too much capacity, so any deals will really need to be supported with a solid business case.

Dick: I think the other issue in the background here is that the credit markets are so dry. Doing a deal now is much more cash intensive than it would have been six months ago. Can you find an opportunity that's worth that kind of investment of precious cash? Because you're not going to

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mill doesn't want to deal with somebody who's taking a minimal amount of steel—they're going to sell all those quantities to a steel center. They're that middle person—and they have been facing a tough situation. When you had steel at a thousand dollars a ton back in the early summer

finance 80 percent of the transaction in this environment. You have to have plenty of cash to be aggressive in this environment. That said, this still may be a terrific opportunity to buy certain assets, especially raw materials in developing countries.

Q: What about sustainability, especially in the supply chain? Is this a priority in these times?

Nick: Right now you really don't have to worry about it when you are taking furnaces down or coke ovens down. However, I don't see any new information out there that would cause any shift in where companies ultimately want to be. I think it will be interesting, though—there's a lot of pressure on the new Obama administration that may yield an increasing focus on sustainability.

Claude: Cash is so important that the priority typically would have to be to focus on that for now, and you can "pick up" sustainability later. The one bright side of this global crisis has to be that in one fell swoop we've done a lot more to address Al Gore's concerns than we could have possibly done with government intervention.

Dick: There's the silver lining.

Q: To close out the macro views, what are some of the key issues for manufacturers in the global metals sector over the next 12 months?

Nick: I personally think it's cash. Cash is king. I think it's companies being able to look now at their structure and drive out fixed costs, not just incremental ones. I think this is the time to look at the business model. Because if this is not just a six-month, short-term issue, then there will be ongoing pressure put on all companies. That is, who's going to get there first when it comes to reducing their entire cost structure?

Claude: I agree with Nick. I feel there needs to be a radical approach to cost reduction and definitely a relooking at structure. And even for healthy

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— Nick Sowar

companies, to take the opportunity now to drive out some of those structural costs that you've been burdened with.

Dick: If we think this is a more sustained problem, we should be thinking about facility restructurings and fundamental alterations to the business.

Q: What indicators do you think will signal a recovery?

Dick: Consumer confidence—when consumers go out and start buying steel-containing goods like refrigerators.

Claude: And cars.

Dick: And houses.

Claude: Effective government infrastructure programs —when we really see those programs kicking in all over the world. Which I'm confident we will, but it will take time.

Q: What can companies do to be ready for the recovery?

Nick: Well, it's a cause and effect. My belief is that you don't look to get ready for the recovery. In fact, what companies need to do is change their structure, drive out fixed costs, and be set to enjoy higher margins when things turn the corner. So I don't think it's about looking to the recovery, but looking to aggressively enhance the cost structure today for the future.

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About the panel



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