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Ferrous Metals Industry Market Research in the Ukraine

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Introduction

Current General Situation in Ferrous Metallurgy of Ukraine: Problems and Outlook

In the Ukraine, rather large capacities on output of steel and rolled steel are available. The country the 2nd greatest producer of ferrous metals in the CIS. Share of Ukraine in ferrous metallurgy production of the CIS is very high: Ukraine yields 37% of total CIS iron, 34% of CIS steel and 27% of CIS rolled steel (in 2008).

The country exported in latest years up to 80% of production volume of its ferrous metallurgy, including the whole range of the sector products: iron ore, iron, ferroalloys, billet, slabs, skelp for pipes, rebar, wire rod, sections, HR and CR flat steel in coils and sheets, pipes, metalware products, coated steel, etc.

In 2009, the country the 8th greatest producer of steel and the 6th of iron in the world.

On results of 2010, Ukraine became the 9th greatest producer of steel and the 7th of iron in the world (in connection with significant restoration of ferrous metals production in European countries and USA).

Ferrous metallurgy is basic sector of Ukrainian economy. It includes around 200 enterprises, including 12 ore mining and concentrating enterprises, 19 metallurgical Integrated Works and plants, 12 pipe plants, 13 metalware plants, 12 by-product coke plants, 10 refractory plants, ferroalloys plants, above 100 secondary ferrous metals enterprises (on processing scrap and wastes), as well as machine building, repair and engineering enterprises.

Notice that, in the Ukraine, a share of ferrous metallurgy in industrial output of the country is one of the greatest among countries of the former USSR, above 20%.

The sector gained above 32% of the country export receipts in hard currency in January-August 2008. But in Q4 2008 and 2009, prices on ferrous metals sharply dropped at world market. As a result, the share of ferrous metals in the country export receipts in hard currency decreased to 25.4%.

Current standing of Ukrainian ferrous metallurgy, in spite of large investments in upgrading the industry in recent years, is characterised by imperfect structure and lag in technology from developed countries and even Russia. For instance, in Ukraine, too large share of steel is produced by open-hearth rout (above 36% in 2008 and 26.3% in 2009), and only around 40% in 2008 and 49% in 2009 are continuously cast. Range and shares of products of Ukrainian ferrous metallurgy are inconsistent with world market demand. Namely, the share of semis and rebar, i. e. products will low added value, is too high.

Thus, Ukrainian sector requires radical modernisation and reconstruction, as well as optimising structure of range of finished products. But this requires large investments, which already were invested in several latest years, first of all, in initial production stages (sintering, blast furnace productions), but the financial-economic crisis in 2008 force to freeze or postpone most of the upgrading projects.

Productive assets of Ukrainian metallurgical enterprises are worn and obsolete: by the end of 2009, depreciation of facilities operating was around 70% (including 54% depreciation of coke-oven batteries, 80% of available blast furnaces, 80% of open hearth furnaces and rolling mills; 26% depreciation of converters), and the completely depreciated facilities yield above a half of the country steel products.

The situation is aggravated by the fact that most of the sector enterprises are so-called city-forming (i.e. are the sole job sources in a district). Thus, closing obsolete capacities results in arising serious social tension owing to growth of unemployment. These problems were especially sharpened since September 2008 in the period of the global and local financial-economic crisis (in 2009 too).

Ukrainian government attempted to improve the situation in the sector by giving various preferences, tax credits to metallurgical companies, decreasing duties and tariffs for them. For instance, from mid-1999 to the end of 2001, a large-scale experiment was conducted in Ukrainian metallurgy: giving considerable tax and other privileges to the sector enterprises to overcome crisis in the sector. The experiment allowed to restore partially working capital of the enterprises and to begin their modernization.

Nevertheless, improving standing of Ukrainian steelmakers, which appeared, first of all, in increasing production volume, was connected with privatisation of most of companies that resulted in arising more effective owners and growth of investments in production reconstruction. This refers, first of all, to Arcelor Mittal Krivyi Rih (AMKR, former Krivorozhstal (until 2006)), which expanded its production and presence at domestic and world market (until 2008), as well as Metinvest Holding (managing metallurgical assets of SCM) and Industrial Union of Donbas (ISD).

Currently processes of re-distribution of assets are in progress in mining-metallurgical industry of Ukraine: Metinvest Holding strengthens its positions; Russian holdings also penetrate into the market, for instance, Evraz Group and other.

However, positive changes in the sector were interrupted by the global crisis, which produced very negative impact on enterprises of mining-metallurgical complex of the country. Sharp drop of demand at both domestic and world market resulted in deep production setback in the country's ferrous metallurgy.

The Ukrainian metal sector is experiencing hard times because of the world crisis. Monthly production of raw steel in Ukraine dropped by 60%, from the average level of 3.7m tonnes to 1.6m tonnes in November 2008. A sharp drop in the prices for steel happened at the same time. As an example, prices for slabs (FOB, Black Sea) decreased from USD 1,055 per tonne in June 2008 to USD 425 per tonne in November 2008.

This was the result of credit crunch and liquidity crisis, which caused reduction in steel consumption by the key clients – construction, heavy engineering and infrastructure areas all over the world. Steel export markets were the first to suffer as supply in Ukraine doubled following the launch of new, export orientated facilities, which became idle as the result of a drop from export market countries. Domestic demand in Ukraine was also very much affected. More than 60% of construction projects are frozen and pipe production reduced by more than 50%.

These two areas consume about 80% of steel inside Ukraine. However, as Ukraine exports more than 80% of the metal produced it is highly dependant on external markets. As the result Ukrainian producers have been very much affected by the crisis.

Although in December 2008 the situation improved and the monthly production of steel grew by 24% compared to November and the prices got stabilized, most market players did not expect rapid recovery.

On the one hand, products of vertically integrated Ukrainian producers are competitive on their key export markets. The production cost before Ukrainian hryvnia (UAH) devaluation was comparable to the production cost of Russian steel and was 25% cheaper compared to Chinese steel. Devaluation of Ukrainian hryvnia from UAH 5.05 to UAH 7.70 significantly improved the competitive positions of Ukrainian producers in comparison to Chinese competitors.

It should be noted that Ukrainian metal sector has significant structural problems. The industry is rather fragmented – the market is divided between several groups. There is a wide spread between different production costs of Ukrainian producers. First of all this is because of differences in the extent of vertical integration between Ukrainian producers, primarily in iron ore production, and in the extent of production modernization.

There are producers, who use obsolete technologies such as open hearth furnaces and blooming and there are producers who are not vertically integrated businesses from the point of view of raw materials. They are in worse condition as their production cost is much higher compared to the vertically integrated players'. In addition, producers with a big debt burden have become very much exposed to crisis as they might have significant problems with liquidity because of a sharp drop in production at the end of 2008 – beginning of 2009.

Ukraine lags much behind USA in the level of labor efficiency. It also lags behind Russia and China, Ukraine's main competitors in export market, in the level of labor efficiency in the blast furnace and steel production. Ukrainian producers with low levels of labor efficiency will be much more affected by the crisis as labor cost is a fixed cost, which does not reduce in line with the decline in production. Low level of labor efficiency also suggests that during crisis industry restructuring, closure of inefficient facilities and upgrading of production, significant redundancy may follow in the metal sector.

Along with structural problems Ukrainian metallurgists face problems on the main export markets. First of all, there is a surge of protectionist actions in the countries – importers of Ukrainian steel. For instance, in January 2009 Russia imposed a 15% duty on imported steel. Secondly, export to Turkey, one of the biggest consumers of Ukrainian steel, is at risk as the country creates own capacities to become a self-supporting player both in rolled and sheet production within the next two or three years.

To settle structural problems of the industry and the problems caused by a sharp drop in demand and prices for metal products, the Ukrainian ferrous metallurgy industry needed in implementing short-term and long-term anti-crisis actions aimed at improvement of the Ukrainian metal sector's competitiveness.

The government of Ukraine has made several steps to overcome the crisis.

In November 2008 the Ukrainian government and the country's mining and metallurgical companies signed a Memorandum of Understanding (MoU) aimed at the minimization of the consequences of the economic crisis in the industry, in particular at the stabilization of prices for ore, coal and steel products, the maintenance of jobs, salary levels and other social securities for employees, and also at the development of the Ukrainian domestic market.

The memorandum has fixed that the Cabinet of Ministers and the mining-metallurgical business (complex) (MMC) of Ukraine have agreed the basic principles of partnership of the business and government, being in force from 10 November until the end of 2008.

Mining Companies have committed themselves to:

- Organize the work in the enterprises at a level not less than the minimum volume that maintains production facilities in working conditions in accordance with the balance of iron production and coke consumption;
- Maintain a professional structure and number of jobs, the level of wages and other social guarantees for workers;
- Implement measures aimed at reducing the cost of steel products;
- Accelerate the completion of the negotiation process with the owners of raw materials, ferroalloys and fuel resources concerning the domestic sales of the products at prices no higher than the world ones;
- Ensure growth in the use of coke to reduce the use of natural gas;
- Expedite handling of freight in railway vehicles on-site of the enterprises;
- Extend the implementation of investment projects related to the introduction of energy-saving technologies.

Later an item was included into the MoU, according to which the supply of steel products to the domestic market should be conducted at prices no higher than export ones.

Within the framework of the MoU, the Ukrainian government granted benefits for domestic mining and metallurgical companies, as well as chemical ones, i.e., imposed a moratorium on the increase of gas, railway transportation and electricity supply tariffs. Among the conditions for granting of benefits is the decreasing of companies' prices for the domestic market to levels not higher than their export prices, the absence of debts to the budget (tax liabilities), to Ukraine's pension fund and to Ukraine's state gas company Naftogaz, and also the payment of wages.

The Cabinet of Ministers has obliged to:

- Negotiate with international institutions to raise funding for reviving the economy of Ukraine;
- Keep the level of fees for use of natural resources at current levels, without applying raising factors to the activities of anti-crisis character;
- Amend the Law of Ukraine "On State Budget of Ukraine for 2008 and Amendments to Some Legislative Acts of Ukraine" in terms of increasing state support for coal mining enterprises in accordance with the decrease in prices for coking coal;

- Amend the Law of Ukraine "On Taxation of Profits of Enterprises";
- Support measures to protect the domestic market from unfair imports, which the measures) will be initiated by the enterprises of MMC;
- Add listings and volumes of energy-saving materials, equipment, hardware and accessories, which are exempt from import duties;
- Expedite the preparation of legal acts under the Kyoto Protocol on climate change, aimed at financing projects and programs concerning the reduction of greenhouse gas emissions, increasing energy-efficiency of materials and reducing the industrial impact on natural environment;
- Apply to the State Property Fund with a view to amend changes to conditions of purchase-sale contracts of objects of metallurgical industry, in part of postponement of implementation of a portion of investment obligations on production modernization ;
- Ensure repayment of debts of state monopolies to companies of the MMC for metal products.

Under the memorandum the government (decree № 925 of 14.10.2008) imposed a moratorium on increasing tariff on rail freight transportation for enterprises of mining and metallurgical and chemical industries, as well as has proposed National Commission for Electricity Regulation to suspend from 1 November 2008, for the enterprise, raising prices on electricity.

According to the Memorandum it was envisaged to increase the period for return of currency gains up to 360 days for energy-saving investment projects and implement a 5-day VAT refund period. It envisaged implementation of a number of benefits for metal companies, in particular lower tariffs for energy and railway road transportation, reduction of income tax down to 20% in case of reinvestment and extension of the list of materials and equipment free of import duties. In addition, the Memorandum extended the period of the existing stable tariff for natural gas till March 2009 and introduced a 25% amortization rate of fixed assets. Some actions had come into force by January 2009 according to the Decrees of the Cabinet of Ministers of Ukraine and Law of Ukraine No. 694.

Then force of the MoU was repeatedly prolonged, the latest time in early March 2010, when the Ukrainian cabinet of ministers has prolonged the MoU for the Q2 of 2010, and finally the MoU ceased to be in force since July 1, 2010.

So, since Q3 2010, freights of mining and metallurgical enterprises of Ukraine are transported by railways without discounts to tariffs, but at stable rate of the tariffs. Actually, in July railage tariffs for metallurgical companies increased by almost 17%.

At the same time, the support actions can help businesses in the short term perspective only and are aimed primarily at overcoming the peak crisis by businesses. In addition, subsidizing the metal sector with the help of tariffs is not the best solution, and the clause of the memorandum requiring from metal plants to keep the staff hinders improvement of the long-term efficiency of the industry.

To solve short term objectives the state can focus its additional actions on the following three areas.

First of all, this includes stimulation and recovery of both domestic and export markets. To keep and recover export it is necessary to hold negotiations with the key trade partners of Ukraine to prevent deterioration of conditions for entry to the Ukrainian steel products market. Such a step will also help stimulate internal demand as piping and heavy engineering, the key steel consumers in Ukraine after construction area, are export-oriented.

In addition, to keep the internal market it is important to expand the volumes of infrastructure construction and to take actions aimed at completion of the objects under construction.

Another important short term action is to ensure quick export VAT refund. Unfortunately, this problem is not solved by the state as yet (as of the end of 2010) that produces negative impact on liquidity of the enterprises and, thus, on their operational activity and competitiveness.

And finally, it is important that the state does not interfere in regulating the level of employment and industry prices because such measures can undermine financial standing of the industry and will not help solve long term social problems.

Along with short term actions aimed at mitigation of immediate consequences of the crisis it is important to help the Ukrainian metal sector to strengthen their competitive positions in the long term perspective. To this end, it is important to remove the barriers for modernization and consolidation of the industry and develop a sustainable internal market as well as to contribute to efficient redistribution of workforce, which is released as the result of restructuring.

To support the restructuring of the steel sector it will be necessary, first of all, to stop helping the least efficient businesses in order to encourage industry consolidation. Secondly, it will be required to stimulate modernization of obsolete facilities and launch of cutting edge and more efficient facilities. To this end, the state could create favorable conditions by liberalizing the import terms and amortization of capital equipment. Such changes were outlined by Law No. 694 of December 18, 2008. It is necessary to apply them to all categories of equipment to modernize the main segments of the industry. It is also important to create favorable environment for the use of the export credit facilities from the countries supplying equipment to Ukrainian steel mills. Thirdly, it is necessary to adjust Ukrainian technical standards to the international ones, for example by acknowledging EU technical standards.

Development of the internal market for metal sector will require actions in the areas of construction, piping and heavy engineering – the key consumers of steel in the internal market. Each of them requires special approach from the point of view of creation of favorable conditions for further development.

For example, for further development of the construction area it is required to have well developed tax and mortgage policies to stimulate natural demand for housing, systematic monitoring of cities and allocation of land plots for site development as well as mid-term program on infrastructure development. In addition, a critical issue shall be liberalization of the permit system and improvement of procedure transparency. Construction area shall be focused on improvement of labor efficiency and quality of construction rather than on obtaining a huge number of

required permits. It can be good to provide export financing to heavy engineering and encourage its consolidation and modernization. Actions to support the piping area shall be aimed at advancing the products in the export markets and improvement of labor efficiency.

Given low labor efficiency the industry will have to reduce employment and the state can provide help in retraining, relocation and employment of the redundant people on the basis of the long term program similar to EU example in 1986-96 when employment in steel industry was reduced by half as the result of a well developed state program. For this reason it is required to have a special law in place, which shall be developed together with the key industry players and which will regulate the employment reduction rate in the industry as well as mutual obligations of the state and major companies regarding retraining and reemployment of redundant employees. The state will be required to create a flexible system of retraining and efficient system of employment as well as to remove the barriers for the workforce mobility.

Unfortunately, the mentioned measures have not found marked application as yet.